Corporate and Financial Markets Law

Adding Sustainability Risks and Factors to the MiFID II Suitability and Product Governance Requirements

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Abstract

This essay proposes a critical analysis of the amendments that introduce sustainability factors and risks into the legal framework for suitability requirements and product governance regulation. It argues that the choice of the European legislator to favour a product-oriented model for sustainability-related financial instruments may undermine the duty of the financial intermediary to act in the best interest of the client.

I. Introduction

The European Commission's Sustainable Finance Action Plan for financing the transition to a sustainable economy gives sustainable finance a key role in supporting financial stability by incorporating environmental, social, and governance (ESG) factors into the investment decision-making process. This perspective has led to a regulatory intervention on Markets in Financial Instruments Directive (MIFID II) package-based disclosure and the conduct-of-business framework for advisors and portfolio managers. The essay proposes a critical analysis of the amendments to the regulation concerned, in particular the suitability requirements and product governance rules through the delegated acts included in the sustainable finance package of 21 April 2021. It argues that EU policy on sustainable finance could jeopardise the rationale for the traditional rules on intermediaries' fiduciary duties, whose goal is to protect financial investors. Indeed, adopting a product-oriented model for sustainable financial instruments within the MiFID II package concerning the suitability assessment and product governance might undermine the financial intermediary's duty to act in the best interest of the client.

To establish the context, the paper begins by outlining the legal basis and rationale for sustainable finance. It goes on to examine the amendments to the legislation that introduces sustainability into the rules on suitability assessment laid down in Regulation (EU) 2017/565 and the product governance norms established in Directive (EU) 2017/593. This analysis highlights the weakness in the legislation, which may actually give rise to a conflict between the interests

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of sustainability and the (economic/financial) interests of the investor.

II. The Legal Basis and Rationale for Sustainable Finance

Acting to fulfil its international commitments,[1] and in line with the role bestowed on it by the Treaty on European Union (Arts 3(3) and (5) and 21(2) TEU) to promote sustainable development, in March 2018 the European Commission published a Sustainable Financial Action Plan (Action Plan). The Action Plan specifically tasks sustainable finance with the dual mission of contributing to sustainable and inclusive growth through long-term financing of society and consolidating financial stability through the integration of environmental, social and governance (ESG) factors in investment decision-making processes.[2]

To this end, the gradual implementation of the European Agenda for Sustainable Finance envisions the use of primary and secondary legislation, as well as soft law measures falling within the competence of the European sectoral Supervisory Agencies (European Banking Authority - EBA, European Securities and Markets Authority - ESMA and European Insurance and Occupational Pensions Authority - EIOPA). These are so numerous that, according to some academics,[3]once it has been fully implemented, the harmonised ESG framework will inevitably become the fifth pillar of financial regulation (together with the pillars of rules, namely prudential, conduct, anti-money laundering, payment systems and market infrastructures).

To date, three pieces of primary legislation implementing the European Action Plan[4] impact on the financial sector. The first is Regulation (EU)

[1] See: Paris Agreement on climate change adopted by 196 Parties at COP 21 in Paris, on 12 December 2015 and entered into force on 4 November 2016, available at https://tinyurl.com/4kyvmmrb (last visited 31 December 2022); the United Nations 2030 Agenda for Sustainable Development Goals available at https://tinyurl.com/mc9ab5h7 (last visited 31 December 2022). About the international initiatives facing sustainability-related issues see M. Siri and S. Zhu, 'L'integrazione della sostenibilità nel sistema europeo di protezione degli investitori' *Banca Impresa Società*, 3 (2020); Id, 'Will the EU Commission Successfully Integrate Sustainability Risks and Factors in the Investor Protection Regime? A Research Agenda' 11 *Sustainability*, 6292 (2019).

[2] See Communication from the Commission, 'Action Plan: Financing Sustainable Growth' COM(2018)097 final,available at https://tinyurl.com/36ypuxdj (last visited 31 December 2022). On this basis, on 6 July 2021, the Commission published the Communication 'Strategy for Financing the Transition to a Sustainable Economy' COM (2021) 390 final, available at https://tinyurl.com/229pw4zy (last visited 31 December 2022). The EC strategy is an ambitious and comprehensive package of measures to help improve the flow of money towards financing the transition to a sustainable economy by enabling investors to re-orient investments towards more sustainable technologies and businesses.

[3] See G. Quaglia, A. Mastroianni, D. Donato and N. Ceruti, 'Rischi finanziari legati al clima: una prospettiva sulle misure prudenziali europee' *dirittobancario.it*, 4 February 2021, 1-11; S. Cavallo, 'Il nuovo paradigma di sostenibilità e la centralità della ESG per l'industria finanziaria'*dirittobancario.it*, 1-5 (22 March 2021).

[4] This regulatory reform is based on the recommendations of a High-Level Expert Group

2019/2088, the so-called Sustainability-related disclosures in the financial sector regulation (SFDR), which deals with sustainability disclosures in the financial services sector.[5] The second is Regulation (EU) 2019/2089, the so-called Low Carbon Benchmark Regulation, which sets forth EU benchmark indices of climate transition, EU benchmark indices aligned to the Paris Agreement, and sustainability-related disclosures for benchmark indices.[6]The last is Regulation (EU) 2020/852, the so-called Taxonomy Regulation.[7] Seeking to encourage sustainable investments in eco-sustainable economic activities, this Regulation establishes harmonised rules to qualify a business as environmentally sustainable, identifying, on the one hand, uniform criteria (sustainability-related objectives, sustainability-related ambitions, and adverse effects on sustainability factors) for classifying an activity as 'eco-sustainable' and, on the other, disclosure rules for the distribution of financial products falling within the category of 'eco-sustainable investments'.

In addition to these Regulations of the European Parliament and the Council (first level legislation), a Sustainable Finance Package[8] was issued on 21 April 2021. It incorporates the European Commission's Proposals for Delegated Acts (second level legislation) in accordance with the provisions of the primary legislation and based on the guidance provided by ESMA in two Technical Advice documents published on 30 April 2019. One relates to the integration of sustainable finance into MiFID II investment services,[9] and the other to the integration of sustainable finance into UCITS (Undertakings for the Collective Investment in Transferable Securities) and AIFM (Alternative Investment Fund Managers) frameworks on mutual investment schemes.[10]

In examining the European Commission's delegated measures, our analysis will focus on the changes arising from the addition of sustainability factors and

on Sustainable Finance set up by the EC to help develop an EU strategy on Sustainable Finance. See M. Siri and S. Zhu, *Will* n 1 above, 6295.

[5] European Parliament and Council Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector [2019] OJ L317/1. For details see, among the latest, S. Hooghiemstra, 'The ESG Disclosure Regulation - New Duties for Financial Market Participants & Financial Advisers' (22 March 2020), available at https://tinyurl.com/2ts677da (last visited 31 December 2022).

[6] European Parliament and Council Regulation (EU) 2019/2089 of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks [2019] OJ L317/17.

[7] European Parliament and Council Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2019] OJ L198/13.

[8] Available at https://tinyurl.com/2p8b63p9 (last visited 31 December 2022).

[9] ESMA Final Report on integrating sustainability risks and factors in MiFID II of the 30 April 2019 (ESMA35-43-1737), available at https://tinyurl.com/bddbcymh (last visited 31 December 2022).

[10] ESMA Final Report on integrating sustainability risks and factors in the UCITS Directive and AIFMD of the 30 April 2019 (ESMA34-45-688), available at https://tinyurl.com/4nrez4pz (last visited 31 December 2022).

risks in the regulation of sustainability assessment and product governance under the so-called MiFID II package.[11] These changes are contained in Delegated Regulation (EU) 2021/1253 (amending Delegated Regulation 2017/565)[12] and Delegated Directive (EU) 2021/1269 (amending MiFID II Level 2 Directive

[11] For more information about financial investor-protection discipline let me allow to refer to: M.E. Salerno, 'La tutela dell'investitore in strumenti finanziari nella MiFID II: problemi di enforcement della disciplina', in M. Mancini et al eds, *Regole e Mercato* (Torino: Giappichelli, 2016), I, 427-475; Id, 'La disciplina in materia di protezione degli investitori nella MIFID II: dalla disclosure alla cura del cliente'*Diritto della banca e del mercato finanziario*, I,437-492 (2016); Id, 'Prospettive di regolamentazione a protezione dell'investitore finanziario alla luce dell'emergenza Covid-19', in U. Malvagna and A. Sciarrone Alibrandi eds, *Sistema produttivo e finanziario post COVID-19: dall'efficienza alla sostenibilità* (Pisa: Pacini, 2021), 289-294. Among the latest, see: S. Gaffuri and L. Belleggia eds, *I servizi di investimento dopo la MiFID II* (Milano: Giuffré, 2019); M. Pellegrini, 'Le regole di condotta degli intermediari finanziari nella prestazione dei servizi di investimento?, in F. Capriglione ed, *Manuale di diritto bancario e finanziario* (Milano: Giuffré, 2nd ed, 2019), 571-612; A. Bartalena, 'La disciplina dei servizi e delle attività e i contratti', in M. Cera and G. Presti eds, *Il Testo Unico finanziario. Prodotti e intermediari* (Bologna: Zanichelli, 2020), I, 356- 415; E. Rimini, 'Le regole di condotta', in M. Cera and G. Presti eds, *Il Testo Unico finanziario* above, 416-453; M. De Poli, 'I conflitti di interessi e gli inducements', in M. Cera and G. Presti eds, *Il Testo Unico finanziario* above, 454-514; M. Rabitti, 'Prodotti finanziari tra regole di condotta e di organizzazione. I limiti di MiFID II' *Rivista di Diritto bancario*, I, 145-177 (2020); F. Annunziata, *La disciplina del mercato mobiliare* (Torino: Giappichelli, 11th ed, 2021), 143-178. About investor-protection regulation in relation to insurance-based investment products see, among the latest, M.E. Salerno, 'La tutela dell'investitore in prodotti di investimento assicurativi nella nuova disciplina Consob' *Diritto della banca e del mercato finanziario*, I, 565-623 (2020); C.G. Corvese, 'La disciplina del "governo e controllo" dei prodotti assicurativi ed i suoi riflessi sul governo societario di imprese di assicurazione e di intermediari'*Diritto della banca e del mercato finanziario*, II, 146-181 (2020); P. Marano, 'Le regole autarchiche sul governo e controllo (Product Oversight and Governance) dei prodotti assicurativi nel prisma dell'ordinamento europeo' *Rivista di diritto bancario*, I, 217-235 (2021); P. Marano andK. Noussia eds, *Insurance Distribution Directive. A legal Analysis. AIDA Europe Research Series on Insurance Law and Regulation* (Cham: Springer, 2021), III, available at https://doi.org/10.1007/978-3-030-52738-9_3 2020; G. Volpe Putzolu, 'La realizzazione del POG nell'ordinamento italiano'*Diritto dei mercati finanziari e assicurativi*, 163-167 (2020).

[12] This Regulation arises from the European Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms [2021] OJ L 277/1. The current version of the delegated Regulation is the fourth of a set of drafts issued by the EC between 2018 and 2021. For more details about the evolution of the content of these drafts and its implications see F.E. Mezzanotte, 'Accountability in EU Sustainable Finance: Linking the Client's Sustainability Preferences and the MiFID II Suitability Obligation' *Capital Markets Law Journal*, 16/4, 482-502 (2021); Id, 'The EU Policy on Sustainable Finance: A Discussion on the Design of ESG-Fit Suitability Requirements' 40 *Review of Banking & Financial Law*, 249-313 (2020); M. Siri and S. Zhu, *L'integrazione* n 1 above, *passim*; Id, *Will* n 1 above, *passim*. About the differences between MiFID II- based and IDD-based investor protection disciplines see V. Colaert, 'Integrating Sustainable Finance into the MiFID II and IDD Investor Protection Frameworks' KU Leuvene, Jan Rose Institute for company & financial law, Working paper no 2020/06, 1-20, *passim*, available at https://tinyurl.com/7a6mbtbn (last visited 31 December 2022) (now in D. Busch, G. Ferrarini and S. Grünewald eds, *Sustainable Finance in Europe. EBI Studies in Banking and Capital Markets Law* (Cham: Palgrave Macmillan, 2021), 455-475.

2017/593)[13] respectively.

III. The Objective Scope of Application of Investment-Services Regulation in the Context of ESG

It is first necessary to identify what the provision of investment services from the perspective of sustainable development refers to. It centres around the notion of 'sustainable financial investment', which both the SFD Regulation (Regulation (EU) 2019/2088) and the Taxonomy Regulation (Regulation (EU) 2020/852) contribute to defining.[14] Both are expressly referenced by the European Commission Regulation 2021/1253 and the Delegated Directive (EU) 2021/1269 of interest here.

The SFDR contains a general definition of 'sustainable investment' (Art 2(17)), whereby an investment is considered 'sustainable' when it concerns an economic activity that complies with the following three conditions: it contributes to an environmental or social objective; it does not significantly harm any of these objectives; and the companies carrying it out follow good governance practices (referred to as 'dark green' products). The SFDR does not limit, however, the scope of its sustainability transparency (disclosure) rules to the strict notion of sustainable investment; it also includes products with different levels and objectives of sustainability-related materiality. These range from those that, according to Art 9 (Transparency of sustainable investments in pre-contractual disclosures), pursue the objective of sustainable investments and do not cause significant harm, to those which, falling within the scope of Art 8 (Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures), promote, among other things, environmental or social characteristics, or a combination of those characteristics, provided by companies that follow good governance practices, without becoming a benchmark of sustainable investment (so-called 'light green' products). In addition, the SFDR implicitly envisages in Art 6 (Transparency of the integration of sustainability risks) a third category of investment products developed by the financial industry, which is residual compared to the first two. This category includes the investments in products that consider the likely impacts of sustainability risks on the returns of the financial products, where relevant.

The Taxonomy Regulation contributes in part to defining the notion of sustainable investment (it only considers activities that comply with the

[13] The delegated Directive is published in [2021] OJ L 277/137.

[14] For an analysis of the SFD Regulation and the Taxonomy Regulation and their impact on the MiFID II-based disclosure obligations see, also for references M.E. Salerno, 'L'integrazione dei fattori di sostenibilità nelle regole di comportamento dell'intermediario finanziario: un ritorno al modello di distribuzione 'orientato al prodotto'' *Diritto della banca e del mercato finanziario*, I, 53, 70-76 (2022).

environmental goal). It establishes a unified classification system for eco-sustainable activities (ie, those that pursue environmental objectives), leaving it to the Commission's delegated acts to quantify the adequate level of sustainability for economic activities so that they are in line with the various environmental sustainability objectives set out therein.[15] The Taxonomy Regulation (in its Art 9) establishes six environmental objectives: climate change mitigation, climate change adaption, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems, based on which an economic activity can be qualified as 'environmentally sustainable'. Once the environmental objectives have been defined, and in order to establish the degree of eco-sustainability of an investment, the Regulation (in its Art 3), considers an activity to be eco-sustainable if it 1) contributes substantially to the achievement of one or more of the environmental objectives, 2) does not significantly harm any of the environmental objectives, 3) is carried out in compliance with the minimum social safeguards,[16] and 4) complies with the technical screening criteria established by the European Commission. In other words, the qualification of an activity as eco-sustainable (and the corresponding investment as a 'sustainable investment') is based on the concept of a 'substantial' rather than marginal 'contribution' to the achievement of environmental objectives and the principle of 'not significantly harming' any of them, the general contents of which (specifying the technical assessment criteria) are laid down in the Regulation itself (in Art 10 et seq) and referred to the Commission's quantitative indicators.[17]

From the regulatory framework outlined above, we can draw the conclusion

[15] In performing this task the EC is supported by the International Platform on Sustainable Finance. It is a permanent forum for dialogue between policymakers, created by the European Union on 18 October 2019 to replace the Technical Expert Group on Sustainable Finance for updating the taxonomy.

[16] According to Art 18, the minimum safeguards shall be procedures implemented by an undertaking that is carrying out an economic activity to ensure the alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

[17] So far the EC has issued the Delegated Regulation (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council [2021] OJ L 442/1. The regulation establishes the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. For more information about the next adoption of complementary Delegated acts of the EU Taxonomy Regulation covering activities not yet covered in the EU Taxonomy Climate Delegated Act see the European Commission Communication of 21 April 2021 'Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal' COM(2021)188 final.

that the EU taxonomy and the notion of sustainable investment in the SFD Regulation do not wholly coincide, as sustainable investment is potentially broader than the EU taxonomy in that it could, in the presence of the three conditions required (substantial contribution to sustainability, no harm to any sustainable objective, following good governance practices), include investments in activities not incorporated in the list. In addition, the SFDR acknowledges the existence of products financing economic activities that promote environmental or social characteristics and/or take into account the main negative impacts on sustainability, despite not actually making a 'substantial contribution' to the achievement of sustainability objectives, as well as the indicators (of qualification and quantification) of the principle of 'not causing significant harm' to sustainability factors contained in the Taxonomy Regulation and specified in the acts delegated to the Commission.

The European Commission also relies on these considerations when, in adding sustainability factors (as defined in the SFDR) to the provisions of the MiFID II package in question, it (implicitly) expresses itself on the objective delineation of ESG investment advice and portfolio management services by identifying eligible products as being 'sustainable investments in the financial sector'. This category includes investments in all financial instruments that have some impact in terms of sustainability, ie, they are used, at least to some extent, either for activities that comply with the taxonomy set out in Art 3 of the Taxonomy Regulation, or for sustainable investments under Art 2(17) of the SFDR, which also includes taxonomy-compliant assets. Otherwise, they may even be used in investments which, despite not falling into these categories because they do not comply with pre-established sustainability criteria, take into account the material negative externalities they bring to the environment (or society) in terms of the main adverse impacts they have on sustainability.

In other words, in order to apply the MiFID II Regulation on investment advice and portfolio management, the updated versions of Regulation (EU) 2017/565 (on the organisational requirements and rules of conduct of investment firms) and Delegated Directive (EU) 2017/593 (on the product governance obligations) include financial instruments/assets with different declared levels of sustainability and sustainability-related ambitions within the notion of sustainability-compliant financial investment. Starting from the maximum level, referring to taxonomy-compliant activities, which automatically integrate the notion of sustainable investment by distinguishing sustainable activities (and sustainable investments) according to the indicators pertaining to the parameters of the positive effects on 'sustainability factors' and 'not causing significant harm' to them, we reach the (so to speak) minimum level, associated with businesses not directly geared towards promoting sustainable objectives but which anyway take into account their main adverse impact on sustainability

factors (so as to mitigate them).[18]

IV. The Impact of Sustainability on Suitability Assessment and Related Disclosure Requirements

The amendments introducing sustainability factors[19] into the regulatory framework regarding suitability assessment outlined in Regulation (EU) 2017/565 affect all aspects of assessment: from the assessment parameters to the verification methods, to the related disclosure requirements.[20] More precisely, the reform introduced by the European Commission with Regulation (EU) 2021/1253 focuses on Art 54 of the 2017 Regulation entitled 'Suitability assessment and suitability reports'. Its provisions apply to both the investment advice and portfolio management services.

The intermediary's benchmarks for assessing suitability consist of the client profile on the one hand and the product profile, on the other.

As regards investor or potential investor profiling, the updated version of Regulation 2017/565 (Art 54(5)) requires the intermediary to obtain information, including information of a 'non-financial' nature, from the client. This information forms part of the set of data required to ascertain the client's goals in making the investment, which, in addition to the time horizon (the length of time for which the client wishes to hold the investment), risk-taking preferences, risk tolerance, and the purposes of the investment, will also include sustainability preferences.[21] In reality, the legislator's choice in this regard stems from the

[18] In this connection, the EC states 'The rules on sustainability preferences ensure consistency with the SFDR and the Taxonomy Regulation and considerably strengthen the effectiveness of sustainability-related disclosures under those Regulations. The Taxonomy Regulation requires disclosures of the degree to which investments are aligned with the EU Taxonomy'. See EC Explanatory Memorandum to the Regulation 2021/1253, 2 (https://tinyurl.com/yjj7ywdj (last visited 31 Deember 2022)).

[19] The EC Delegated Regulation (EU) 2021/1253 and the EC Delegated Directive (EU) 2017/593 recall the definition of 'sustainability factors' laid down by the SFDR (Art 2, point (24)), of Regulation (EU) 2019/2088). Sustainability factors mean 'environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters'. In addition, in specific connection with the organisation requirements, the Regulation refer to the SFDR (Art 2, point (22)), of Regulation (EU) 2019/2088 notion of 'sustainability risk', that 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'.

[20] For more details about MiFID II-based suitability regulation see, also for references, M.E. Salerno, 'La disciplina in materia di tutela dell'investitore nella MiFID II: dalla disclosure alla cura del cliente' *Diritto della banca e del mercato finanziario*, I, 437, 474-478 (2016).

[21] ESMA Final Report - Guidelines on certain aspects of the MiFID II suitability requirements (ESMA35-43869) (available at https://tinyurl.com/ycyh3p5v (last visited 31 Deember 2022)) already includes a similar provision (Annex IV, point 28) stating 'it would be a good practice for firms to consider non-financial elements when gathering information on the client's investment objectives, and (…) collect information on the client's preferences on environmental, social and governance factors'. However, being not binding, this rule was not implemented by intermediaries

process of evolution of the amending Regulation (EU) 2021/1253, which saw not a few hesitations, uncertainties, and indecisions on the part of the European Commission concerning whether (as we shall see in more detail shortly) to give greater weight to 'sustainability preferences' from the enforcement perspective by incorporating them in the client's investment objectives, or a lesser impact by generically equating them with the investor's other personal characteristics.[22]

The legislator then proceeded to define the term 'sustainability preferences' (inserting a new point in Art 2 of the 2017 Regulation), referring to the choice of a client or potential client as to whether or not, and to what extent, to include a financial instrument in his or her investment and regarding which he or she determines:

- a minimum proportion (minimum level) to be invested in environmentally sustainable investments within the meaning of the EU Taxonomy Regulation, and/or;

- a minimum proportion (the minimum level) to be invested in sustainable investments according to the SFDR and/or;

- the qualitative (type) or quantitative (degree) elements demonstrating the 'consideration' of principal adverse impacts on sustainability factors at the basis of investments that take that consideration into account.

Three elements relevant to our investigation may be derived from this definition. Firstly, the European legislator identifies three general categories of eligible financial instruments with regard to client sustainability preferences: those that fully or partially pursue sustainable investments in economic activities that, according to the Taxonomy Regulation, are environmentally sustainable; those that pursue sustainable investments in accordance with the SFDR; and those that take the main adverse effects on sustainability factors into account. Secondly, the regulation leaves it to the client to decide his or her 'sustainability preferences' regarding the quality (type) and quantity (degree) of sustainability of the eligible financial instruments that the intermediary may recommend or offer to the client. Lastly, the fact that the legislator incentivises investment in instruments that finance 'environmentally sustainable' businesses, pursue 'sustainable investments', or take into account and reduce significant adverse effects on sustainability factors caused by investments in financial instruments, does not translate into an obligation for clients or potential clients

in an adequate manner, as the EC underlines in its Action Plan on Sustainable Finance (7). On 29 January 2021, ESMA launched a public consultation to gather feedback on how to take into account sustainability factors and risks in the suitability assessment under MiFID II. See ESMA, 'Consultation Paper. Guidelines on certain aspects of the MiFID II appropriateness and execution-only requirements', of 29 January 2021, 1, 16 and Q16 at 18 (available at https://tinyurl.com/5n8bzjad (last visited 31 Deember 2022)).

[22] Unlike the 2019 and 2020 versions of the Regulation, available at https://tinyurl.com/ytbt7buy, and at https://tinyurl.com/4nk4ye9f (last visited 31 Deember 2022). For the analysis of these changes see F.E. Mezzanotte, *Accountability* n 12 above,21-28.

to provide information on their interests in sustainability issues, unlike the requirement to provide other personal and financial information.

In practical terms, applying the provision in question will require the addition of new questions to the profiling questionnaire in order obtain fairly fine-grained information from clients on their preferences regarding sustainability issues.[23] The intermediary will have to take this information into account when deciding on the list of products to recommend as potentially suitable for a specific customer. Thus, according to the new para 9 of Art 54 of Regulation (EU) 2017/565, the intermediaries must implement appropriate policies and procedures demonstrating their ability to understand the nature and characteristics, including costs and risks, of the investment services and financial instruments they select for the client, including any sustainability factors. Advisors and portfolio managers must also assess - taking into account costs and complexity - whether any investment services or equivalent financial instruments match the client's profile. Sustainability performance indicators thus feature among the elements intermediaries have to take into account in the product-selection/offering process when formulating a suitable investment proposal/decision.

According to the updated version of Regulation (EU) 2017/565, once any sustainability factors have been added to the subjective (client preferences) and objective (characteristics of the financial instruments) parameters, the intermediary must also perform a suitability assessment on these. Specifically, new Art 54(2)(a) requires intermediaries to verify whether the specific financial instrument to be recommended or offered when providing investment advice or portfolio management services actually corresponds to their client's investment objectives, including risk tolerance and any sustainability preferences.

Assuming that the expressed sustainability preferences relate to financial instruments falling into the three eligible categories, an intermediary may not propose instruments that fall below the minimum sustainability proportion established by the client for sustainability-related investments in accordance with the taxonomy, sustainable investments under the SFDR, or investments that take into account the main adverse effects on sustainability factors. However, the Commission also points out that

> 'Given the rules on sustainability preferences, financial instruments with different levels of sustainability-related materiality will not need to be adapted. Those financial instruments will either benefit from the regime of sustainability preferences or will continue to be recommendable, but not as financial instruments meeting the sustainability preferences of the client or

[23] In relation to the granularity requirement, many scholars highlight that it this provision is disproportionate and difficult to be implemented, at least at the first stage. See M. Siri and S. Zhu, *Will* n 1 above, 6302-6303.

potential client, as defined in this Regulation'.[24]

This means that, if clients express sustainability preferences, intermediaries may only recommend, or trade on their behalf, eligible financial instruments compatible with the *minimum sustainability proportion* established by the client. Conversely, if an investor does not express any such preferences, an intermediary may offer or recommend a much broader range of financial products (with a wider variety of sustainability levels), provided that they meet the MiFID II suitability criteria. In other words, hypothetically eligible (under the sustainability profile) financial instruments that are not, however, in line with the level of sustainability indicated by the client may not be recommended as matching the individual's sustainability preferences, but they may be proposed on the basis the suitability assessment results, ie, if they are in line with the client's financial and personal characteristics. As part of this process, Regulation (EU) 2021/1253 (new Art 54(10)) allows investors to change their sustainability preferences (ie, the minimum level of sustainability they establish during the profiling phase), adapting them to the sustainability characteristics of the available products. The new para 10 states that if no instrument (among the hypothetically eligible ones) meets the client's (or potential client's) sustainability preferences, the latter may adapt his or her sustainability preferences so that further recommendations may be evaluated. In this case, investment firms must keep a record of the decision to change and the reasons for it, in order to prevent mis-selling and greenwashing.

It is evident that, through this last provision, the legislator has adopted a *product-oriented* distribution model for sustainable financial instruments (ie, adapting the client's profile to that of the product) in order to encourage this type of investment. Nevertheless, the evolution of investment services regulation has gradually abandoned this paradigm for the distribution by investment firms providing investment advice and portfolio management services of financial instruments per se, preferring a *client-oriented' model* (ie, adapting the product profile to that of the client), which offers greater protection for the investor.

The measures contained in the 2021 Regulation reflect the legislator's conception of a dual paradigm regarding the sustainable or non-sustainable nature of the financial instruments to be recommended or offered. In order to curb improper sales practices, despite the inclusion of sustainability preferences feature in the investor's investment objectives, the 2021 Regulation clearly distinguishes between the client's financial and sustainability profiles, laying down in relation to the former more stringent regulation of the intermediary's conduct. With this in mind, and in line with the principle of acting in the best interests of the client, the Commission underlines in its explanatory memorandum to the provision in question (see above para I) that sustainability factors should

[24] Se EC Explanatory Memorandum to the Regulation 2021/1253, 4.

not be considered of greater weight than the client's financial investment objective. It also states that sustainability preferences should only be considered during the suitability assessment process after the client's (financial) investment objective has been taken into account, thus introducing a system of two-pronged and sequential suitability assessment. Similarly, the last para of recital 5 of the Regulation reads:

> 'In order to avoid such [mis-selling] practices or misrepresentations, investment firms providing investment advice should first assess a client's or potential client's other investment objectives, time horizon and individual circumstances, before asking for his or her potential sustainability preferences'.

Among the measures the Commission adopted to ensure the necessary differentiation, in terms of weight, between the investor's financial and sustainability profiles is the updated rule on the consequences of product unsuitability. If an instrument is deemed unsuited to the client's (financial and sustainability) profiles (with a result of unsuitability), it may be neither proposed nor negotiated. If the instrument results incompatible with the client's sustainability preferences, the unsuitability (which must be explained and documented) will block the proposal or transaction presented in accordance with the investor's sustainability profile, but this will not prevent the intermediary from making the proposal or transaction if the characteristics of the instrument are appropriate to the client's financial profile. *Mutatis mutandis,* this means that, with regard to the financial instruments hypothetically eligible when sustainability preferences are expressed, the law allows the intermediary to recommend or trade them insofar as the instrument in question is suited to the client's financial profile even though it is unsuited to his or her sustainability profile (since it does not meet the level of sustainability chosen by the client during the profiling phase). Instead, the opposite is unlawful: Regulation does not allow an investment proposal if the financial instrument is suited to the client's sustainability preferences but not to his or her financial profile. Essentially, a financial instrument that is hypothetically permissible but does not comply with an investor's sustainability preferences may still be recommended insofar as it is suited to his or her financial profile but not because it meets their preferences, unless the client adjusts, as is their right, their sustainability preferences to be compatible with the degree of sustainability of the proposed instrument.

The more stringent regulation regarding the consequences linked to the suitability assessment for the client's financial profile is also confirmed by the fact that the rule contained in Art 54(8) of the 2017 Regulation is unchanged insofar as it does not extend to information regarding the client's sustainability preferences. According to this rule, when an intermediary offers advice, he or she must not propose a transaction in the absence of sufficient information from the client such as to prevent financial profiling (ie, necessary information

regarding knowledge and experience with investments in the type of product or service in question and the client's financial situation, including the ability to bear losses, as well as their investment objectives, including risk tolerance). Instead, in the event of a lack of, or insufficient, information from the client making it impossible to draw up a sustainability profile, the law permits the intermediary to propose financial instruments in general – including those that are hypothetically permissible from the point of view of sustainability – if the intermediary has sufficient information to determine the investors' financial profile, and, on the basis of the suitability assessment, recommended financial instruments are appropriate to this latter aspect.

In addition, pursuing its regulatory objective of finance supporting sustainability, Regulation (EU) 2021/1253, unlike previous proposals, seeks to strengthen the enforcement capacity of the additional regulations concerning sustainability by opting, in the context of the rules on suitability assessment, to equate sustainability preferences with client investment objectives rather than other personal characteristics (as in the 2019 and 2020 versions).[25] This choice brings with it two implications. The first is that, if a client or potential client expresses sustainability preferences, the law requires intermediaries to take them into careful account when selecting the financial instruments to recommend or offer and to conciliate them with the client's financial needs. The second is that if the intermediary fails to take the client's declared sustainability preferences into account during the suitability assessment, and given the relative equivalence to the investor's investment objectives legally imposed as a parameter for assessing suitability, he or she may face liability for breach of the rules of conduct, and specifically for breach of the suitability requirements under Art 25(2) of MIFID II, at least when taking into account sustainability preferences does not compromise compliance with the client's financial objectives.[26]

Despite the lack of an express provision by the legislator, it goes without saying that sustainability preferences should also be taken into account during periodic suitability assessments. This will occur when these preferences have served as a parameter for initial suitability assessment, or else, if the client's sustainability profile changes, due, for example, to subsequent awareness of sustainability issues or, on the contrary, a lack of any such interest. Sustainability preferences must also be taken into account if the product's sustainability characteristics change, due, for example, to an increase in the investment's sustainability risk.

Lastly, the revised text of Art 52 of Regulation (EU) 2017/565 requires (with regard, of course, to the distribution of eligible financial instruments deemed

[25] For a critical analysis of the 2020 version of the Regulation, where the suitability assessment in relation to the sustainability preferences was treated as those connected to other personal characteristics, see V. Colaert, n 12 above, 9-10.

[26] See F.E. Mezzanotte, *Accountability* n 12 above, 32.

suited both to the client's financial profile and sustainability preferences) intermediaries providing the investment advice to supplement the statement on suitability that must be provided before concluding the proposed transaction, by including an explanation of how the recommendation meets the client's financial and sustainability profiles equally.

Concerning periodic suitability reporting, since Regulation (EU) 2017/565 only requires reports subsequent to the initial conclusion of the investment contract to record the changes that have occurred to the services or instruments concerned and/or the client's circumstances, and they do not necessarily have to repeat all the details recorded in the initial statement, it is merely necessary to state the reasons why the investment continues to be aligned to the client's sustainability preferences only in the event of changes to the client's sustainability profile or the sustainability characteristics of the product.

V. The Insertion of Sustainability Factors in Product Governance Regulation

The EU legislator's additional intervention on the investor protection regulation set forth in the Sustainable Finance Package of 21 April 2021 concerns the effects of sustainability issues on the MiFID II-based product governance regulation, by the amendments to Level 2 MiFID II Directive 2017/593 brought by Delegated Directive (EU) 2021/1269 of 21 April 2021.[27] Through this intervention, sustainability factors come to affect the product's entire life cycle, impinging on the definition of the target market, affecting the characteristics of the products and the type of client or potential clients, and therefore the manufacturers and distributors of financial instruments, in reshaping their production and distribution processes.

The EU drive to create *sustainable* product governance processes takes the form of interventions to modify the requirements of manufacturers and distributors in the three phases of a finance product lifecycle, ie, pre-distribution, marketing and distribution, and post-distribution.

The reform, which affects Arts 9 and 10 of the Directive (EU) 2017/565,

[27] The legal framework on product governance is composed of: Art 16 of MiFID II; Arts 9-10 of Directive (EU) 2017/593; ESMA Guidelines on MiFID II product governance requirements of 28 May 2018 (ESMA35-43-869) available at https://tinyurl.com/2entf93r (last visited 31 Deember 2022)). On this subject, see, among the latest, also for references: V. Colaert, 'Product Governance: Paternalism Outsourced to Financial Institution?'KU Leuvene, Jan Rose Institute for company & financial law, Working paper no 2019/2, 1-21, (accepted for publication in the European Business Law Review), available at https://ssrn.com/abstract=3455413 (last visited 31 Deember 2022); E. Rimini, n 11 above, 438-444; A. Perrone, 'Oltre la trasparenza, Product Governance e Product Intervention e le "nuove" regole di comportamento', in E. Ginevra ed, *Efficienza del mercato e nuova intermediazione* (Torino: Giappichelli, 2019), 75-84; M.E. Salerno, *La tutela dell'investitore* n 11 above, 614.

requires manufacturers and distributors of financial instruments to provide, in relation to each financial instrument, a fine-grained description[28] of the positive target market (ie, the set of potential clients or groups of clients targeted by the instrument in question), both in the abstract and actual, taking elements of sustainability into account. Thus, it is necessary to specify, with regard to each financial instrument, the type(s) of client whose financial and sustainability profile (ie needs, financial characteristics and investment objectives, including any sustainability-related objectives) is compatible with its characteristics. To this end, the Community legislator adds the sustainability factors that characterise it to the product's risk-return and suitability characteristics. These are factors which, together with the product's other financial characteristics, the manufacturer must consider when designing and implementing the product in order to assess its compatibility with the financial and sustainability needs of the target market (potential clients). During the pre-distribution phase, the product's sustainability factors are included in the information flow regarding financial instruments from the manufacturer to the distributor; they are also part of the process in which the distributor defines the boundary limits of the real positive target market. Lastly, in the post-distribution phase, both manufacturers and distributors are required to periodically review the financial instruments produced and distributed in order to ascertain that they continue to meet clients' needs and objectives, including those of sustainability.

An examination of the changes imposed by adding sustainability factors to the sphere of product governance shows that the rules underlying the definition of the potential and real negative target market (ie, the categories of clients to whom the product cannot be distributed because their needs, financial characteristics, and investment objectives are not ordinarily and hypothetically compatible with the characteristics of the product) remain unaffected. This is the result of a reasoned choice of the EU legislator in line with the EU product-oriented distribution model, which, in order to ensure that hypothetically eligible financial instruments (compliant with the taxonomy, or falling within the category of sustainable investments according to the SFD Regulation, or simply with no negative impact on the environment and social issues) remain easily available to clients who show preferences, ie levels of sustainability different from those of the instrument in question, has deemed unnecessary and inappropriate – in the case of sustainable instruments/investments – to identify the set of clients or categories of clients to whom the instruments/investments may not be proposed because of incompatible needs, characteristics, and sustainability objectives.[29]

VI. Concluding Remarks

[28] For many doubts regarding this provision, see V. Colaert, *Integrating* n 12 above, 15-16.
[29] See Recital 7 of the Delegated Directive(EU) 2021/1269.

An examination of the rules shows a clear drive on the part of the EU legislator to involve finance in sustainable development. As far as the legislation protecting those investing in financial instruments is concerned, this goal is reflected in the inclusion of sustainability preferences in the client's investment objectives and the adoption of a product-oriented model for distributing products financing sustainable economic activities. However, this is a model that the legislator has gradually and ever-more insistently sought to curb in the distribution of financial instruments in general, requiring intermediaries to adopt a client-oriented model to better protect the investor.

From the provisions examined, it is evident that the product-oriented model is to be favoured when the product has elements of sustainability. As for the norms under pinning the suitability assessment, we have seen that, in comparison with the financial assessment parameters, the inclusion of sustainability as an assessment parameter is regulated less severely. This is true of the legal consequences (no block) when a (sustainable) product does not comply with the client's sustainability preferences and, above all, as the client is free to adjust his or her sustainability preferences so that investment proposals that otherwise would not comply with the type or 'minimum proportion' of sustainability chosen may become available.

Concerning the regulatory framework on product governance, we have highlighted that, with reference to sustainable products, the Community legislator did not deem it appropriate to require manufacturer and distributor intermediaries to identify the negative target market. Consequently, and without prejudice to compliance with the MiFID II financial suitability criteria, there is nothing to prevent them also being distributed to clients who have not expressed sustainability preferences or have expressed different suitability preferences.

Without doubt, this choice is the result of commendable considerations, even though its application will have to be carefully tested and monitored, since it is just as likely that it might produce risky situations for investors by offering intermediaries new opportunities to steer the latter's sustainability preferences to their own advantage. The EU legislator is certainly aware of this and has repeatedly stressed the supremacy of what constitutes the bulwark of the regulations protecting the client, namely the requirement that intermediaries must always act in the (economic) best interest of the client, and that they should consider the investor's financial investment objectives before their sustainability objectives when assessing suitability. However, this does not detract from the fact that integrating sustainability issues into the framework of interest here may create circumstances in which the client's economic and sustainability interests are incompatible, as investing in eligible financial instruments when sustainability preferences have been expressed may not actually serve the client's best interest, which the intermediary must always pursue. There is also no doubt that this integration may give rise to a risk of greenwashing in its

multiple forms of misrepresentation, mislabelling, misinformation, mis-selling, and/or mis-pricing phenomena.[30] In investment services, risks arise with regard to how conduct of business rules, such as suitability, product governance and information requirements, should be applied when selling ESG products. Suffice it to think of cases where the intermediary induces the client to change his or her sustainability preferences in order to sell financial instruments aimed at financing a company with a sustainable business and with which the intermediary has economic or legal ties, even though this would not be in the client's best interest. Consequently, there will be increasingly frequent legal disputes between clients and intermediaries, in which it will be more difficult for the investor to prove the damage caused by the counterparty's conduct;[31] conduct which, under the reform examined, would be formally lawful.

As things stand, we must ask ourselves: are we sure that the legislator has found the right balance between investor protection and sustainability incentives? Are we confident that the legislator's recommendations that the best possible interest of the client must always be the priority are sufficient to contain the aforementioned risks for the investor and at the same time provide the right input for sustainable finance in the investment services sector as well?

Certainly, the supervisory convergence measures to address greenwashing risks to financial investors, envisaged by the ESMA in the Sustainable Finance Roadmap 2022-2024,[32] can make an important contribution to the issue of reconciling potential conflicting (public and private) interests.

We can only wait for the regulatory revision in question to actually be applied and assess the results for the answers to our uncertainties.

[30] About the definition of the term 'greenwashing', see ESMA, Sustainable Finance Roadmap 2022-2024, 8, available at https://tinyurl.com/3crmcx6j (last visited 31 Deember 2022)). In this connection, ESMA notes (12) that 'Investor education also plays a role in making sure that product offerings related to ESG investing can be properly understood, for example in relation to the sustainability impact of different investment strategies put in place to integrate ESG factors'.

[31] About the difficulty for investors to prove the breach of conduct of business regulation by financial intermediaries, see: F. Della Negra, *MiFID II and Private Law. Enforcing EU Conduct of Business Rules* (Oxford-Chicago: Hart Publishing, 2019); Id, 'The civil effects of MiFID II between private law and regulation', in R. D'Ambrosio and S. Montemaggi eds, *Private and public enforcement of EU investor protection regulation*,115-143 (2020); O.O. Cherednychenko, 'Two Sides of the Same Coin: EU Financial Regulation and Private Law' 22 *European Business Organization Law Review*, 147-172 (2021); M. Rescigno, 'La responsabilità civile dei soggetti abilitati e la tutela speciale degli investitori', in M. Cera e G. Presti eds, *Il Testo Unico finanziario. Prodotti e intermediari* (Bologna: Zanichelli, 2020), 513-560.

[32] See, ESMA Sustainable Finance Roadmap 2022-2024, n 30 above, 8 and 27-28.