

New ESG changes to MiFID II – what private banks, wealth managers and advisers need to know

1. Speed read

As a further step in the roll out of its green agenda, the European Commission is shortly expected to finalise certain ESG related changes to MiFID II. This will contain various requirements, including a new obligation on advisers and portfolio managers to capture information about their client's ESG preferences and comply with these when considering suitability. There are also prescribed changes to organisational requirements. This briefing gives further detail on the new requirements and when they will come into effect.

2. How did we get here?

In June 2020, the European Commission published the long expected drafts of its proposed changes to MiFID II to reflect ESG considerations; in particular, the proposal would amend the MiFID II Delegated Regulation and the MiFID Delegated Directive. For a copy of the drafts, see [here](#).¹ To see a mark-up of the proposed changes, please click [here](#). This reflected various recommendations made in a 2018 report published by the High-Level Expert Group on Sustainable Finance.²

More broadly, this is a key part of the European Commission's strategy to reorient private capital flows into investments that will help "green" the EU. In turn, this will help realise the Commission's aim to make Europe the world's first climate neutral continent and achieve net zero carbon emissions by 2050.

Underlying one of the key changes being proposed to MiFID II is essentially a hope or belief that, if asked whether they care about ESG or (in particular) climate change, a number of clients and investors will say "yes". Their advisers and portfolio managers will then have to steer them into investments that match those preferences, when providing advice or making investment decisions in relation to their portfolio. In turn, this will encourage a flow of funds into investments that are, at minimum "ESG friendly".

If you want a copy of our separate briefing on related changes for asset and fund managers, let us know.

01 [https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive EU-2017-593- and https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017-565-](https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive-EU-2017-593-and-https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017-565)

02 https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

3. What are the new requirements?

To navigate the new rules, you need to know four key concepts. These relate to key concepts in the new Disclosure Regulation³ – if you would like a copy of our briefings on this, let us know.

“Sustainability preferences”

Means a client’s choice as to whether either of the following should be integrated into their investment strategy:

- (a) a financial instrument that has as its objective “sustainable investments” (defined as explained below); or
- (b) a financial instrument that promotes environmental (E) or social (S) characteristics, and that either:
 - (i) pursues (among others) sustainable investments; or
 - (ii) as of 30 December 2022, considers the principal adverse impacts on sustainability factors, as referred to in Article 7(1) of the Disclosure Regulation.

“Sustainability factors”

Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.⁴

A “sustainability risk”

An environmental, social or governance event or condition that, if it occurs, would cause a negative material impact on the value of an investment.⁵

A “sustainable investment”

An investment in an economic activity that:

- contributes to an **environmental** objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, **OR**
- contributes to a **social** objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that:
 - such investments do not significantly harm any of those objectives, PLUS
 - the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

In short, a “sustainable investment” must therefore advance either a specific “E” OR “S” objective, PLUS it must “do no significant harm” as regards any such objective and involve “G”.

A shorthand way to remember this is “E or S + DNSH + G”.

03_ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R2088-20200712&from=EN>
– the full name of this regulation is “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”.

04_ This is defined by reference to Article 2(24) of the Disclosure Regulation – see <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R2088-20200712&from=EN>.

05_ This is defined by reference to Article 2(22) of the Disclosure Regulation.

4. Summary of key points

Suitability ⁶	<p>You must obtain information from a client about their sustainability preferences so that, when providing advice or portfolio management, you have a reasonable basis for concluding that investments recommended or made comply with those preferences.</p> <p>A client's investment objectives is expressly stated to include their "sustainability preferences, if any".</p>
ESG due diligence	<p>You must have adequate policies and procedures in place to ensure you understand the nature and features of the investment services and financial instruments you select for your clients, "including any sustainability factors".⁷</p>
Suitability reports – retail advisors only	<p>The suitability report you give a retail client must explain how the recommendation provided is suitable for the client, including how it meets the client's sustainability preferences.</p>
Pre-contractual disclosures – advisors only	<p>When you provide a description of the factors taken into consideration in the selection process you use to recommend financial instruments (eg risks, costs and complexity of the financial instruments), you must include sustainability factors.⁸</p>
Organisational and systems/controls requirements	<p>You must take into account sustainability risks when complying with the organisational requirements in MiIFD II – eg when establishing, implementing and maintaining internal controls, employing personnel with the necessary skills, knowledge and expertise, when establishing, implementing and maintaining effective internal reporting and communication, when keeping records, etc.⁹</p> <p>Going forward, when establishing, implementing and maintaining adequate risk management policies and setting the level of risk tolerated by the firm, you must take into account sustainability risks.¹⁰</p> <p>When identifying the types of conflicts that arise in the course of providing investment and ancillary services and whose existence may damage the interests of a client, the client's interests will specifically include "his or her sustainability preferences".¹¹</p>

06_See amendments proposed to Article 54 (suitability assessments and reports) of the MiFID Delegated Regulation.

07_See amendments proposed to Article 54 (9) of the MiFID II Delegated Regulation.

08_See amendments proposed to Article 52 (information about investment advice) of the MiFID II Delegated Regulation.

09_See amendments proposed to Article 21(7) (general organisational requirements) of the MiFID II Delegated Regulation.

10_See amendments proposed to Article 23 (risk management) of the MiFID II Delegated Regulation.

11_See amendments proposed to Article 33 (conflicts) of the MiFID II Delegated Regulation.



Product governance –
manufacturers¹²

In essence, you must include sustainability preferences and sustainability factors into your target market analysis. In particular:

- When you identify the potential target market for a product and specify the type(s) of client for whose needs, characteristics and objectives the product is compatible, you must include sustainability preferences.
- When you determine whether a product meets the identified needs, characteristics and objectives of the target market, you must consider whether the product’s sustainability factors are consistent with the target market.
- When you periodically review the products you manufacture, you must consider if they remain consistent with the needs, characteristics and objectives, “including any sustainability preferences”, of the target market.

Product governance –
distributors¹³

Similarly, you must include sustainability preferences and sustainability factors into your target market analysis. In particular:

- You must have in place adequate product governance arrangements to ensure the products and services you intend to offer or recommend are compatible with the needs, characteristics, and objectives, “including any sustainability preferences”, of an identified target market.
- When you periodically review the products you offer or recommend and the services you provide, you must assess whether the products or services remains consistent with the needs, characteristics and objectives, “including any sustainability preference”, of the identified target market.

12_ See amendments proposed to Article 9 (product governance - manufacturers) of the MiFID II Delegated Directive.

13_ See amendments proposed to Article 10 (product governance - distributors) of the MiFID II Delegated Directive.

5. Timing

When finalised, the new law will enter into force on the twentieth day following its publication in the Official Journal of the European Union. Its requirements are expected to come into force 12 months after publication in the Official Journal. As relevant to this timeline, however, it is yet to be clarified as to whether the new requirements will apply in relation to both current and historic clients.

6. Brexit

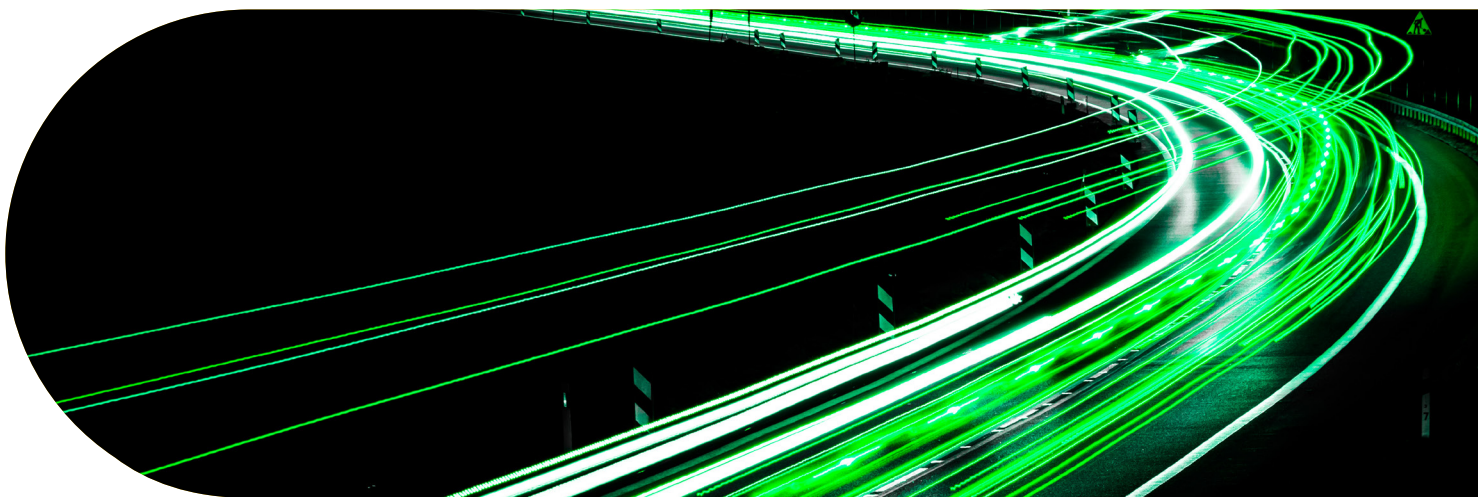
It is not clear whether the changes proposed to MiFID II will apply in the UK post Brexit. The UK government has expressed a desire to prioritise climate change initiatives, and in particular, wishes to encourage private investment in activities that would “green” the UK. On the other hand, it may be reluctant to be seen to track EU regulatory initiatives too closely post Brexit.

This point is therefore one to watch.

7. Recommendations

In terms of what firms should be doing now:

- Get up to speed on the proposed new regulations
- Consider establishing a cross-functional internal team to consider what changes will be required within your business
- Undertake a preliminary gap analysis
- In light of the outcome of the gap analysis, identify actions required to put in place the necessary internal systems, procedures, policies and expertise in order to comply with the requirements.



Up to date as of 1 January 2021

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