

# New ESG changes to MiFID II – What investment firms and banks need to know



## Speed read

The European Commission has finalised its proposed ESG-related changes to MiFID II. These are intended to fit together with SFDR, and are part of a suite of ESG related changes being made via amends to AIFMD, the UCITS directive etc. However, the ESG changes to MiFID II apply more broadly than SFDR – with impacts for MiFID investment firms and banks that manufacture and distribute MiFID products.

In part, these changes are intended to “mainstream” the consideration of ESG risks by relevant EEA firms and banks, contributing to a push to put “sustainability considerations” at the heart of the financial system.

Equally importantly, they are intended to “turbo charge” the European Commission’s efforts to redirect private capital into efforts to “green” the EU, plus avoid greenwashing.

The changes clarify the requirement that firms must incorporate ESG considerations into organisational requirements (including suitability assessments), risk management, conflicts and product governance arrangements. This briefing gives further detail on the new requirements and when they will come into effect.

If you would like a copy of our separate bulletins for private banks/wealth managers, and for asset/fund managers, please let us know.

<sup>1</sup>Please see Recital (11) of the Taxonomy Regulation: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852>

## How did we get here?

- December 2016 – The EU Commission established a High-Level Expert Group (**HLEG**) to develop an EU strategy on sustainable finance.
- January 2018 – The HLEG published its final report with various recommendations, including the need to improve the contribution of finance to sustainable and inclusive growth, and strengthen financial stability by incorporating ESG factors into investment decision making. Another recommendation was that, as a routine component of financial advice, advisers should ask about/respond to investor preferences on sustainability.<sup>1</sup>
- 10 March 2021 – A key plank of the EU's reforms began to apply – the Sustainable Finance Disclosure Regulation (**SFDR**)<sup>2</sup>. This imposes new transparency and disclosure requirements on certain firms, to increase the focus on ESG risks and address the risk of “greenwashing”. But importantly, SFDR **only applies to a very limited set of firms and products**, eg:
- **in scope** – portfolio managers and investment advisers, fund managers, insurance advisers, and insurers (for certain products only).
- **not in scope** – structured products, derivatives, securitisation vehicles, bonds, etc.
- In June 2020, the European Commission published draft changes to MiFID II to reflect ESG considerations, together with similar changes to AIFMD, the UCITS Directive, the IDD and Solvency II. For a copy of a previous briefing on this, see [here](#).<sup>3,4</sup>
- On 21 April 2021, the European Commission adopted the delegated regulation and directive, which were then subject to a c.3 month scrutiny period as regards the European Parliament and Council. No significant changes were made as a result of this process, despite industry push back.
- On 2 August 2021, the new law was published in final form in the Official Journal.

## What you need to know<sup>5</sup>

### What

The European Commission has issued final new rules amending MiFID II for ESG. As above, these are intended to fit together with SFDR, and sit alongside changes to other key directives, establishing a level playing field across relevant sectors. In other words, to have a horizontal application. These are the key details:<sup>6</sup>

LEGISLATION	AMENDMENTS	SOURCE
Commission Delegated Regulation (EU) 2021/1253 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms	Amended MiFID – in particular, Delegated Regulation (EU) 2017/565 <sup>7</sup>	For the new law, see <a href="#">here</a> . <sup>8</sup> For a copy of the original law, marked up to show the changes made, please contact your usual A&O contact. But please make sure you view this alongside the new Delegated Regulation as the recitals are important.
Commission Delegated Directive (EU) 2021/1269 as regards the integration of sustainability factors into the product governance obligations	Amended MiFID – in particular, Delegated Directive (EU) 2017/593 <sup>9</sup>	For the new law, see <a href="#">here</a> . <sup>10</sup> For a copy of the original law, marked up to show the changes made, please contact your usual A&O contact. But please make sure you view this alongside the new Delegated Directive as the recitals are important.

<sup>1</sup> [https://ec.europa.eu/info/sites/default/files/180131-sustainable-finance-final-report\\_en.pdf](https://ec.europa.eu/info/sites/default/files/180131-sustainable-finance-final-report_en.pdf)

<sup>2</sup> Regulation (EU) 2019/2088.

<sup>3</sup> <https://www.allenavery.com/en-gb/global/news-and-insights/publications/new-esg-changes-to-mifid-ii-aifmd-and-the-ucits-directive-what-fund-and-asset-managers-need-to-know>

<sup>4</sup> For the text of the initial proposed changes to MiFID II, see <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> and <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>

<sup>5</sup> In this bulletin, “firm” means a MiFID II investment firm or a bank that conducts relevant activities in scope of MiFID II.

<sup>6</sup> See [https://ec.europa.eu/info/publications/210421-sustainable-finance-communication\\_en](https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en) under the heading “Amending Delegated Acts on sustainability preferences, fiduciary duties and product governance”.

<sup>7</sup> [https://ec.europa.eu/finance/docs/level-2-measures/mifid-2-delegated-act-2021-2616\\_en.pdf](https://ec.europa.eu/finance/docs/level-2-measures/mifid-2-delegated-act-2021-2616_en.pdf)

<sup>8</sup> <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32021R1253>

<sup>9</sup> [https://ec.europa.eu/finance/docs/level-2-measures/mifid-2-delegated-act-2021-2612\\_en.pdf](https://ec.europa.eu/finance/docs/level-2-measures/mifid-2-delegated-act-2021-2612_en.pdf)

<sup>10</sup> <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32021L1269>

## When

2 August 2021 – Final rules published in EU Official Journal

2 August 2022 – ESG changes to the MiFID delegated regulation come into force

22 November 2022 – ESG changes to MiFID delegated directive on product governance come into force<sup>11</sup>

## What market segments and scope

- The new rules apply to MiFID II firms generally, whether they focus on professional or retail clients. NB: *This bulletin focuses on sell side firms – for a copy of our separate bulletins for wealth managers/private banks and asset/fund managers, let us know.*
- It is worth noting that currently there is no indication that the FCA will amend the UK version of MiFID II and the other relevant directives to reflect the new ESG requirements discussed in this bulletin.
- The ESG changes to MiFID II will have a broader scope than SFDR. eg:
  - ESG changes to MiFID II – **in scope** – for at least some of the new rules, all MiFID II firms in relation to all MiFID II product and services.
  - SFDR – **in scope** – portfolio managers and investment advisers, fund managers, insurance advisers, and insurers (for certain products only); **not in scope** – structured products, derivatives, securitisation vehicles, bonds, etc.

## Who

There are three key strands to the ESG changes to MiFID II, which apply differently to different types of firms:

### First strand – new general ESG requirements

This applies to all MiFID II firms, and is essentially intended to “mainstream” the consideration of ESG or sustainability risks. For an explanation, go to paragraph 4 of this bulletin.

### Second strand – product governance requirements

This applies to all firms that manufacture or distribute financial instruments, emphasising the integration of sustainability factors and preferences into their product governance arrangements. For an explanation, go to paragraph 5 of this bulletin.

### Third strand – new MiFID sustainability preferences regime

This is a new regime relating to the sustainability preferences of retail and institutional clients. Depending on your business model, it may have a direct impact or affect you as outlined below:

- **Direct impact** – It will apply directly to you if you are a firm or bank with:
  - a private banking arm;
  - a wealth management arm that provides advisory or portfolio management services to retail; and/or
  - an asset management arm, whether retail or institutional.
- **Other ways it could affect you** – It will affect you if you manufacture products which are distributed via one of those types of firms – eg if you manufacture structured products that are distributed to retail clients in the EU, or sell a derivative to an EU portfolio manager acting for an institutional client.

For an explanation, go to paragraph 6 of this bulletin.



<sup>11</sup> EU Member States will need to amend their national rules to implement these changes – the deadline for this is 21 August 2022, and the new rules are intended to apply from 22 November 2022.

## New general ESG requirements<sup>12</sup>

### Summary

- **Organisational requirements** – Firms must take into account sustainability risks when complying with the general organisational requirements imposed by MiFID II.
- **Risk management** – Firms must take sustainability risks into account in their risk management policies and procedures.
- **Conflicts** – Firms must regard damage to a client's sustainability preferences as a type of client detriment for the purposes of their conflicts policies and procedures.

### Detailed overview

<b>Timing and impact</b>	Affected firms will have to ensure they have updated their internal systems and controls by <b>2 August 2022</b> , when the relevant changes to MiFID II come into force.
<b>Key concepts</b>	<p>The new law introduces various new concepts to MiFID II, as follows:</p> <ul style="list-style-type: none"><li>– “sustainability risk” – this is defined as per SFDR, which in turn defines it as follows: “<i>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</i>”;<sup>13</sup></li><li>– “sustainability preferences” – this is a new concept introduced by the new law and essentially comprises three specific types of ESG preferences a particular client (retail or institutional) may specify going forward. For a detailed explanation, see paragraph 6 below.</li></ul> <p>The recitals to the new law also relevantly note as follows:</p> <p><i>“It is necessary to address concerns about ‘greenwashing’, that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial instrument as environmentally friendly or sustainable, when in fact that financial instrument does not meet basic environmental or other sustainability-related standards”</i> (recital 7);</p> <p><i>“Recognising [the net zero] challenge, the Commission presented the European Green Deal in December 2019. The Green Deal represents a new growth strategy that aims to transform the Union into a fair and prosperous society with a modern, resource-efficient and competitive economy where there are no net greenhouse gas emissions from 2050 onwards and where economic growth is decoupled from resource use. That objective requires that clear signals are given to investors with regard to their investments <b>to avoid stranded assets</b> and to raise sustainable finance”</i> (emphasis added, recital 2).</p> <p>The final point here in emphasis should be carefully noted – in addition to ‘nudging’ investment into the green economy, regulators and central banks are seeking to ensure that climate change risk is accurately reflected in asset prices. From a prudential and fiduciary perspective, firms should be careful to ensure assets do not become stranded or the subject of a “fire sale”. In particular, it is thought that the implementation of climate change policies may ultimately lead to large fossil fuel asset write-offs, an issue termed the Carbon Bubble. This is considered sufficiently material to pose risks to financial stability, as well as to individual investors exposed to such assets.</p>

<sup>12</sup> This section only considers the “sell side” activities of an investment firm or bank – for a separate briefing on for firm/banks with a private banking, wealth or asset management arm, please contact your usual A&O contact.

<sup>13</sup> Article 2(22) SFDR.

<b>Organisational requirements</b>	<p><b>What does the new law require?</b></p> <p>The new law requires firms, going forward, to specifically take into account sustainability risks when:</p> <ul style="list-style-type: none"> <li>(a) establishing, implementing and maintaining decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities;</li> <li>(b) ensuring that their relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities;</li> <li>(c) establishing, implementing and maintaining adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the investment firm;</li> <li>(d) employing personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them;</li> <li>(e) establishing, implementing and maintaining effective internal reporting and communication of information at all relevant levels of the investment firm;</li> <li>(f) maintaining adequate and orderly records of their business and internal organisation;</li> <li>(g) ensuring that the performance of multiple functions by their relevant persons does not and is not likely to prevent those persons from discharging any particular function soundly, honestly, and professionally.<sup>14</sup></li> </ul>
	<p><b>Implementation steps</b></p> <ul style="list-style-type: none"> <li>– Establish a working group to conduct relevant implementation work</li> <li>– Identify the business lines, activities, teams and functions the new law is likely to impact – including outsource service providers and third party contracts where relevant</li> <li>– Conduct an analysis as to where the ESAs are likely to wish to see the firm take account of sustainability risk in practice, given the list of items in paragraphs (a)-(g) above and likely regulatory expectations</li> <li>– Formulate a high level list of the types of changes to be proposed and obtain internal approval</li> <li>– In light of that list, conduct a gap analysis and (for any gaps) prepare a project plan to conduct any necessary work</li> <li>– Update relevant policies and procedures</li> <li>– Consider the data needs of the business, and if changes are required, what additional third party data may be required and how this may be sourced</li> <li>– Consider if a regulator would be comfortable that key personnel have the right skill set, experience etc. If additional training, new hires etc are required, consider how this may be done and on what timeline</li> <li>– Consider if “sustainability risk” is specifically mentioned on key committee terms of reference, agendas, template reports etc – and if not, consider updates for this</li> <li>– Consider what changes can/should be made to internal reporting and management information (MI) systems to capture and report on sustainability risk</li> <li>– Check if existing record keeping processes are “fit for purpose” – if not, considering tightening these or adding new relevant requirements</li> <li>– Consider if additional awareness building or training is required, and if so, roll this out on an initial and ongoing basis</li> </ul>

<sup>14</sup> Amendments to Article 21 MiFID Delegated Regulation (EU) 2017/565 (general organisational requirements).

<p><b>Risk management</b></p>	<p><b>What does the new law require?</b></p> <p>The recitals to the new law relevantly note:</p> <p><i>"Investment firms should therefore consider not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks as referred to in [SFDR] that, where they occur, could cause an actual or potential material negative impact on the value of an investment. [MiFID] Commission Delegated Regulation (EU) 2017/565 does not explicitly refer to sustainability risks. For that reason and to ensure that internal procedures and organisational arrangements are properly implemented and adhered to, it is necessary to clarify that processes, systems and internal controls of investment firms should reflect sustainability risks, and that technical capacity and knowledge is necessary to analyse those risks"</i> (recital 3).</p> <p>The new law also specifically amends the MiFID II risk management regime as follows (the redlining represents new words being inserted):</p> <p><i>"Investment firms shall take the following actions relating to risk management: (a) establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems, and, where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall take into account sustainability risks".</i></p>
	<p><b>What does this mean?</b></p> <p>In our view, the new law requires a firm, going forward:</p> <ul style="list-style-type: none"> <li>– to ensure processes, systems and internal controls reflect sustainability risks, alongside more traditional financial risks such as credit risk; and</li> <li>– to establish and maintain the technical capacity and knowledge necessary to analyse those risks.</li> </ul> <p>In particular, the firm must take into account sustainability risks:</p> <ol style="list-style-type: none"> <li>(a) when establishing, implementing and maintaining adequate risk management policies and procedures which identify the risks relating to the firm's activities, processes and systems; and</li> <li>(b) when setting the level of risk tolerated by the firm.<sup>15</sup></li> </ol> <p><b>How broadly should my project go?</b></p> <p>First, for those firms subject to SFDR, it is important to note that the new law contains specific obligations (eg "consider X"), rather than disclosure based obligations (eg "tell us whether/how you consider X"). Similarly, the new requirements are mandatory rather than "comply or explain".</p> <p>Secondly, it is not entirely clear whether the new law was meant to apply on a broad or more narrow basis as regards a firm's business.</p> <ul style="list-style-type: none"> <li>– A broad reading might suggest a firm should include ESG risks generally into its risk management framework.</li> <li>– A more narrow reading would take account of the reference to investment below in the definition of "sustainability risk", imported into MiFID II from SFDR: "<i>'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</i>". On this view, a firm must first consider where there is an "investment" (either from its perspective or from the perspective of a client or end-client). It then reads the new rule as only requiring it to consider ESG risks in this context.</li> </ul> <p>In the absence of regulatory guidance, the second view is likely to be a defensible position, but it would be prudent to keep a look out for regulatory guidance on scope.</p> <p>It may also be prudent to consider taking a broader approach via a separate project in due course, given that the direction of travel in the EU on ESG risk.</p>

<sup>15</sup> Amendments to Article 23 MiFID Delegated Regulation (EU) 2017/565 (risk management).

### **Implementation steps**

- Establish a working group to conduct relevant implementation work
- Larger firms may wish to consider establishing a sustainability risk subcommittee.
- Identify the areas of your business where sustainability risks may arise, in which scenarios, and with what potential consequences for the firm or its clients – including outsource service providers and third party contracts where relevant
- In that light, consider if sustainability risks are adequately captured/covered by existing policies and procedures or if changes are required – ie consider a gap analysis
- Update your risk framework to specifically mention sustainability risk and document the scenarios etc as above. Incorporate sustainability risk into the firm's risk appetite statement.
- Consider the data needs of the business, and if changes are required, what additional third party data may be required and how this may be sourced
- Consider what qualitative or quantitative thresholds may be applied in all or certain relevant parts of the business
- Consider if a regulator would be comfortable that key personnel have the right skill set, experience etc. If additional training, new hires etc are required, consider how this may be done and on what timeline
- Consider if “sustainability risk” is specifically mentioned on key committee terms of reference, agendas, template reports etc – and if not, consider updates for this
- Consider what changes can/should be made to internal reporting and management information (MI) systems to capture and report on sustainability risk
- Check if existing record keeping processes are “fit for purpose” – if not, considering tightening these or adding new relevant requirements
- Consider if additional awareness building or training is required, and if so, roll this out on an initial and ongoing basis
- Consider the impact (if any) on outsource service providers or third party contracts, and if relevant, formulate a strategy to roll out any relevant new requirements to them

Note: In our view, regulators will wish to see evidence that “sustainability risk” has a real footprint within the business and its documented policies and procedures, and firms should focus on ensuring they have a defensible “day 1” position in this regard by 2 August 2022.

<p><b>Conflicts</b></p>	<p>The recitals to the new law relevantly note as follows:</p> <p><i>"To maintain a high standard of investor protection, investment firms should, when identifying the types of conflicts of interest the existence of which may damage the interests of a client or potential client, include those types of conflicts of interest that stem from the integration of the client's sustainability preferences"</i> (recital 4).</p> <p>In particular, under the new law, a firm is directed to regard damage to a client's sustainability preferences as a type of client detriment for the purposes of the firms' conflicts policies and procedures.<sup>16</sup></p>
	<p><b>What does this mean?</b></p> <p>We have provided below a detailed explanation of the meaning of this new term, "sustainability preferences". In our view, however, it may be prudent to regard this new element of the MiFID II conflicts regime as referring to the general ESG preferences of investors, clients and end-clients. Eg see sample scenario 2 below.</p> <p><b>Implementation steps</b></p> <ul style="list-style-type: none"> <li>– Establish a working group to conduct relevant implementation work</li> <li>– Brainstorm the types of scenarios where a conflict could arise that may cause damage to an investor, client or end-client's sustainability preferences (or if you wish to take a broader view, to their ESG preferences generally) – eg: <ul style="list-style-type: none"> <li>– <b>Sample scenario 1:</b> <i>a firm's marketing or product development team is working on a new structured product for sale via third party private banks, who will sell the product on an advised basis to retail clients who have expressed a specific sustainability preference. That team could be motivated to exaggerate the relevant ESG credentials of the firm or products as regards relevant matters. End clients could therefore be encouraged to buy/invest, on a false impression – ie where they have sustainability preferences that may not in fact be met. This may be described as greenwashing risk.</i></li> <li>– <b>Sample scenario 2:</b> <i>a firm's marketing or product development team could be motivated to exaggerate the ESG credentials of the firm generally, to get stronger sales. As above, this may be described as greenwashing risk.</i></li> </ul> </li> <li>– Where specific scenarios are identified, consider if they are adequately covered by existing policies and procedures or if changes are required – ie consider a gap analysis</li> <li>– Update your policies and procedures on conflicts: <ul style="list-style-type: none"> <li>– to specifically include this new type of conflict (ie recognising damage to sustainability preferences as a specific type of client detriment)</li> <li>– potentially add practical guidance as to when this conflict may arise in practice</li> <li>– if the gap analysis suggests changes or improvements should be made to remove or mitigate relevant risks, introduce these</li> </ul> </li> <li>– Consider if existing disclosure wording on conflicts, as given to clients, investors, intermediaries etc, is sufficient or requires updating</li> <li>– Check if existing verification and record keeping processes are "fit for purpose" – if not, considering tightening these or adding new relevant requirements</li> <li>– Update your conflicts register where appropriate</li> <li>– Consider if additional awareness building or training is required on any conflicts risks or issues, and if so, roll this out on an initial and ongoing basis. Note: <i>In relation to greenwashing risk in particular, this is recommended.</i></li> </ul>

<sup>16</sup> Amendments to Article 33 of the MiFID Delegated Regulation (EU) 2017/565 (conflicts of interest).

# Product Governance – New requirements for manufacturers and distributors

## Summary

As noted above, we see three strands to the ESG changes to MiFID II. The second strand emphasises the consideration by MiFID II product manufacturers or distributors of sustainability factors and preferences in product governance arrangements.

The work required to implement these changes will likely build upon industry approaches adopted ahead of MiFID II implementation. Discussions are already progressing within a number of working group forums, particularly in the wholesale context, and proposals for a proportionate approach may be developed in line with requirements and expectations.

## Detailed overview

<b>Timing and impact</b>	<p>Affected firms will have to ensure they have updated their internal systems and controls and documents by <b>22 November 2022</b>, when the relevant changes to MiFID II come into force.</p> <p>For manufacturers, it is not clear on the face of the new law whether existing products must be considered against the requirements of the new law, or whether these can be considered “grandfathered” in some way. This is a point to be considered further, and (if possible) clarification obtained from the ESAs and/or the European Commission.</p> <p>A middle ground may be to assume as follows:</p> <ul style="list-style-type: none"><li>– products manufactured for the first time after 22 November 2022 – must be put through a process compliant with the new law;</li><li>– existing products manufactured on an ongoing basis before and after 22 November 2022 – same position;</li><li>– existing products manufactured prior to that date and the manufacturer not making them available to new clients/end-clients after that date – only required to be considered against the new requirements when their next periodic review falls due after that date (if any).</li></ul>
<b>Purpose of new law</b>	<p>We see two key goals here:</p> <ul style="list-style-type: none"><li>– First, to support the European Commission’s efforts to reorient private capital flows into investments to help “green” the EU. Eg: <i>“Proper implementation of the [EU’s climate change action] plan encourages investors’ demand for sustainable investments. It is therefore necessary to clarify that sustainability factors, and sustainability-related objectives should be considered within the product governance requirements set out in Commission Delegated Directive (EU) 2017/593”</i> (recital 4).</li><li>– Secondly, to mitigate the risk of greenwashing. Eg: <i>“It is necessary to address concerns about ‘greenwashing’, that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial instrument as environmentally friendly or sustainable, when in fact that financial instrument does not meet basic environmental or other sustainability-related standards”</i> (recital 7 Commission Delegated Regulation (EU) 2021/1253).</li></ul>
<b>Key concepts</b>	<p>The new law uses the term “sustainability factors”. This is defined by a cross reference to SFDR, where it is defined as follows: “‘sustainability factors’ mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters”.<sup>17</sup></p> <p>In shorthand, we may think of this as essentially “ESG” – E (environment), S (social), G (governance). Beyond this, the new law uses various phrases to refer to clients with ESG requirements or preferences – eg “clients seeking financial instruments with a sustainability-related profile” and “clients with sustainability related objectives”. These should be understood as generic concepts referring to clients with some form of preference for ESG or ESG friendly products. It is therefore distinct from ESG classifications that are emerging under various EU legislation – eg:</p> <ul style="list-style-type: none"><li>– an Article 8 or Article 9 product under SFDR;</li><li>– in particular, a product with a sustainable investment objective under SFDR;</li><li>– a product with an objective to make environmentally sustainable investments under the Taxonomy Regulation;</li><li>– the concept of a “sustainability preference” under the new MiFID II regime itself – explained in paragraph 6 below.</li></ul>

<sup>17</sup> Article 2(24) SFDR.

**What  
manufacturers  
have to do<sup>18</sup>**

**Product approval, governance and oversight** – You must consider sustainability factors as follows: “Investment firms manufacturing … financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile” (recital 5).

In other words, if you are targeting clients or end-clients with any form of ESG preference (however positioned or framed), you must specifically cover ESG in:

- your product approval process;
- your product governance and oversight arrangements.

This is presumably intended to address greenwashing risk.

**Target market** – When you identify the potential target market for a product and specify the types of client for whose needs, characteristics and objectives the product is compatible, you must include “any sustainability related objectives”.

This must be done in a granular way. As per the recitals:

“Considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed” (recital 6).

Also, under the existing law, you need to determine whether a product meets the identified needs, characteristics and objectives of the target market, including by examining certain prescribed elements such as whether the product's risk/reward profile is consistent with the target market. The new law requires you to now expressly consider an additional element, namely “[whether] the financial instrument's sustainability factors, where relevant, are consistent with the target market”.

**No negative target market analysis** – Under the existing law, you need to identify any negative target market a product may have- ie any group of clients for whom the product is not compatible. The new law explicitly states that this need not be done where the product “considers sustainability factors”.

The recitals also clarify as follows:

“To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible” (recital 7).

**Information given to distributors** – You must present the sustainability factors of the product in a transparent manner and provide distributors with “the relevant information to duly consider any sustainability related objectives of the client or potential client”. The recitals also add as follows:

“The sustainability factors of a financial instrument should be presented in a transparent manner to enable the distributor to provide the relevant information to its clients or potential clients” (recital 8).

**Periodic review** – When you periodically review the products you manufacture, you must consider if they remain consistent with the needs, characteristics and objectives, “including any sustainability related objectives”, of the target market.

<sup>18</sup>Amendment to Article 9 of the MiFID Delegated Directive (2017/593) (product governance obligations for investment firms manufacturing financial instruments) and recitals 4-8 of Delegated Directive 2021/1269.

<p><b>What distributors have to do<sup>19</sup></b></p>	<p><b>Due diligence, governance and oversight arrangements</b> – As with manufacturers, you must consider sustainability factors as follows:</p> <p><i>"Investment firms ... distributing financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile" (recital 5).</i></p> <p>In other words, if you are offering or recommending products to clients with any form of ESG preference (however positioned or framed), you must specifically cover ESG in:</p> <ul style="list-style-type: none"> <li>– your due diligence and product approval process;</li> <li>– your product governance and oversight arrangements.</li> </ul> <p>As above, this is presumably intended to address greenwashing risk.</p>
	<p><b>Due diligence and mis-selling risk</b> – You must ensure you only offer or recommend products that do what they “say on the tin” from an ESG perspective. In particular:</p> <p><i>"investment firms [must] have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, <b>including any sustainability related objectives</b>, of an identified target market and that the intended distribution strategy is consistent with the identified target market"</i> (emphasis added).</p>
	<p><b>Target market</b> – As with manufacturers, this must be set in a granular way. As per the recitals:</p> <p><i>"Considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed" (recital 6).</i></p>
	<p><b>No negative target market analysis</b> – Under the existing law, you need to identify any negative target market a product may have - ie any group of clients for whom the product is not compatible. The new law explicitly states that this need not be done where the product “considers sustainability factors”.</p> <p>The recitals also clarify as follows:</p> <p><i>"To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible" (recital 7).</i></p> <p>In our view, despite the wording of recital 7, appropriateness and the client's best interest rules will still apply. A distributor will not be entitled to distribute a product with sustainability factors to any client regardless of risk.</p>
	<p><b>Periodic review</b> – When you periodically review the products you offer or recommend, you must consider if they remain consistent with the needs, characteristics and objectives, <i>"including any sustainability related objectives"</i>, of the target market.</p>

<sup>19</sup> Amendment to Article 10 of the MiFID Delegated Directive (2017/593) (product governance obligations for investment firms manufacturing financial instruments)

## Implementation steps

- Establish a working group to conduct relevant implementation work
- For manufacturers
  - Form a view as regards the scope of the project and existing vs new products as discussed above
  - If existing products are considered out of scope:
    - Ensure your approach is clear/document, with a documented supporting analysis and rationale
    - Ensure your approach gives rise to no overarching TCF issues
  - If existing products are considered in scope:
    - Determine how you will define sustainability objectives and sustainability-related profiles.
    - Conduct an inventory of your MiFID II products to identify which of those products (if any) target clients or end-clients with sustainability objectives or a sustainability-related profile.
    - Prepare a project plan to consider these against your updated policies and procedures (as below).
- For both manufacturers and distributors
  - Conduct a gap analysis of your existing product approval, due diligence, product governance and oversight policies, procedures, internal documents etc against the new requirements
  - For any gaps, prepare a project plan to conduct any necessary work
  - In particular, update your policies and procedures:
    - to expressly require a consideration of sustainability factors
    - to expressly require the new target market elements to be considered for relevant products
    - to ensure these are developed in a way that would be considered sufficiently granular by regulators
    - (for manufacturers that use third party distributors) to expressly require a consideration as to the information needs of distributors and end-clients and to include steps to ensure these are met
    - (for distributors) to require appropriate due diligence is undertaken to gain comfort that the product will deliver “what it says on the tin” from an ESG perspective, as verified by the product documents provided
    - add practical guidance on relevant issues to help staff
    - to ensure the periodic review process expressly picks up ESG and ESG related target market considerations
- Consider any data needs, and if changes are required, what additional third party data may be required and how this may be sourced
- Consider if a regulator would be comfortable that key personnel have the right skill set, experience etc. If additional training, new hires etc are required, consider how this may be done and on what timeline
- Consider if existing wording in any distribution agreements/ disclosure documents is sufficient or requires updating
- Check if existing verification and record keeping processes are “fit for purpose” – if not, considering tightening these or adding new relevant requirements
- Consider if additional awareness building or training is required, and if so, roll this out on an initial and ongoing basis. *Note: In relation to greenwashing risk in particular, this is recommended.*



## New sustainability preferences regime

### Summary

As noted above, we see three strands to the ESG changes to MiFID II. The third strand is the new MiFID sustainability preferences regime. Depending on your business model, this may have a direct impact or affect you as outlined below:

- **Direct impact** – It will apply directly to you if you are a firm or bank with:
  - a private banking arm;
  - a wealth management arm that provides advisory or portfolio management services to retail; and/or
  - an asset management arm, whether retail or institutional.

– **Other ways it could affect you** – It may affect you if you manufacture products which are sold to or distributed via one of those types of firms – eg:

- if you manufacture structured products that are sold on an advised basis to retail clients in the EU; or
- if you sell structured products or derivatives to an EU portfolio manager, acting for an institutional client.

Industry discussions may focus on this potential impact over the coming months as thinking develops and proportionate approaches may be adopted.

### Detailed overview for sell side firms – other ways it could affect you<sup>20</sup>

<b>Timing</b>	<p>Firms directly affected by the new regime have to comply from <b>2 August 2022</b>, when the new law comes into force.</p> <p>As regards manufacturers, we would expect knock on impacts at minimum on/from this time.</p> <p>That said, however, advisers and managers may feel they need to move well ahead of this deadline – ie to ask manufacturers for information and/or impose new requirements ahead of this time, so they are ready to begin to comply with the new law by 2 August. We therefore recommend you begin to engage with relevant third party firms as soon as possible to understand their timelines and information needs, and integrate these into your own planning.</p> <p>Overall, this strand of the ESG changes to MiFID II is expected to require considerable thought and work between now and Q3 2022.</p>
<b>Purpose of new law</b>	<p>As noted above, the main goal here is to “turbo charge” the European Commission’s efforts to redirect private capital into efforts to “green” the EU.</p> <p>A second goal relates (again) to greenwashing risk:</p> <p><i>“It is necessary to address concerns about ‘greenwashing’, that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial instrument as environmentally friendly or sustainable, when in fact that financial instrument does not meet basic environmental or other sustainability-related standards. In order to prevent mis-selling and greenwashing, investment firms should not recommend or decide to trade financial instruments as meeting individual sustainability preferences where those financial instruments do not meet those preferences. …”</i> (recital 7)</p> <p><i>“[advisers and managers] should have in place appropriate arrangements to ensure that the inclusion of sustainability factors in the advisory process and portfolio management does not lead to mis-selling practices or to the misrepresentation of financial instruments or strategies as fulfilling sustainability preferences where they do not”</i> (recital 4)</p> <p><i>“[advisers and managers] shall have in place … adequate policies and procedures to ensure that they understand the nature [and] features, including … risks of … financial instruments selected for their clients, including any sustainability factors….”</i></p> <p>A key takeaway point here for manufacturers is the need of firms in a “point of sale” relationship with end-clients to obtain from you the information they need to mitigate the risk of mis-selling and greenwashing mentioned above, and their need to thoroughly due diligence products for the same purpose.</p> <p>Industry working group discussions may focus on proportionate approaches in this context.</p>

<sup>20</sup>The following section of this bulletin focuses on the latter but for a copy of our bulletins on the former (eg for wealth managers/private banks, and for asset/fund managers), please ask your usual A&O contact.

<p><b>What is required?</b></p>	<p>Under the new regime, going forward, it will be <b>mandatory</b> for all investment advisers and portfolio managers, both retail and institutional, to:</p> <ul style="list-style-type: none"> <li>– capture information about a client's <b>sustainability preferences</b>; and</li> <li>– where a client has such preferences, to comply with them when conducting transactions or recommending products.</li> </ul> <p><i>"An investment firm shall not recommend financial instruments or decide to trade such instruments as meeting a client's or potential client's sustainability preferences when those financial instruments do not do meet those [sustainability] preferences".</i></p> <p><b>Examples</b></p> <ul style="list-style-type: none"> <li>– If you manufacture structured products that are sold on an advised basis to retail clients in the EU, the private bank or other distributor: <ul style="list-style-type: none"> <li>– may require you to provide it with information to enable it to ensure it only sells your product to underlying clients where the ESG credentials of your product (if any) are a match to the sustainability preferences of its underlying clients (if any);</li> <li>– may say it needs or wants your products to incorporate certain</li> </ul> </li> <li>– Going forward, if you sell derivatives or structured products to an EU portfolio manager acting for an institutional client, and that client indicates it only wishes to have products in its portfolio that match its sustainability preferences, the portfolio manager: <ul style="list-style-type: none"> <li>– will require you to provide it with information to enable it to ensure it matches relevant products with the client's sustainability preferences;</li> <li>– may need to exit products that do not match those preferences;</li> <li>– may say it needs relevant products to incorporate certain ESG creds going forward, to match the actual or expected sustainability preferences of its underlying clients.</li> </ul> </li> </ul>
<p><b>Key concepts</b></p>	<p><b>What does the term “sustainability preferences” mean?</b></p> <p>“sustainability preferences” means a 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:</p> <ul style="list-style-type: none"> <li>(a) a financial instrument for which the client ... determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of [SFDR];</li> <li>(b) a financial instrument for which the client ... determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of [SFDR];</li> <li>(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 ... ”.</li> </ul> <p><b>What does this mean in practice?</b></p> <p>The concept of a sustainability preference has two levels:</p> <ul style="list-style-type: none"> <li>– <b>Level 1</b> – Yes or no, does the end-client want all or some of its products to fall within one or more of the following categories: <ul style="list-style-type: none"> <li>– <b>Category 1</b> – a financial instrument for which a minimum portion must be invested in environmentally sustainable investments as per the Taxonomy Regulation.</li> <li>– <b>Category 2</b> – a financial instrument for which a minimum portion must be invested in sustainable investments as per SFDR.</li> <li>– <b>Category 3</b> – a financial instrument whose manufacturer considers principal adverse impacts or PAI on sustainability factors.</li> </ul> </li> <li>– <b>Level 2</b> – If yes, then the end-client has to say essentially how much: <ul style="list-style-type: none"> <li>– For category 1 and 2, the client has to determine the minimum proportion – presumably from a range of options given to them.</li> <li>– For category 3, the client has to determine what quantitative or qualitative elements will be required to demonstrate the consideration of PAI elements – again, presumably from a range of options given to them.</li> </ul> </li> </ul>

<p><b>What do these other concepts mean?</b></p>	<p><b>“Environmentally sustainable investment”</b></p> <p>This means “an investment in one or several economic activities that qualify as environmentally sustainable under [the Taxonomy] Regulation” – ie a investment in something considered “green” under the EU’s classification system.<sup>21</sup></p> <p>In very general terms, something is environmentally sustainable if it meets 4 tests: (1) it contributes to one of the six key Taxonomy Regulation environmental objectives; (2) it does not significantly harm any of those objectives (<b>DNSH</b>); (3) it complies with minimum safeguards; (4) it complies with technical screening criteria.<sup>22</sup></p> <p>This is an onerous test, involving a consideration of detailed technical requirements developed by the European Commission in the form of Level 2 requirements under the Taxonomy Regulation.</p>
	<p><b>“Sustainable investment”</b></p> <p>This refers to a sustainable investment under SFDR. This is defined as follows:<sup>23</sup></p> <p><i>“sustainable investment” means an investment in an economic activity that contributes to an environmental objective … or an investment in an economic activity that contributes to a social objective … , provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance”.</i></p> <p>In shorthand, we think of this as “E or S + DNSH + G”.</p>
	<p><b>“Principal adverse impacts” on “sustainability factors”</b></p> <p>The concept of principal adverse impacts or PAI comes from SFDR:</p> <p><i>“Principal adverse impacts should be understood as those impacts of investment decisions and advice that result in negative effects on sustainability factors.”<sup>24</sup></i></p> <p>Plus as above, “sustainability factors” has the following meaning as per SFDR: “sustainability factors’ mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters”.<sup>25</sup> (In shorthand, we may think of this as essentially “ESG” - E (environment), S (social), G (governance).)</p> <p>So in shorthand, we may think of PAI as a concern with the negative externalities of a particular investment or product.</p> <p>In the new sustainability preferences regime, this concept can apply to any type of MiFID II product, not just those in scope of SFDR. Eg a manufacturer of a structured product or CLO could consider PAI factors and provide information, reporting etc on a voluntary basis, possibly to track the requirements of SFDR or possibly on another bespoke/agreed basis.</p> <ul style="list-style-type: none"> <li>– <b>Sample scenario 1:</b> An institutional investor invest GBP100 million in a structured product, 10% of the underlying of which comprises shares in oil and gas companies - this may give rise to a negative effect on the environment via climate change issues. But the manufacturer of the structured product says it considers principal adverse impacts or PAI by 100% active/specific engagement to force them to transition their businesses to net zero by a specified date, with hard internal targets by 2025, 2030 etc, rigorous climate change KPIs for all senior executives, regular meetings with the CEO, engagement with other shareholders, putting specific people on the company board that will push the transition agenda etc.</li> <li>– <b>Sample scenario 2:</b> An institutional investor invests GBP100m in a structured product, the manufacturer of which says they do not invest in shares in companies whose businesses have a significant negative effect on the environment.</li> </ul>

<sup>21</sup> Article 2(1), Taxonomy Regulation – see <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852>.

<sup>22</sup> See Article 3 of the Taxonomy Regulation (“Criteria for environmentally sustainable economic activities”): “For the purposes of establishing the degree to which an investment is environmentally sustainable, an economic activity shall qualify as environmentally sustainable where that economic activity: (a) contributes substantially to one or more of the environmental objectives set out in Article 9 in accordance with Articles 10 to 16; (b) does not significantly harm any of the environmental objectives set out in Article 9 in accordance with Article 17; (c) is carried out in compliance with the minimum safeguards laid down in Article 18; and (d) complies with technical screening criteria that have been established by the Commission in accordance with Article 10(3), 11(3), 12(2), 13(2), 14(2) or 15(2).”

<sup>23</sup> Article 2(17) SFDR.

<sup>24</sup> Recital 20 SFDR

<sup>25</sup> Article 2(24) SFDR.

## Implementation steps

- The new regime is incredibly complex and innovative, and it is not yet clear how advisers and portfolio managers will seek to implement the new requirements in practice.
- Two initial recommendations:
  - Engage to the extent you can, first, with industry working groups and trade bodies working in the industry to develop “solutions”, and secondly, with the main advisers and portfolio managers you sell to or through, to understand how they are approaching this regime and what may work with them in practice going forward.
  - A “gating” question for all manufacturers is whether you wish to “lean in” to the new requirements (and ESG generally), seeking to actively respond to the commercial opportunity and market appetite for ESG friendly products and the new sustainability preferences regime. Alternatively, you may wish to do the minimum required to “tick off” any applicable requirements but focus on other market segments or opportunities in the industry.
- More broadly, you may wish to consider the following:
  - Establish a working group to conduct relevant implementation work.
  - Build awareness in relevant internal teams as regards the new regime.
  - Map how this may work across your product range – eg:
    - Consider what opportunities there may be for any existing or new products to be revised or developed to fall within one of the three sustainability preferences categories.
    - Consider what information, reporting etc could be offered and on what basis (eg contractual undertaking, best efforts, reasonable efforts etc).
    - Consider how you would deal with changing positions
      - eg a product falls within a client’s sustainability preferences on day 1, but there is a change on day 30.
    - Consider what legal, operational, regulatory and reputational risks may arise.
  - Prepare a project plan to conduct any necessary internal work.
  - Consider any data needs, and if changes are required, what additional third party data may be required and how this may be sourced.
  - Determine (as noted above) whether you wish or need to “lean into” the new sustainability preferences regime, or wish to take a more “hands off” approach at the outset.

## UK position post-Brexit

For completeness, it is worth noting that whilst the FCA has not stated that it will amend the UK version of MiFID II and the other relevant directives to reflect the new ESG requirements discussed in this bulletin, both the FCA’s strategy regarding its ESG priorities (as published at the start of November 2021) and Discussion Paper DP21/4 make clear that the regulator is focused on the same areas. The FCA intends to work closely with government and proposals are expected in due course.

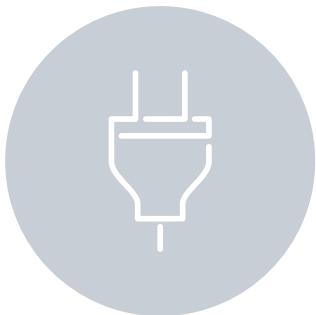


## Recommendations

In terms of what firms should be doing now:



Get up to speed on the new requirements and establish an internal team to run your implementation project



Ensure you are “plugged in” to industry work on the new law



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

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.

