MAPLES GROUP

UPDATE

MiFID Sustainability Preferences: Putting ESG at the Centre of the Sales Process

A wide range of new EU sustainable finance measures come into force on 1 August 2022. In total, there are five Commission Delegated Regulations and two Commission Delegated Directives (collectively the "Delegated Acts"). They integrate sustainability issues and considerations into the following EU legislative regimes:

- UCITS Directive 2009/65/EC;
- AIFMD 2011/61/EU;
- MiFID II 2014/65/EU;
- Solvency II Directive 2009/138/EC; and
- Insurance Distribution Directive /2016/97/EU.

The Delegated Acts complement the obligations in Regulation (EU) 2019/2088[1] ("SFDR") and Regulation (EU) 2020/852[2] ("Taxonomy Regulation") and form part of the European Commission's 'ambitious and comprehensive' package of measures to help improve the flow of money towards sustainable activities across the EU. For further details, please see our previous Sustainable Finance: New EU Delegated Legislation[3] client update.

MiFID ESG Changes

One specific aspect of the Delegated Acts is: (i) Commission Delegated Regulation (EU) 2021/1253[4] (the "MIFID ESG Regulation"); and (ii) Commission Delegated Directive (EU) 2021/1269[5] ("MIFID ESG Directive") to integrate sustainability considerations into the suitability assessment and product governance obligations under MIFID II.

This update examines the changes under the MIFID ESG Regulation on suitability assessment obligations and considers how this may impact the distribution of ESG-focused investment funds in the EU.

Sustainability Preferences

MIFID II currently provides that when an investment firm offers investment advice or portfolio management services to a client, it is first required to obtain information on (among other things): (i) the client's investment objectives (i.e. financial objectives); and (ii) the client's risk tolerances, in order to be able to recommend suitable investments.

Under the MiFID ESG Regulation, it will also be mandatory to obtain information and assess investment suitability on the basis of a third element, that is, the client's sustainability preferences.

In terms of expressing a client's sustainability preferences, the MiFID ESG Regulation outlines three categories of sustainability for investment products that it considers should be integral to a client's sustainability preferences, as summarised below:

- **Environmentally sustainable investments** - Financial instruments that pursue a minimum

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN
[3] https://maples.com/en/knowledge-centre/2021/8/sustainable-finance-new-eu-delegated-legislation
[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1253&from=EN
[5] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021L1269&from=EN

proportion of sustainable investments in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation;

- **Sustainable investments** - Financial instruments that pursue a minimum proportion of sustainable investments, as defined in Article 2, point (17), of SFDR, where the minimum proportion is determined by the client or potential client; and
- **Investments that consider sustainability factors** - Financial instruments that consider principal adverse impacts ("PAIs") on sustainability factors, where elements demonstrating that consideration are determined by the client or potential client.

Investors will be asked if they want their investment to have one or more of these features and if so, how much of each. Distributors will then have to make investment recommendations based on these preferences relating to sustainability. These three sustainability preference categories are separate and distinct. So, in theory, one investor could express a preference only for "*environmentally sustainable investments and investments that consider sustainability factors*" and another could express a preference for only "*sustainable investments*". The investor may set its own minimum proportion for "*sustainable investments*" or its own elements to demonstrate that PAIs are being considered.

A financial product that meets all three criteria will be best placed to be recommended for investment. However, matching financial products to what could be highly specific and aspirational preferences could be quite a challenge and it may, therefore, be quite difficult to design a financial product that is fully 'sustainability preferences' eligible in all cases.

To add to the complexity, under the MIFID ESG Directive, firms that are in scope of MIFID II product manufacturer obligations will need to consider the sustainability related objectives of clients when identifying a target market for the financial product – effectively coming at the issue from the opposite direction of the investor.

No Alignment with SFDR Categorisations

This will not simply be a case of asking an investor whether they would like to invest in product is categorised as Article 6, Article 8 or Article 9 under SFDR.

Two of the three categories reflect a drill down, through the financial product, to the level of underlying exposure to: (a) taxonomy aligned environmentally sustainable investments; or (b) sustainable investments more generally, i.e. including non-taxonomy aligned. The third category relates to financial products that consider the PAIs of investments on sustainability factors.

In an explanatory memorandum[6] to an earlier draft of the MIFID ESG Regulation, the European Commission noted that certain Article 8 products "*might lack sustainability-related materiality".* It is thus acknowledged that certain SFDR Article 8 products will not align with a client's sustainability preferences, per the extract below:

"…*financial instruments that promote environmental or social characteristics without a proportion of sustainable investments or without a proportion of investments in taxonomy-compliant activities or where they do not consider principal adverse impacts will not be eligible for recommendation to the clients or potential clients based on their individual sustainability preferences*."

In effect, only the more materially ESG-focused products will be eligible for recommendation to the clients who express clear sustainability preferences.

ESMA Guidance

ESMA has provided some useful guidance on this issue in its revised guidelines[7] on MIFID II suitability requirements that are currently under consultation. It proposes ranking and grouping products across a spectrum for the three investor sustainability preference categories. Recognising that many

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=PI_COM:C(2021)2616&from=EN
[7] https://www.esma.europa.eu/sites/default/files/library/esma35-432998_consultation_paper_on_review_mifid_ii_guidelines_on_suitability.pdf

investment funds will not meet investor preferences when they are expressed in the abstract and without regard to the types of investment funds available, ESMA has proposed the option of getting the investor to adapt their preferences.

How this aspect is formulated in the finalised guidelines could be critical to how distributors can match investor preferences with available financial product options, at least in the short term, as the regime change comes on stream.

Non-ESG Financial Products

Other financial products can still be offered to clients, but they will not be eligible for recommendation to clients that have expressed specific sustainability preferences.

SFDR Article 8 Financial Products Implications

This could be a key consideration when assessing the merit of investment funds categorised as Article 8 financial products under SFDR that: (a) do not make a quantitative commitment to investment in sustainable investments and / or; (b) do not consider PAIs on sustainability factors.

If we explore this to its logical conclusion, it is reasonable to determine that, in time, a simple Article 8 categorisation will not be considered sufficiently ESG focused (or 'green enough') to meet the sustainability preferences of clients investing through MIFID distribution channels.

What could potentially emerge is a split between 'Article 8 Lite' and 'Article 8+ categories of funds – with only the latter (in addition to Article 9 funds) having the necessary level of 'sustainability-related materiality' in order to be able to meet one or more of the three criteria to be eligible for recommendation to clients that have expressed sustainability preferences to their distributors / sales advisers.

Impact on Demand for ESG Financial Products

Systematically asking investors, at the outset of the sales process, to indicate specifically if they have a preference for ESG products, in the detailed way prescribed, could cause a radical shift in the demand levels for ESG financial products.

This could also be an important factor for Level 2 of SFDR (in force from 1 January 2023) and play a part in how firms develop detailed disclosures for ESG-focused funds' prospectuses, websites and periodic reports.

Further Information

Further information on our Irish Financial Services Regulatory Group, and the services we provide is available on our website[8] and in our brochure[9].

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[8] https://maples.com/en/services/specialty-services/irish-financial-services-regulatory
[9] https://maples.com/-/media/files/pdfs/articles-and-chapters/financial-services-regulatory-group---core-services.pdf