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

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

Executive Summary

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

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

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

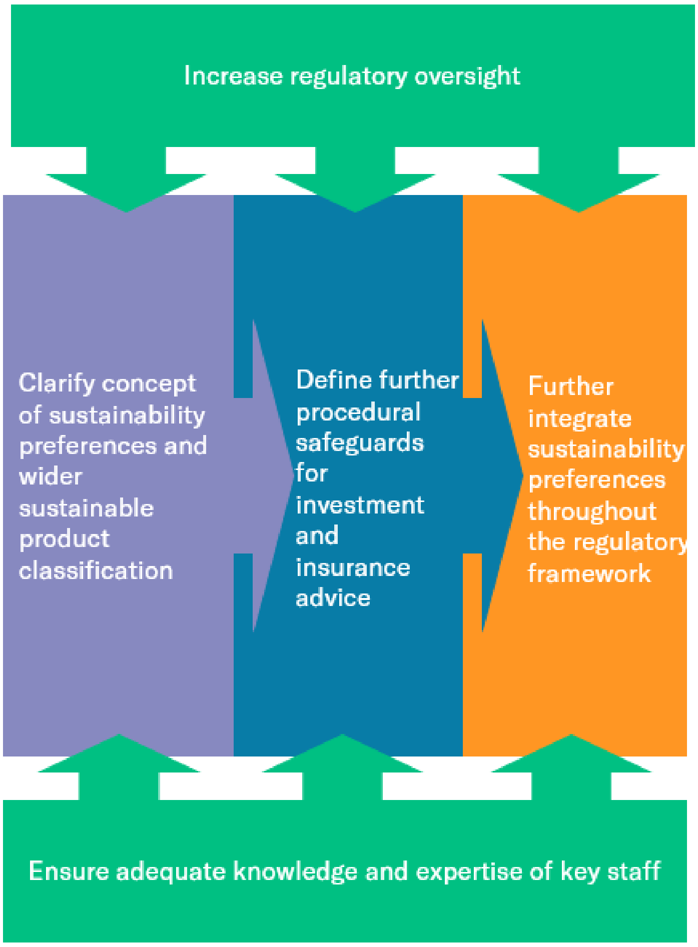
This paper analyses the extent to which these regulatory changes contribute to these dual objectives. It discusses first the current state of evidence in relation to client preferences for sustainable investment and how the market is responding. It then reviews the regulatory changes to comment on the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

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

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

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

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



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

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About

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

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

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

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The project leading to this application has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 894345.

Introduction

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

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

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

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

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

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

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

Section 1

Advancing sustainable finance through client preferences for sustainable investment

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

1.1 Client preferences for sustainable investment are increasing

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

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

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

Level of interest in sustainable finance

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

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

Typical sustainability goals and topics

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

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

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

The responses allow several important observations:

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

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

Table 1: List of sustainability topics[5]

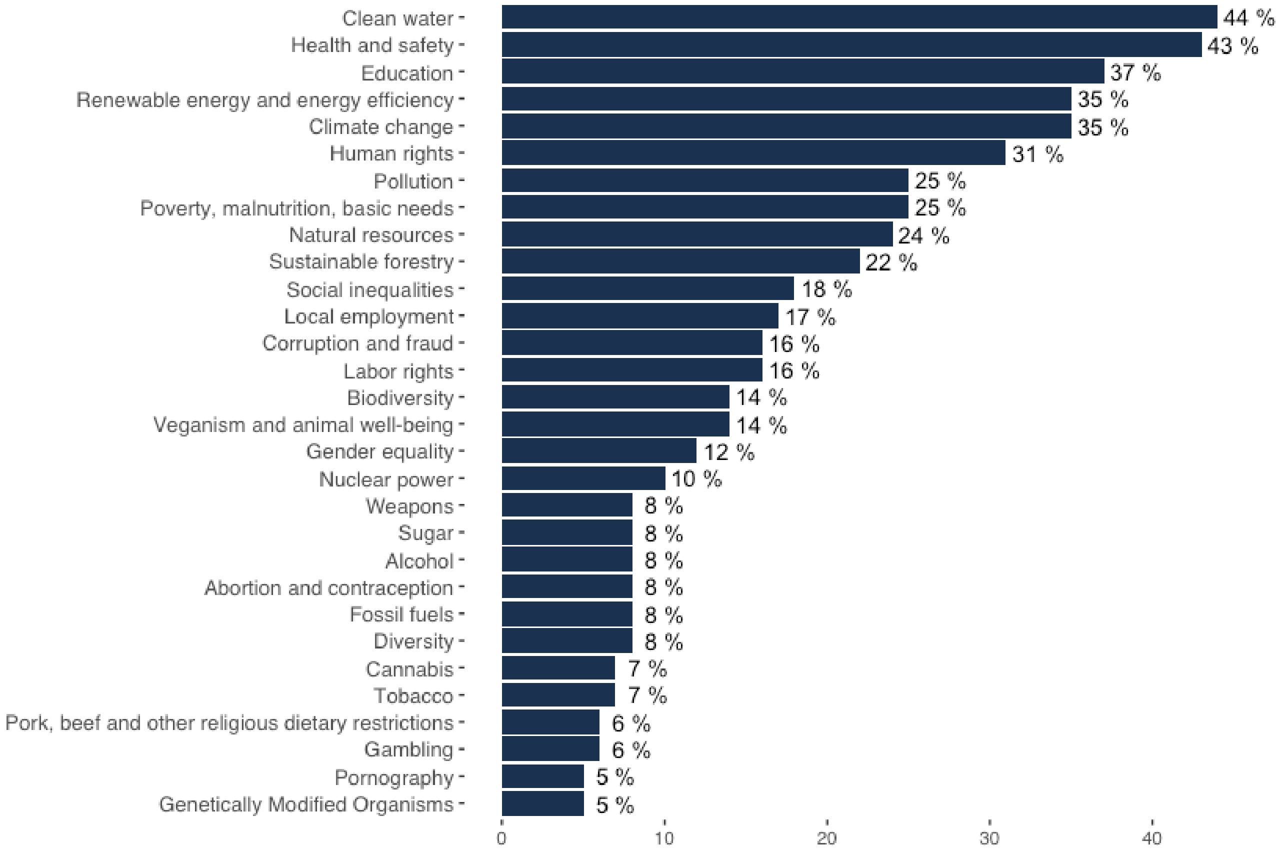
Environmental topics	Social and governance topics	Ethical topics
Climate change	Human rights	Veganism and animal well-being
Fossil fuels	Education	Weapons
Renewable energy and energy efficiency	Health and safety	Alcohol
Nuclear power	Gender equality	Sugar
Biodiversity	Diversity	Abortion and contraception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

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

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

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

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



Understanding of financial trade-offs

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

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

Information Box: Overview of 2021 survey results

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Financial advisor consideration of client preferences for sustainable investment

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

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

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

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

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

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

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

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

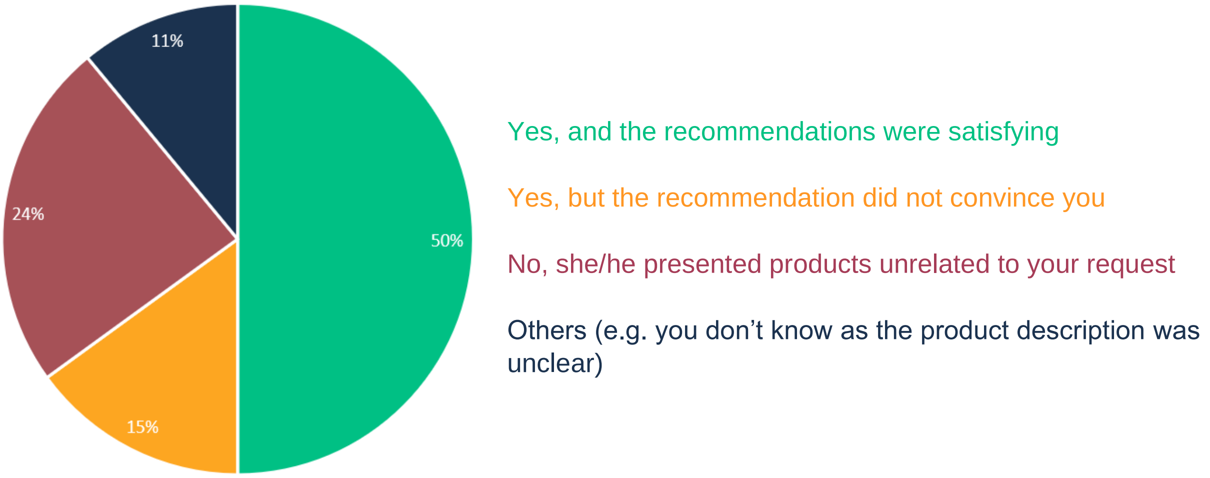
[11] Delegated Regulation (EU) 2021/1253

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

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

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

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



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

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

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

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

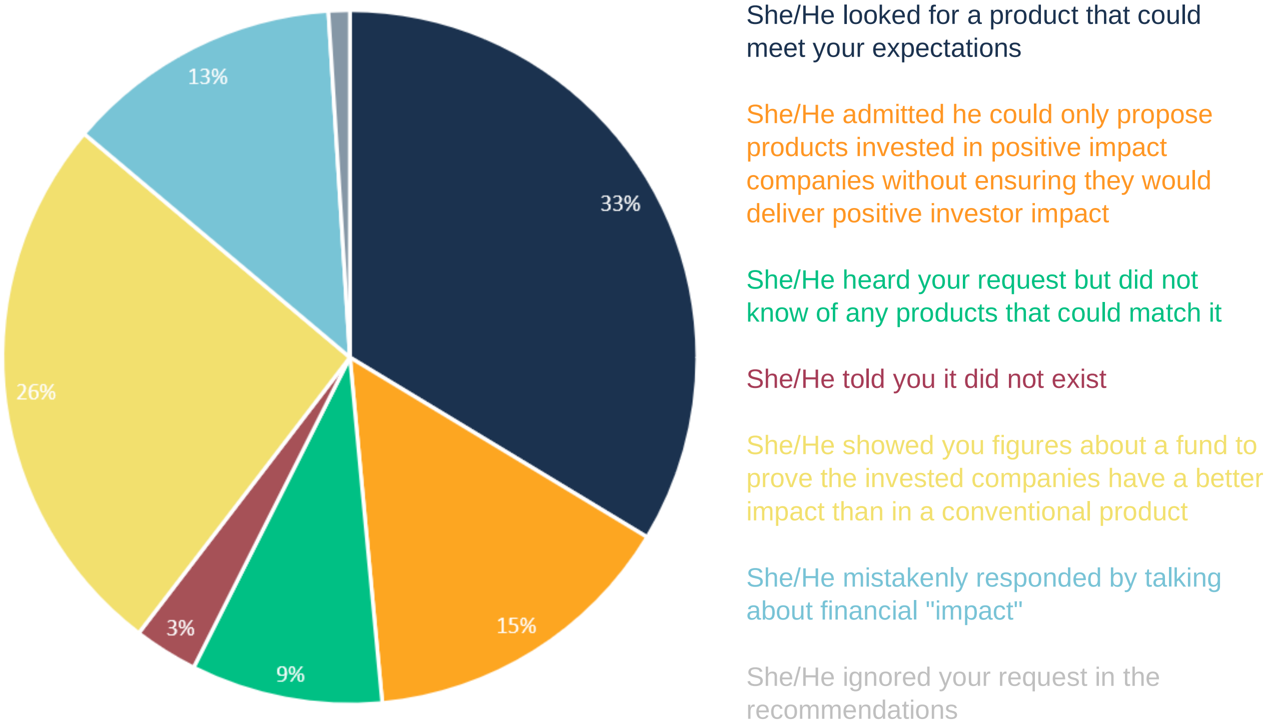
Investor impact thus corresponds to the change(s) induced through using different financial products in the impact of invested companies. Investor impact and invested companies' impact should always be segregated as being two different concepts not fully correlated across each other. An investor might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

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

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

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

Figure 3: Financial advisor responses to client motivation for impact



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

Financial advisor influence on client expression of preferences for sustainable investment

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

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

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

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

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

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

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

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

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

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

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

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

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

Next phase for EU sustainable finance policy making

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

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

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

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

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

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

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

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

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

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

Section 2

Regulatory landscape for financial institution legal duties to clients

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

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

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

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

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

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

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

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

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

[23] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012

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

[25] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

[26] Article 4(1)(a) AIFMD

[27] Directive 2016/97/EU of the European Parliament and of the Council of 20 January 2016 on insurance distribution

[28] Commission Delegated Regulation 2015/35/EU of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

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

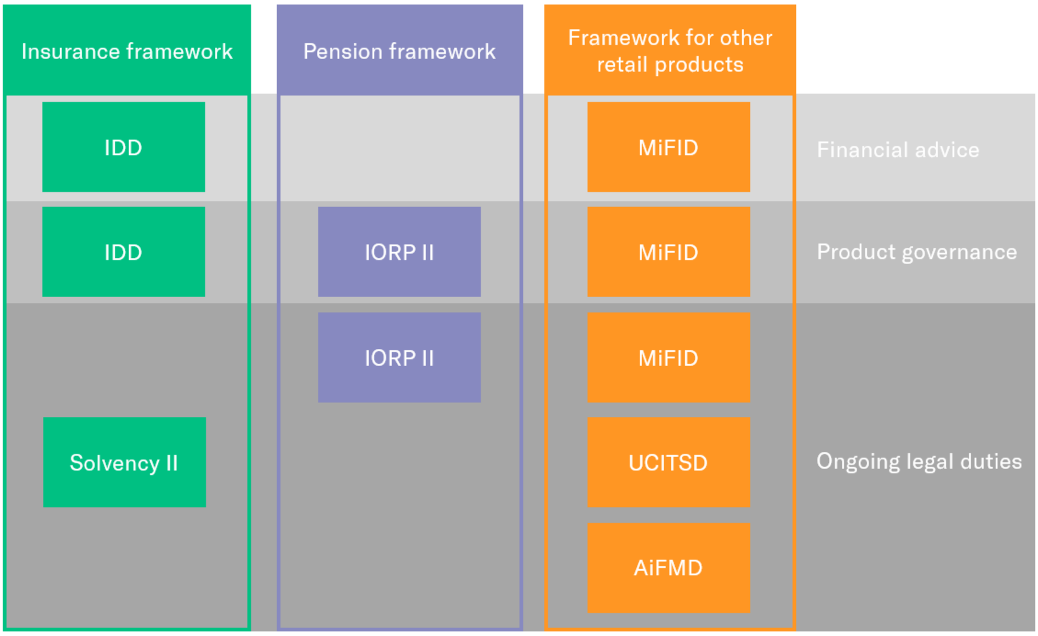
Note that *Table 2* does not cover all the EU legislation relevant to all possible financial products and services which retail clients can access. For example, it does not cover the Consumer Credit Directive[30], Mortgage Credit Directive[31], pan-European Personal Pension Product regulation[32] and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

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

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

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

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



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

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

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

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

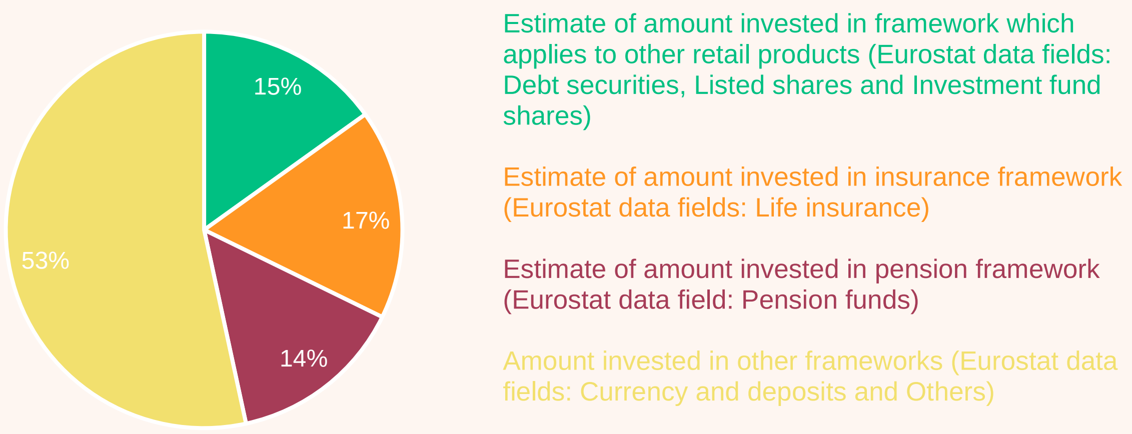
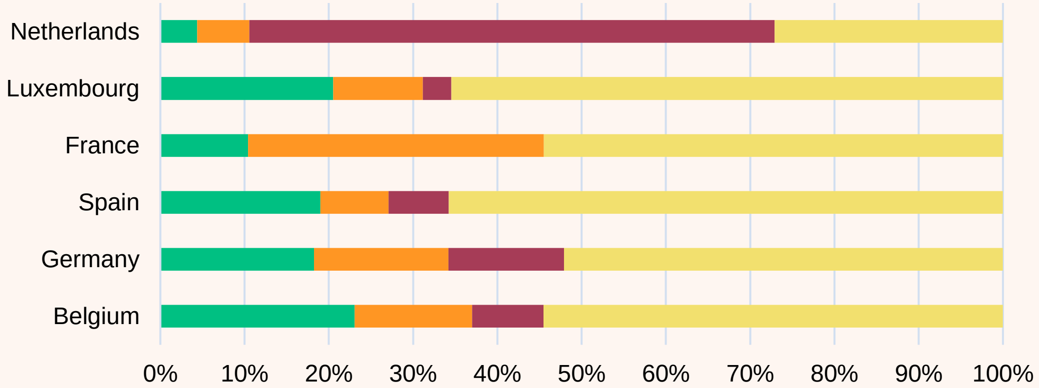


Figure 6: Variation in relative amounts invested under the insurance framework, the pension framework and the framework for other retail products by Member State (Source: Eurostat, Legend as for Figure 5)



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

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

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

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

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

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

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

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

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

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

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

Introduction of sustainability preferences into investment and insurance advice

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

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

MiFID suitability assessments to consider sustainability preferences

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

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

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

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

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

IDD suitability assessments to consider sustainability preferences

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

Integration of sustainability factors into product governance obligations

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

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

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

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

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

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

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

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

The MiFID Product Governance Amendments also require product manufacturers to:

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

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

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

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

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

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

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

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

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

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

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

Clarification of ongoing legal duties

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

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

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

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

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

'sustainability risk' means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment[70]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

For each Member State covered by this paper, Annex 1 provides information on regulatory oversight and enforcement powers in relation to sustainability related financial regulation together with actual cases of enforcement powers being exercised and sustainability enforcement trends. However, given that we are now in the transitional period for all the delegated acts in the April Package, it is too soon to form a view on implementation of these specific regulatory changes at national level.

[84] The delegated regulations referred to in this paper are binding in their entirety and directly applicable in all Member States from 1 August 2022 (for the AIFMD Amendments) or 2 August 2022 (for the MiFID II Amendments, IDD Amendments and Solvency II Amendments).

[85] For the delegated directives referred to in this paper, Member States are required to adopt the laws, regulations and administrative provisions necessary to comply and apply those provisions from 1 August 2022 (for UCITSD Amendments) and 22 November 2022 (for MiFID II Product Governance Amendments).

Section 3

Weak integration of client preferences into financial institution legal duties

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

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

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

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

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

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

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

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

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

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

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

3.2 Concept of sustainability preferences lacks clarity

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

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

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

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

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

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[90] With the exception that underlying assets may also be for specific purposes such as hedging or liquidity (although there are currently limited rules and guidance on the product design, strategies, methodologies, and thresholds to be applied in such circumstances).

[91] https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_application.pdf

[92] Morningstar, 2021, Global Sustainable Fund Flows: Q3 2021 in Review

[93] The explanatory memorandum to the MiFID Amendments recognises that '[w]hilst financial products referred to in Article 9 of the SFDR must pursue the objective of sustainable investments … financial products that fall under Article 8 of the SFDR might integrate different strategies, even including those that, despite claiming environmental, social and governance (ESG), socially responsible investing (SRI) or sustainability orientation, might lack sustainability-related materiality.'

The key point here is that sustainability preferences are not defined as a simple preference for the different product categories established in the SFDR, but rather different types of financial product categories established in the SFDR *may* match sustainability preferences if they satisfy the criteria in the definition of sustainability preferences (and this is a separate assessment to categorisation for SFDR purposes). But given the existing momentum behind SFDR product categorisation and current market behaviour in this area, there is a risk that this feature of the definition of sustainability preferences might be lost, and investment firms might pursue a strategy of matching categories of sustainability preferences with SFDR categories of financial products.

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

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

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

Information Box: Wider sustainability motivations

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

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

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

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

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

3.3 Risk of influence for investment and insurance advice

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3.5 Poor regulatory oversight of financial institution compliance with legal duties

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

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

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

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

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

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

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

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

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

Section 4

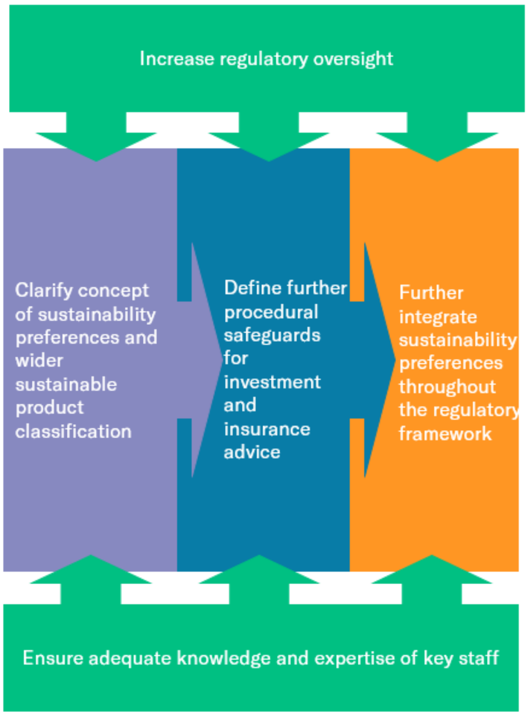
Recommendations

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

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

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

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



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

4.1 Clarify concept of sustainability preferences and wider sustainable product classification

The concept of sustainability preferences is the (single) conceptualisation in the regulatory framework of the (multiple) ways in which client preferences for sustainable investment can exist. According to the regulatory concept, client preferences for sustainable investment is a preference for one of three types of financial product. But this concept does not accommodate impact-oriented financial instruments – therefore assessing sustainability preferences will not reveal if a client is impact-oriented and cannot result in recommending an impact-oriented financial product (see *Section 3.1 Impact-oriented financial products are not properly accommodated in the concept of sustainability preferences*). And neither does the concept accommodate a client's wider sustainability motivations (see *Section 3.2 Concept of sustainability preferences lacks clarity*). Furthermore, lack of clarity in this definition may result in variable approaches to how financial institutions categorise their products for clients. This variability will work against comparability across the market and will work against the consumer protection objective.

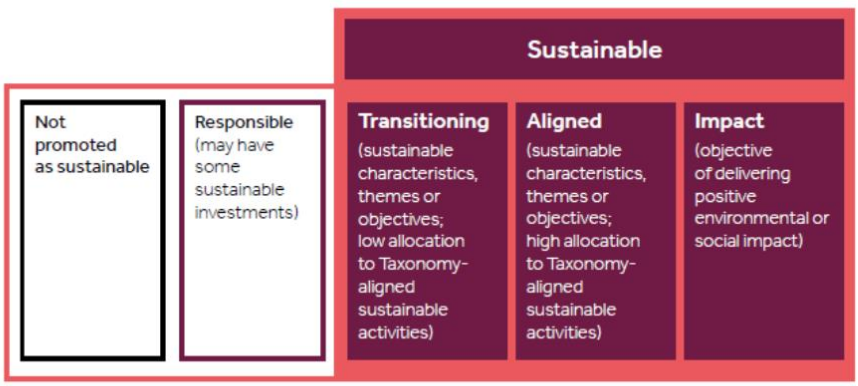
Because of the poor definition of sustainability preferences, there are weaknesses associated with how financial institution legal duties to clients are conceived right from the outset. Clarifying the definition of sustainability preferences in a manner which accommodates impact-oriented financial products and takes account of wider sustainability motivations is a critical first step.

In the UK, the FCA has recently consulted on a proposed approach to a sustainable product classification and labelling system.[104] There are several aspects to the FCA's policy proposals which can serve as inspiration for how to clarify the confusion in the EU financial regulatory framework.

First, the potential labelling system differentiates between *Impact* financial products (that aim to deliver positive environmental or social impact) and other types of sustainable financial products such as *Transitioning* and *Aligned* investment products (which can have varying degrees of sustainability). According to this classification, impact-oriented products are clearly demarcated as a separate category – and therefore much easier to identify and recommend for an impact-oriented client.

Second, the FCA is planning to develop detailed minimum criteria which are linked to tangible product features which determine how to categorise each financial product. For example, both *Sustainable-Transitioning* and *Sustainable-Aligned* are structured with underlying assets meeting sustainability criteria set out in the forthcoming UK Taxonomy, but the minimum proportion for *Sustainable-Aligned* is set at a higher level than for *Sustainable-Transitioning*.

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



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

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

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

As mentioned, the ESAs have requested clarification of the financial product classification under SFDR. While the Commission has responded to this request, that response has not shed much light on the topic. In addition, it remains to be seen what effect the departure from a simple correspondence to Article 8 and Article 9 which is evident in the definition of sustainability preferences will have. Furthermore, the regulatory technical standards under SFDR have only recently been released[105] and further delegated acts for the Taxonomy Regulation are still being developed.

Currently, the review period articulated in the SFDR is 30 December 2022 but, given the various delays associated with other sustainable finance regulation, it seems unlikely the Commission will comply with that initial timescale. What is clear though is that this is still an area with a high degree of regulatory uncertainty and this review of the SFDR is an opportunity to provide clarification.

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

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

4.2 Detail further procedural requirements for investment and insurance advice

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

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

[105] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/sustainability-related-disclosure-financial-services-sector_en As at the date of this paper, this legislation is now subject to scrutiny by the European Parliament and the Council. They are scheduled to apply from 1 January 2023.

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

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

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

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

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

However, national financial regulators also have a role to play in ensuring the suitability assessment is conducted in the right way and with a faithful adherence to the intended regulatory changes. National financial regulators are directly responsible for ensuring the appropriate degree of regulatory oversight and there is nothing to prevent their own publishing of guidance and supervisory expectations regarding the conduct of the suitability assessment. In this regard, our recent mystery shopping research[106] sets out seven more detailed recommendations about specific topics which regulator guidance or supervisory expectations could focus on.

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

[106] 2DII, 2022, Please Don't Let Them Be Misunderstood!

Information Box: A default suitability questionnaire and guidance

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

2DII outreach to financial institutions and what we have observed at public events[107] leads us to believe that many financial institutions are struggling to progress on implementing the organisational changes required to comply with the new suitability assessment requirements. Anecdotal evidence suggests that the current state of knowledge among financial institutions is not what it should be to ensure implementation is successful and supportive of the overarching policy objective.

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

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

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

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

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

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

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

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

4.3 Further integrate sustainability preferences throughout the regulatory framework

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

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

The pension framework already requires financial institutions to invest in accordance with prudent person rules which define what assets the financial institution can invest in, and that assets should be invested in the long-term best interest of members and beneficiaries. It would be relatively simple to integrate the concept of sustainability preferences here.[108] What is potentially more difficult (although still readily achievable) is establishing a means by which members and beneficiaries can express their sustainability preferences as currently there is no equivalent of the suitability assessment as for insurance and investment advice.

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

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

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

In addition to the proposals to integrate sustainability preferences into the pension framework, the Commission should also complete the integration of sustainability preferences throughout the regulatory frameworks referred to in this paper.

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

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

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

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

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

However, this guidance will only apply to the new suitability assessment requirements. For the other regulatory changes, these supervisors should assess what supervisory tools could be relevant. ESMA has a practice of releasing Q&As as an additional form of guidance on the acts within ESMA's remit. ESMA also publishes Strategic Orientation documents which set out ESMA's future focus and objectives over a defined period. The most recent Strategic Orientation document[109] stated that ESMA will co-ordinate mystery shopping on retail investment products, develop retail risk indicators and collect analyse and report on consumer trends. Each of these tools can assist with setting supervisory expectations and ensuring compliance with regulation.

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

National regulators can look to their own toolbox for how to set expectations around compliance through their regulatory mandates. Possible actions might include (depending on the jurisdiction) releasing supervisory statements, so called "Dear CEO letters" or articulating a specific focus in thematic reviews. National regulators in some jurisdictions are also starting to carry out mystery shopping campaigns (e.g. the AMF in France has been carrying out mystery shopping since 2011 to assess the conditions under which financial products are marketed[110]).

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

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

[109] ESMA, 2020, ESMA Strategic Orientation 2020-22 (published following the outcome of the ESAs Review granting ESMA new powers and responsibilities)
[110] https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/first-mystery-shopping-campaigns-under-mifid-ii-amf-examines-practices-11-retail-banks

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

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

Information Box: MyFairMoney

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

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

Section 5
Conclusion

Clarifying financial institution duties to clients is a cornerstone of the Commission's sustainable finance agenda. Through clarifying that financial institution legal duties to clients are to take account of client sustainability preferences, this should leverage client preferences for sustainable investment in support of reorienting capital towards sustainable investment.

The six amending delegated acts in the *April Package* are the regulatory changes in response to this objective. They are billed as an 'ambitious and comprehensive package of measures to help improve the flow of money towards sustainable activities.'[111] But the legal analysis in this paper reveals a variable extent to which client preferences for sustainable investment have been integrated into financial institution legal duties.

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

Integration of sustainability preferences into legal duties outside of the suitability assessment is patchy and incomplete. Only the insurance framework requires ongoing legal duties to take account of sustainability preferences. There are no regulatory changes to the pension framework. And for the framework for other retail products, ongoing legal duties are clarified by virtue of updating organisational requirements to include sustainability risks and sustainability factors – but there is no integration of sustainability preferences into these legal duties.

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

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

The recommendations in this paper are a direct response to each of the identified weaknesses. First, it is imperative to clarify the concept of sustainability preferences and wider sustainable product categorisation so that the regulatory framework reflects a more accurate conception of client preferences for sustainable investment and a separate category for impact-oriented financial products. Then advisors must be properly incentivised to ensure they respond appropriately to client sustainability preferences through defining further procedural safeguards for the suitability assessment. Further integration of sustainability preferences in all regulatory frameworks (pensions, insurance and other retail products) ensures that legal duties are consistent across the board. Finally increased regulatory oversight and appropriate training for key staff can support and ensure the right enabling environment. Given the objective of clarifying financial institution legal duties to clients to take account of client preferences for sustainable investment, there is still some way to go before this objective is achieved.

[111] https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en

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UCITS

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

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

Commission Delegated Directive (EU) 2021/1270 of 21 April 2021 amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS) **(UCITSD Amendments)**

AIFMD

Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 **(AIFMD)**

Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

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Solvency II

Commission Delegated Regulation 2015/35/EU of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) **(Solvency II)**

Commission Delegated Regulation (EU) 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings **(Solvency II Amendments)**

IDD

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

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IORP II

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

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

Spain

Regulatory oversight of ESG financial regulation

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

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

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

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

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

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

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

Enforcement powers in relation to ESG financial regulation

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

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

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

ESG trends in relation to regulatory enforcement

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

Germany

Regulatory oversight of ESG financial regulation

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

Enforcement powers in relation to ESG financial regulation

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

This includes the following measures:

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

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

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

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

ESG trends in relation to regulatory enforcement

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

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

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

Belgium

Regulatory oversight of ESG financial regulation

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

Enforcement powers in relation to ESG financial regulation

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

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

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

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

ESG trends in relation to regulatory enforcement

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

Luxembourg
Regulatory oversight of ESG financial regulation

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

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

Enforcement powers in relation to ESG financial regulation

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

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

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

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

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

employed by the management company or the UCI who is held responsible, from exercising management functions in those or in other such entities; and
- administrative fines.[112]

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

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

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

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

ESG trends in relation to regulatory enforcement

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

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

France

Regulatory oversight of ESG financial regulation

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

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

These three institutions published recent papers and positions about sustainable finance

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

Since 2011, asset managers must specify in their annual report how criteria relating to compliance with social, environmental and governance quality objectives are taken into account in their investment policy. With the transposition of SFDR, this obligation became more important by adding more information to their investment policy and an extra-financial performance statement.[113]

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

Enforcement powers in relation to ESG financial regulation

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

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

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

ESG trends in relation to regulatory enforcement

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

- In July 2020, AMF published a position concerning information that must be provided by collective investments incorporating extra-financial approaches. The position recommendation sets out the information on the inclusion of non-financial criteria that French collective investment schemes and foreign funds authorised to be marketed in France may disclose. These provisions are set out in the various regulatory documents (key investor information documents, prospectus) and commercial document consultation.[114]
- The general regulation of AMF specify that distributors must ensure compliance with the applicable provisions stemming from Directive 2014/65/EU of 15 May 2014, including those relating to client information, assessment of the suitability or appropriateness of the financial instrument for the client, incentives and the identification and management of conflicts of interest.[115]

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

- In 2019 AMF published a position concerning suitability preferences. The AMF position incorporates ESMA's guidance on certain aspects of MiFID II matching requirements. Thus, AMF currently presents as a good practice the collection of environmental, social, and governance preferences of the clients in the suitability assessment.[116]
- AMF also published a guide on carbon footprint offsetting by collective investment collective investment schemes.[117]

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

Netherlands

Regulatory oversight of ESG financial regulation

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

Enforcement powers in relation to ESG financial regulation

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

This includes the following measures:

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

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

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

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

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

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

ESG trends in relation to regulatory enforcement

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

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

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

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

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

Fighting greenwashing ... what do we really need?

A review of the legislative and regulatory framework applicable to environmental impact claims of financial products and concrete propositions to fight greenwashing more efficiently

2° Investing Initiative

Executive Summary

With increasing client preferences for sustainable investment, it is little surprise to observe a concurrent increase in marketing claims by financial institutions relating to the environmental credentials of their financial products and services.

At the same time, the problem of greenwashing is fast climbing the policy and regulatory agenda. Apart from the consumer protection implications that greenwashing may entail, the issue also casts doubt on whether financial markets are genuinely responding to the changing profile of client preferences for sustainable investment. This distortion of market integrity may even undermine broader sustainable finance policy objectives.

Addressing greenwashing is a key focus for the European Commission and comes despite the raft of sustainable finance disclosure requirements introduced under the Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation and voluntary ecolabels in the finance sector. This emerging body of sustainable finance disclosure requirements does little to assist environmental impact claims for financial products or services.

In the finance sector context, it is useful to distinguish environmental impact claims as a specific sub-category of broader environmental claims which refer to the practice of suggesting or otherwise creating the impression that a financial product or service has a real-economy impact which is positive for the environment (as opposed to broader statements in relation to environmental features which may be evident for a financial product or service).

This paper reviews the regulatory framework which is applicable to environmental impact claims in the finance sector and the extent to which this regulatory framework provides adequate governance of these claims. Several pieces of EU legislation (both finance sector specific regulation and consumer protection regulation) are potentially applicable, though none are sufficient to prevent greenwashing based on environmental impact claims.

While general finance rules are applicable to environmental impact claims in the finance sector, these rules are too general and high level to provide effective governance of environmental impact claims. And sustainable finance rules do not provide further assistance since they are not adapted to regulate environmental impact claims. Indeed, the current sustainable finance regulation does not integrate the concept of investor impact and consequently is not aligned with current academic theories of attribution differentiating investee company impact and investor impact. Even worse, market practices that use SFDR categories as marketing labels may create additional confusion and greater risk of greenwashing, especially when combined with environmental impact claims.

Moreover, consumer protection rules stemming from the Unfair Commercial Practices directive (UCPD) are also not sufficient to regulate environmental impact claims in the finance sector. Indeed, the absence of a definition of environmental impact of the investor and the lack of recognised tools and methodologies to evidence impact prevent the efficient application of UCPD rules in the finance sector.

All these issues identified at EU level are compounded by variability of approach at Member State level. National rules applicable to environmental impact claims show a lack of harmonisation not only in the content of the rules but also in their core logic, creating legal uncertainty for financial institutions and unequal levels of protection for retail investors in Europe.

Further problems for effective governance of environmental impact claims are apparent when analysing regulatory oversight and enforcement and the legal framework for investor redress. Regulatory authorities and retail investors will be confronted with the fact that it is impossible to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions. Moreover, considering it is difficult (or impossible) to prove the loss caused by the misleading environmental impact claim, current investor redress mechanism cannot be efficient.

To address the problems in the current regulatory framework, this paper identifies recommendations which are conceived so that they refine and improve the focus of several initiatives and activities which are already apparent in the EU sustainable finance policy agenda:

- As a first step, the Commission should provide specific rules at EU level to regulate environmental claims in the finance sector with a focus on environmental impact claims.
- Further steps to integrate the notion of environmental impact in the finance sector are necessary. These include: (1) creating a category for impact-oriented products; and (2) developing methodologies and tools to evaluate the impact potential.
- Developing guidance for responsible environmental impact claims can assist financial institutions with regulatory compliance.
- Further research is required to identify suitable adaptations to the redress framework to ensure it is not a barrier to retail investors who want to take action against financial institutions in respect of misleading environmental impact claims.
- Finally, assessing supervisory activities and capabilities in relation to the current regulatory framework to analyse where it impedes the effective discharge of oversight responsibilities in relation to environmental impact claims should assist with enhancing market integrity.

Contents

About

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

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

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

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The project leading to this application has received funding from the European Union's Horizon 2020 research and innovation programme under grant agreement No 894345.

Introduction

With increasing client preferences for sustainable investment, it is little surprise to observe a concurrent increase in marketing claims by financial institutions relating to the environmental credentials of their financial products and services. For sustainability minded retail investors, these environmental marketing claims are likely to impact the decision-making dynamics of whether to invest in financial products and services and will therefore be a key part of a financial institution's marketing strategy. Alongside the growth in environmental marketing claims, the problem of greenwashing is climbing the policy and regulatory agenda. Apart from the consumer protection implications that greenwashing may entail, the issue also casts doubt on whether financial markets are genuinely responding to the changing profile of client preferences for sustainable investment. This distortion of market integrity may even undermine broader sustainable finance policy objectives.

Addressing greenwashing is a key focus for the European Commission and comes despite the raft of sustainable finance disclosure requirements introduced under the Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation[1] and voluntary ecolabels in the finance sector. However, this emerging body of sustainable finance disclosure requirements does little to assist environmental impact claims for financial products or services. Environmental impact claims are a specific sub-category of broader environmental claims and refer to the practice of suggesting or otherwise creating the impression that a financial product or service has a real-economy impact which is positive for the environment (as opposed to broader statements in relation to environmental features which may be evident for a financial product or service)[2]. 2DII research continues to provide empirical evidence that a significant proportion of clients are impact-oriented - therefore it is these environmental impact claims which are most important for these impact-oriented retail investors.

This paper is addressed to the legislator and regulators at EU level and may be of interest for national legislators and regulators. It reviews the regulatory framework which is applicable to environmental impact claims in the finance sector. It then reviews the extent to which this regulatory framework provides adequate governance of environmental impact claims in the finance sector and articulates recommendations for where improvements need to be made. This analysis covers regulation at EU level and that of six Member States: Spain, Germany, Belgium, Luxembourg, France and the Netherlands.[3]

- Section 1 summarises 2DII's most recent research on client preferences for sustainable investment with a specific focus on impact-oriented financial products. It then analyses the problems attendant to environmental impact claims in the finance sector and how these contribute to the increasing problem of greenwashing.[4]
- Section 2 provides a high-level summary of the regulatory framework that may apply to environmental impact claims in the finance sector. It analyses the finance sector specific regulation which requires communications to be fair, clear, and not misleading. It demonstrates the emerging body of sustainable finance rules is not adapted to regulate environmental impact claims. It then focusses on the application of consumer protection regulation in the finance sector context before analysing the variation in national implementation of these rules.
- Section 3 analyses how the current procedure for regulatory oversight and enforcement and investor redress is not effective in the context of environmental impact claims in the finance sector.
- Section 4 identifies recommendations to address the problems identified in this paper and ensure better market practice in relation to environmental impact claims in the finance sector.
- Section 5 sets out concluding remarks.

[1] As well as the reporting requirements under the Non-Financial Reporting Directive shortly to be replaced by the Corporate Sustainability Reporting Directive.
[2] Impact claims can also refer to social impacts however in this report we only focus on environmental impact claims.
[3] These Member States are the focus countries for the LEVEL EEI project and were selected according to criteria defined for that project (including volume of savings, capacity to engage effectively in that jurisdiction etc.)
[4] Or more precisely *Impact washing*

Section 1

Greenwashing in the context of environmental impact claims

This section summarises 2DII's most recent research on client preferences for sustainable investment with a specific focus on impact-oriented financial products. It then analyses the problems attendant to environmental impact claims in the finance sector and how these contribute to the increasing problem of greenwashing.

1.1 Client preferences for impact-oriented financial products

A growing number of consumer surveys and behavioural finance experiments point to the increasing importance of sustainability considerations in client investment decisions.[5]

2DII's first research in this area involved a series of quantitative and qualitative surveys conducted in France and Germany and identified that 65% to 85% of retail clients say they want to invest more sustainably when they are asked.[6] But 'wanting to invest more sustainably' or 'being interested in sustainable investment' is a somewhat superficial analysis of the guiding sustainability motivations which retail clients have or what outcomes clients actually expect and why. Our research programme has sought to dig deeper into these granular details to understand how – if at all – these expectations intersect with the broad range of financial products available which integrate sustainability features in product design.

Our most recent research at the end of 2021 consisted of a survey in six European countries.[7] This was designed to increase the evidence base regarding household beliefs and preferences in relation to sustainable finance and reveal any variations in client preferences for sustainable investment and level of interest of European retail investor by country.

We asked a series of questions regarding the extent to which client investment decision making features one or more of the following financial/sustainability goals: (1) aligning investments and savings with values (*value alignment*); (2) achieving an impact in the real world (*achieving impact*); and (3) achieving maximum return for a certain level of risk (*maximising return*). This enabled us to generate a typology of seven profiles, either pure (focussing on one goal only) or mixed (incorporating two or three goals).

Select results from this research[8] are as follows:

- In all countries most participants fall in mixed profiles: from 50% in Denmark to 71% in Romania (60% on average).
- Overall, maximizing return is the most frequently cited sustainability/financial goal: from 62% in Ireland to 78% in Romania (68% on average).
- But just a small minority of participants *only* care about maximising returns (20% on average) leaving 80% having at least one sustainability goal.
- Value alignment is the second most cited goal: from 47% in Denmark to 75% in Romania (60% on average).
- Achieving impact is important for a significant fraction of participants: from 35% in Denmark and Estonia to 61% in Romania (46% on average i.e. almost half of all participants).

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[5] See summary of third-party research in 2DII, 2020, A Large Majority of Retail Clients Want to Invest Sustainably
[6] 2DII, 2020, A Large Majority of Retail Clients Want to Invest Sustainably
[7] Denmark, Estonia, Germany, Greece, Ireland and Romania
[8] 2DII, 2022, What do your clients actually want?

These findings are broadly aligned with our previous research findings that 42% of retail investors want to have a positive environmental impact in the real economy through the way in which their money is invested.[9]

1.2 Exposition of an environmental impact claim in the finance sector

Our research reveals that most participants fall in mixed profiles which means that they have more than one financial/sustainability goal to balance. But the fact that nearly half of retail investors have a goal to achieve impact means that environmental impact claims associated with a financial product or service may influence their investment decisions.

While we are not aware of any formal legal or regulatory definition of an environmental claim, the following definition is taken from formal EU guidance on the topic:

'The expressions "environmental claims" or "green claims" refer to the practice of suggesting or otherwise creating the impression (in the context of a commercial communication, marketing or advertising) that a product or a service, is environmentally friendly (i.e. it has a positive impact on the environment) or is less damaging to the environment than competing goods or services. This may be due to, for example, its composition, the way it has been manufactured or produced, the way it can be disposed of and the reduction in energy or pollution which can be expected from its use.'[10]

The practice of providing environmental claims arose in the consumer goods sector and it is through this lens that much of the guidance and understanding has developed. However, in the finance sector context, it is useful to distinguish between environmental claims and *environmental impact claims*, which are a subset of environmental claims and refer to the specific practice of suggesting or otherwise creating the impression that a product or service has a real-economy impact which is positive for the environment (i.e. *environmental impact*).

There are several aspects which relate to why this distinction between environmental claims and environmental impact claims is useful in the finance sector context.

Environmental claims in the finance sector do not always relate to environmental impact

Many environmental marketing claims in the finance sector do not communicate information about environmental impact *per se*, but rather about various environmental features which a financial product might have.

An example of this is where the marketing claim relates to the thematic criteria which an investment fund adopts for its portfolio holdings. These thematic criteria may be constructed on a negative basis (e.g. avoiding investing in specific sectors) or a positive basis (e.g. focus on investing in predefined sectors). And while these marketing claims certainly feature in the investment decision making of sustainability minded retail investors, they do not explicitly communicate information on environmental impact.

Investor impact is not the same as investee company impact

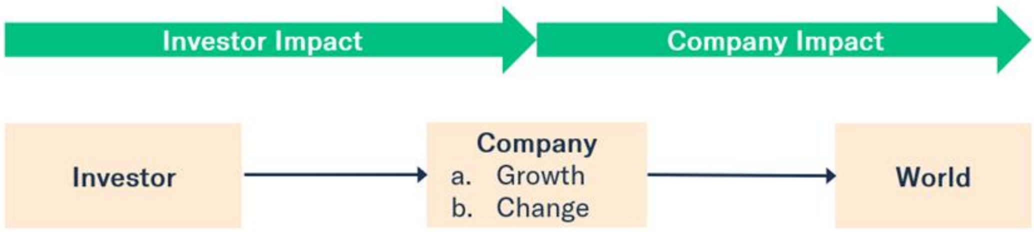
If we take the climate context as an example, *investor impact* can be defined as the change that the investor causes in the activities of real-economy actors (most often the investee company benefitting from the investment) that directly or indirectly reduces GHG emissions. Meanwhile *investee company impact* is the change that the company has caused in the real economy. Note that either investor impact or investee

[9] 2DII, 2020, A Large Majority of Retail Clients Want to Invest Sustainably
[10] Multi-stakeholder Dialogue on Environmental claims, 2016, Compliance Criteria on Environmental Claims: Multi-stakeholder advice to support the implementation/application of the Unfair Commercial Practices Directive 2005/29/EC

company impact can be positive (e.g. a reduction in emissions) or negative (e.g. an increase in emissions). In this paper, we refer to impact as meaning a positive impact.

Therefore, investor impact is not synonymous with investee company impact. In the climate context, investor impact is the extent to which the investor has caused the investee company to grow its green activities (e.g. a growth in green power production) or improve the quality of the investee company's activities (e.g. an increase in the energy efficiency of a plant).[11] But it is not legitimate for the investor to claim that its impact equates to all the positive investee company impact (the investor may have done nothing to bring about the investee company impact, or the investee company may have financing arrangements with multiple investors etc.).

Figure 1: A synthetic definition of investor impact (Kölbel et al., 2020)



Investor impact therefore designates a causal, demonstrable relationship between an investor's action and a real-world change (in the climate context a reduction in GHG emissions). Many factors (beyond the investor's actions) can affect investee company activities (e.g. consumer pressure, regulations, etc.). But assessing investor impact therefore requires being able to effectively identify which specific investee company activities are attributable to the actions of the investor.[12]

1.3 Difficulties demonstrating investor environmental impact

Because *investor impact* is not the same as *investee company impact,* this means that allocating environmental impact in the finance sector is a challenge.

Investor impact can be delivered through implementing various *climate actions* that mobilize one or more different *impact mechanisms*.

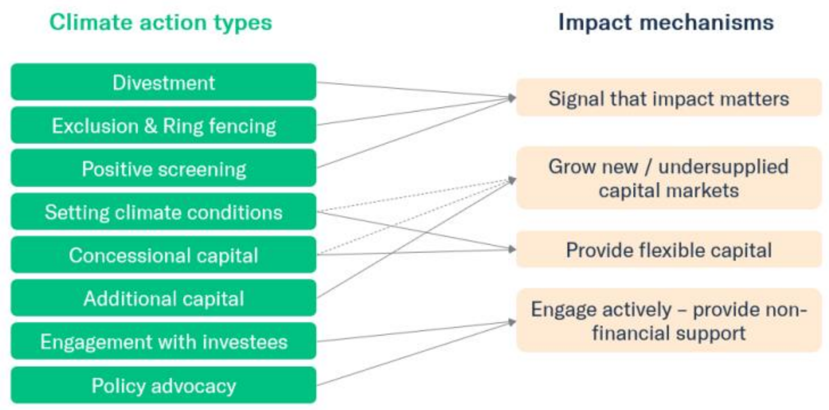
Table 1: Classification of impact mechanisms

Active engagement	Engagement can include a wide spectrum of approaches - dialogue with companies, creation of industry standards, taking board seats and management support (often seen in private equity), that all contribute to the same goal: improving the sustainability performances of the targeted companies. The mechanism can be split into two main categories: provide non-financial support, and investee engagement. 2DII suggests extending this impact mechanism to policy advocacy, to capture the influence that investors can exert on policy makers.

[11] Kölbel et al., 2020, Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact.
[12] Note that *investor impact* can refer to the financial institution impact or to retail investor impact (either through direct investment in investee companies or through an indirect investment with a financial institution intermediary). For the purpose of this paper, we do not propose to dig further into the distinction between financial institution and retail investor impact since the more crucial issue related to the distinction between investor impact (retail or institutional) and investee company impact.

Growing new or undersupplied capital markets	Investors can provide capital to new or previously overlooked opportunities, thus enabling their growth. This can for example involve offering capital at below-market rates.
Providing flexible capital	Investors can accept below-market, risk-adjusted financial returns when investing in impactful companies, thus lowering their cost of capital and enabling their growth.
Signalling that impact matters	Investors can choose not to invest in, or to favour, certain investments such that, if many investors did the same, it would ultimately impact the access to capital of high-carbon companies or send a nonmarket signal to society that impact matters – through nonmarket channels.

Figure 2: Overview of existing climate actions mapped to impact mechanisms



The causal chain from an investor implementing a climate action to the change that the company has caused in the real economy (e.g. GHG emissions reduction) consists of multiple steps. If an investor:

- implements a *climate action* (for example, engagement with investee companies in high carbon sectors);
- this can lead to an *output* as a direct consequence of the climate action (for example, a change in the WACC of targeted investee companies);
- this can in turn lead to an *outcome* in terms of growth or improvement in investee company activities (for example, a change in the investee company's capex plans and growth in production); and
- this can trigger an *impact* in the real economy (for example, a reduction of GHG emissions).

However, the causal change from an investor implementing a climate action to an impact in the real economy is subject to uncertainties. A climate action may not always result in an output[13] and similarly an output might not translate into an outcome[14] and an outcome might not translate into an impact.[15]

Investigating investor impact is a nascent research field and as such numerous gaps and uncertainties remain about the effectiveness of different climate actions and impact mechanisms. A recent authoritative meta study on the topic[16] concluded that we do not have a consensus that any particular climate action or impact mechanism always has an impact under different conditions. However, while there may be no robust or

[13] For example, excluding high-carbon assets from a portfolio (the action) might not tangibly increase the cost of capital for the underlying high-carbon company (the unachieved output).
[14] For example, the increased cost of capital resulting from an exclusion policy (the output) might not trigger a change in the investee's activities (the unachieved outcome) due to a disproportion between the incentive to change and the cost of change.
[15] For example, an investee company implements a new green project because of a financial institution action (the outcome), but it fails due to competition.
[16] Kölbel et al., 2020, Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact.

measurable link between climate actions/impact mechanisms and real-world impact in all cases, there is an emerging understanding of the conditions in which different climate actions/impact mechanisms would be more or less likely to influence investee company behaviour and generate real world impact (i.e. impact potential). This work has led to the development of a framework for assessing the level of evidence of impact that can be attributed to different climate actions/impact mechanisms depending on the asset class concerned.[17]

For the line of enquiry of this paper – which relates to environmental impact claims of typical financial products and services – it is worth noting that regarding secondary markets and liquid financial assets (which are an essential part of the offer available to retail investors) the level of evidence identified is extremely low. Capital allocation approaches in secondary markets (green bonds, exclusions, positive screening etc.) are model based predictions at most while under certain conditions engagement activities have a higher (albeit non-decisive) level of evidence.[18]

1.4 The negative effects of greenwashing

What has come to be a widespread and accepted term – greenwashing – also lacks a formal legal or regulatory definition. But it can be understood to describe the practice of making misleading claims about the environmental benefits of a product or of a company's policies more generally[19] or referring to circumstances where environmental claims are not true or cannot be verified.[20]

Various research identifies the harmful effects of greenwashing on market function. The research universally points to a significant detriment to consumers and organisations that adhere to the rules.[21] Greenwashing can increase consumer distrust – and eventually prevent the mobilisation of sustainability minded consumers – and create the conditions for unfair competition and free-riding behaviours.[22]

Through the package of policy proposals in the *Action Plan on Finance Sustainable Growth*, the Commission is seeking to leverage increased client preferences for sustainable investment in support of the objective to reorient capital towards sustainable investment and address the investment gap to achieve EU climate and energy targets. As the extent of the greenwashing problem becomes clearer, there are concerns that it can undermine these policy objectives in the Action Plan. Either through increasing distrust and loss of confidence by retail investors meaning they are discouraged against sustainable investment, or perhaps even more problematically, through greenwashing permitting market distortion so that the market is not responding to these client preferences for sustainable investment (i.e. mis-selling).

Many argue that the recent disclosure requirements under the Sustainable Finance Disclosure Regulation[23] **(SFDR) and** the Taxonomy Regulation[24] go some way to combat greenwashing through increased transparency and helping end-investors identify credible investment opportunities. However, as this paper will show, these disclosure requirements provide a limited framework unfit to regulate environmental claims – and provide no assistance at all in relation to environmental impact claims.

[17] Heeb, F., Kölbel, J., 2020, The investor's guide to impact
[18] 2DII, 2021, Sustainable finance and market integrity: promise only what you can deliver
[19] EU Technical Expert Group on Sustainable Finance, 2019, Taxonomy Technical Report, p.14.
[20] Multi-stakeholder Dialogue on Environmental claims, 2016, Compliance Criteria on Environmental Claims: Multi-stakeholder advice to support the implementation/application of the Unfair Commercial Practices Directive 2005/29/EC
[21] European Social and Economic Committee, 2015, Opinion on 'Environmental, social and health claims in the single market'
[22] 2DII, 2021, Sustainable Finance and Market Integrity, p.13.
[23] 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
[24] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

Last year's *Strategy for Financing the Transition to a Sustainable Economy* reveals that the Commission now has a specific focus on greenwashing. With the support of the European Supervisory Authorities, the Commission will assess whether supervisory powers, capabilities and obligations are fit for purpose. And based on this assessment and the monitoring of greenwashing risks by the ESAs, the Commission will consider steps to ensure a sufficient, consistent level of enforcement and supervision to address greenwashing.[25]

This focus on greenwashing is welcome – but the details of the precise activities to be undertaken remain scant. And as this paper will show, there are far more aspects to consider in order to address the greenwashing problem than is currently indicated in this strategy.

[25] European Commission, 2021, Strategy for Financing the Transition to a Sustainable Economy

Section 2

Critical analysis of the relevant regulatory framework

This section provides a high-level summary of the regulatory framework that may apply to environmental impact claims in the finance sector. It analyses the finance sector specific regulation which requires communications to be fair, clear and not misleading. It demonstrates the emerging body of sustainable finance rules is not adapted to regulate environmental impact claims. It then focusses on the application of consumer protection regulation in the finance sector context before analysing the variation in national implementation of these rules.

2.1 A difficult mapping of applicable rules at EU level

Identifying the legal and regulatory framework applicable to environmental marketing claims of financial products is not straightforward.[26] Several pieces of EU legislation can apply to these claims though none of them are sufficient to prevent greenwashing based on environmental impact claims.

There are two main categories of regulation which are potentially applicable - finance sector specific regulation and consumer protection regulation. Moreover, within finance sector specific regulation, there are general rules applicable to all communications linked to financial products whereas other more recent rules relate specifically to sustainable finance.

Among the various frameworks, some contain compulsory rules (*hard law*, such as provisions in Directives and Regulations) whereas others are recommendations and principles (*soft law*, such as ESMA guidelines or other supervisory materials from regulators).

The table below identifies the European provisions analysed in this paper to assess if and how they regulate environmental impact claims in the finance sector.

Table 2: Regulatory provisions analysed for relevance to regulation of environmental impact claims in the finance sector

	Finance sector specific regulation		Consumer protection regulation
	General finance	Sustainable finance	
Hard law	MIFID II CBDF Regulation Prospectus Regulation	SFDR Taxonomy Regulation EU Green Bond Standard	UCPD Proposal of amendment to UCPD
Soft law	ESMA Guidelines on marketing communications		UCPD Guidance MDEC Principles

[26] The mapping includes only rules related to marketing claims, meaning that we exclude rules that only apply to regulatory documentation such as KIID, prospectus or annual reports and focus on provisions applying to all marketing material (brochures, sections of the website).

2.2 Study of EU finance sector specific regulation

The commentary below analyses the finance sector specific regulation articulated in Table 2 above to define the scope and identify where there are rules that could be used to fight greenwashing linked to environmental impact claims in the finance sector.

As illustrated in Table 2 above, a first distinction must be made between general finance rules and rules developed recently in relation to sustainable finance.

General finance rules are too high level

MIFID II[27] contains rules on all information, including marketing communications, addressed by an investment firm to clients or potential clients.[28] It states that the communication must be 'fair, clear and not misleading' both in its content and its presentation. It notably means that any marketing communication should 'be sufficient for and presented in a way that is likely to be understood by the average member of the group to whom it is directed, or by whom it is likely to be received.'[29] MIFID II thus provides a high-level principle and does not provide any further detail or criteria that could be used to assess whether an environmental impact claim made by an investment firm is fair, clear and not misleading.

The regulation on facilitating cross-border distribution of collective investment undertakings (**CBDF Regulation**)[30] sets a similar principle. This establishes uniform rules on the publication of national provisions concerning marketing requirements for collective investment undertakings and on marketing communications addressed to investors, as well as common principles concerning fees and charges levied on managers of collective investment undertakings in relation to their cross-border activities. According to the CBDF Regulation, marketing communications of collective investment undertakings must be:

- identifiable as marketing communications;
- describe the risks and rewards of purchasing units or shares of a fund in an equally prominent manner;
- contain fair, clear and not misleading information.[31]

ESMA guidelines on marketing communications under the CBDF Regulation[32] provide further precision related to information on sustainability-related aspects. The marketing claim should be consistent with the information included in the legal and regulatory documents and should be proportionate to the extent to which the investment strategy and product integrates sustainability-related characteristics or objectives.[33]

In addition, the Prospectus Regulation[34] applies to advertisement relating to offer of securities to the public or to an admission to trading on a regulated market. This Regulation states that 'advertisements shall be clearly recognisable as such. The information contained in an advertisement shall not be inaccurate or misleading and shall be consistent with the information contained in the prospectus, where already published, or with the information required to be in the prospectus, where the prospectus is yet to be published.'[35] Here again the

[27] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II)
[28] Art 24(3) MIFID II
[29] Art 44 Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive
[30] Regulation (EU) 2019/1156 of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014
[31] Art 4 CBDF Regulation
[32] ESMA, 2021, Guidelines on marketing communication under the Regulation on cross-border distribution of funds
[33] Section 6.5 of ESMA Guidelines on marketing communications under the Regulation on cross-border distribution of funds
[34] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC
[35] Art 22 Regulation (EU) 2017/1129

principle is high-level, and there is no further guidance on how to determine whether a marketing claim is misleading.

While the above high-level principles could be applicable to an environmental impact claim in the finance sector, considering the lack of detailed criteria, it is unclear how they would apply. The MIFID II principle stating that communication must be 'fair, clear and not misleading' must be transposed at national level. It is therefore up to national legislators and regulators to detail the criteria to consider a marketing claim as 'fair, clear and not misleading' (which may be based on the ESMA Guidelines and other legal norms). This leaves room for the development of heterogenous rules, especially regarding environmental impact claims.[36]

Sustainable finance rules are not adapted to environmental impact claims

The Commission has introduced three key sustainable finance legislation initiatives: the Sustainable Finance Disclosure Regulation[37] (**SFDR**), the Taxonomy Regulation[38] and the proposed EU Green Bond Standard (**EUGBS**).[39] These texts were not initially intended to regulate marketing claims; however, the industry has lately developed a practice to use certain regulatory classifications as marketing arguments, thus leading us to test the applicability of said regulations to environmental claims in general and environmental impact claims more specifically.

The SFDR is not adapted to regulate environmental impact claims

The SFDR sets out 'harmonised rules for financial market participants and financial advisers on transparency with regards to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.'[40]

The SFDR also categorises financial products according to the degree of sustainability related ambition for that product.

- Article 6 products do not pursue sustainable investment but may or may not integrate sustainability risk into the investment process. These are generally not marketed as having any sustainability credentials.
- Article 9 products (often referred to as dark green products) have sustainable investment as an objective and their underlying assets will always be in sustainable investment.
- Article 8 products sit between the other two categories and are those that promote environmental or social characteristics. They may or may not pursue sustainable investments and may invest in a wide range or underlying assets.

For each category of financial product, a level of compulsory disclosures is defined for pre-contractual documentation, periodic reports and the website.

Misuse of SFDR product categories as sustainability labels

The SFDR was initially not intended to provide *sustainability labels* or criteria for marketing claims related to sustainability. However, industry practice has developed to categorise products falling within Article 8 or Article 9 as 'light green' and 'dark green' product labels, respectively and use these regulatory categories as a marketing claim.

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[36] In the absence of consensus on the definition of environmental impact of financial products.
[37] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector
[38] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088
[39] Proposal for a Regulation on European green bonds COM/2021/391 final
[40] Art 1 SFDR

Examples of marketing claims using Articles 8 and 9 SFDR classifications are as follows:[41]

- 'The vast majority of strategies will be classified as Article 8. These are funds which form part of our Sustainability range, which has ESG integrated as standard, or the Sustainability Focused range, which has more specific targets, such as achieving a lower carbon footprint than the benchmark.'
- '90% of our AUMs are Article 8 or 9 (SFDR)'

These observations about current market practice demonstrate a significant risk of misunderstanding and misuse of SFDR provisions. Indeed, in the absence of clarification by the European legislator or regulator, a market practice appears to be evolving whereby SFDR disclosure provisions are viewed as defining criteria for marketing claims.[42]

This misuse of SFDR provisions is especially detrimental to transparency and fair marketing of sustainable products considering the lack of clarity in relation to the definitions of Article 8 and Article 9 of SFDR.[43]

Risk of greenwashing to impact-oriented clients created by SFDR

But predicating a marketing claim on the categorisation for SFDR purposes is even more problematic in the context of environmental impact claims. This is because the SFDR does not adhere to the distinction between investor impact and investee company impact (see *Section1.2 Exposition of an environmental impact claim in the finance sector*). There is no requirement for Article 8 and Article 9 products to reveal investor impact, therefore the SFDR is not adapted to apply to environmental impact claims.

Regarding Article 8, there is no regulatory criteria to specify eligible investment targets, investing styles, investing tools, strategies or methodologies to be employed. As a result, Article 8 products may apply various strategies (for example, screening and exclusion strategies[44]) many of which are unlikely to have an environmental impact.

Regarding Article 9, this refers to financial products which have 'sustainable investment' as an objective. Sustainable investment is then defined as '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 an investment in an economic activity that contributes to a social objective …'[45]

Therefore Article 9 products should not be considered to meet the definition of impact-oriented financial products either.[46][47] To develop the previous argumentation (see *Section1.2 Exposition of an environmental impact claim in the finance sector*) further, the impact of an investor is the change caused by this investor in the world. This definition includes two conditions:

- *Causality:* For the investor to get credit for impact, it needs to have caused a change in the activities of real economy actors (i.e. a change that would not have occurred without its intervention).
- *Distinction between investor impact and investee company impact:* The impact of the investor is the share of the investee company's impact that it has caused. An investee company's impact can be

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[41] 2DII research on limited sample for the purpose of this paper with key words 'article 9' and 'article 8', May 2022
[42] See Responsible Investor article: 'SFDR reclassifications raise "legitimate" greenwashing concerns, warns Morningstar'
[43] The ESAs were compelled to write to the Commission requesting clarification of the meaning of 'promotion' in the context of Article 8 products and the application of Article 9. While the Commission has responded to this request, that response has not shed much light on the topic.
[44] Annex to Commission Decision (c(2021) 4858 final)
[45] Art 2(17) SFDR
[46] As explained in 2DII, 2021, Does the SFDR help the impact-focused retail investor?
[47] Despite the confusion created by Recital 21 of SFDR implicitly referring to Article 9 as 'financial products which have as an objective a positive impact on the environment and society'.

much larger than that caused by any one investor. Therefore, investor impact is simply the part of the investee company's impact that it caused, and the investor cannot get credit for impact that it did not cause.

The drafting of Article 9 merely refers to 'investing in an economic activity that has a positive impact.' As such, it fails to consider the causality angle i.e. what role the investor may have played in bringing about this positive impact. In addition, it fails to preserve the distinction between investor impact and investee company impact.

Article 9 products refer to what might generally be understood as thematic investment more likely to fit the goals of investors looking for value alignment rather than impact. And even though many financial institutions have understood the difference between investor impact and investee company impact, some still make the mistake of equating Article 9 products with impact products.

Information Box: Examples of marketing claims creating confusion between Article 9 products and impact products[48] [49]

'The investment funds that comply with Article 9 go even further: they show a willingness to have a real impact on the social or environmental spheres.'

'The third category includes impact products with a clearly identified sustainable development objective (so-called "Article 9" products).'

'Asset Manager is offering a new dark-green equity-based investment product for investors keen to make a simultaneous impact on the climate and society.'

'Asset Manager's Impact Investing range of strategies will be classified as Article 9. These include bespoke funds targeting climate change, renewable energy, the UN's Sustainable Development Goals and specific themes such as gender equality.'

On the contrary certain rightful asset managers avoid greenwashing by clearly differentiating regulatory categories of financial products and impact: 'An Article 9 is not an impact fund'.

In conclusion, the SFDR is not adapted to regulate environmental impact claims of financial products. Worse still, an emerging trend of equating Article 9 products with impact-oriented products creates significant risks of mis-selling non-impact financial products to impact-oriented clients.

The Taxonomy Regulation is not applicable to environmental impact claims

The Taxonomy Regulation establishes the concept of 'environmentally sustainable investments.' For an economic activity to be environmentally sustainable under the Taxonomy Regulation, it must:

- contribute substantially to one or more of environmental objective[50];
- do no significant harm to any of the environmental objectives;

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[48] 2DII research on limited sample for the purpose of this paper with key words 'article 9' and 'article 8' and 'impact', May 2022
[49] A recent study was led on 185 funds that claim to achieve an impact on the environment and/or society (mainly domiciled in Europe and in North America). 'The Impact of Impact Funds – A Global Analysis of Funds with Impact-Claim', Lisa Krombholz, Timo Busch and Johannes Metzler, April 2022. It shows that among the funds falling under the SFDR, 63% were assigned to Article 9 and 37% to Article 8. The paper further explains it 'reflects the widespread perception that Article 9 products are "impact products"' and indicates that 'the analysis suggests that only 37% of the funds assigned to Article 9 met the outlined impact requirements.
[50] The six environmental objectives are: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems.

- be carried out in compliance with minimum social safeguards[51]; and
- comply with the technical screening criteria.[52]

Taxonomy compliant investments reflect economic activities that are environmentally sustainable but do not necessarily bring about positive change. For example, an environmentally sustainable investment can be neutral in terms of impact on the environment. This is a qualitatively different concept to that of bringing about a positive impact. In addition, while the Taxonomy Regulation provides a framework as to whether an economic activity can be classified as sustainable, it does not address the distinction between investor impact and investee company impact. Therefore, the Taxonomy Regulation is not applicable to environmental impact claims of financial products.

The EU Green Bond Standard is not applicable to environmental impact claims

The proposed EUGBS is envisaged to be implemented as a voluntary standard available to all issuers to help finance sustainable investments. It is intended to reduce the risk of greenwashing as financial institutions may only describe their product as an *EU Green Bond* where it complies with the EUGBS.[53]

To be able to claim that a product is an EU Green Bond, financial institutions must ensure the following four requirements are met:

- 'The funds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy;
- There must be full transparency on how bond proceeds are allocated through detailed reporting requirements;
- All EU green bonds must be checked by an external reviewer to ensure compliance with the Regulation and that funded projects are aligned with the Taxonomy. Specific, limited flexibility is foreseen here for sovereign issuers;
- External reviewers providing services to issuers of EU green bonds must be registered with and supervised by the European Securities Markets Authority. This will ensure the quality and reliability of their services and reviews to protect investors and ensure market integrity. Specific, limited flexibility is foreseen here for sovereign issuers.'[54]

Green bonds would not necessarily be associated with increased volumes of climate-friendly activities (although green bonds can be used to action certain impact mechanisms).[55] Moreover, the information which would be available in relation to green bonds in compliance with the EUGBS is not directly relevant to the line of enquiry of this paper. Therefore investing in green bonds that comply with the EU GBS cannot be used by investment funds as sufficient evidence to back their environmental impact claims.[56]

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[51] As articulated in Art 18 Taxonomy Regulation
[52] Art 3 Taxonomy Regulation
[53] As such the EUGBS is indirectly relevant to the line of enquiry of this paper as (where a financial product invests in green bonds) then financial institutions will base their own marketing claims on the EUGBS.
[54] Legislative train schedule, Establishment of an EU Green Bond Standard
[55] See 2DII, 2021, I've got the power! Really? for a detailed review of the impact potential of green bonds in supporting the energy transition.
[56] Retail clients are unlikely to invest directly in a green bond itself, but rather in a financial product which is itself invested in green bond(s) – therefore it is the environmental impact claims associated with the financial product which is relevant.

Information Box: The EU Ecolabel as a first step towards integrating the notion of investor impact

The EU Ecolabel technical criteria for financial products is currently being developed. The criteria would need to be adopted through a Commission Decision under the EU Ecolabel Regulation[57] and the working assumption is that this is expected by the end of 2022 with a view to being operational in 2023. However, this calendar is still uncertain – see below.

In the most recent draft of the technical criteria[58], Criterion 5 refers to measures taken to enhance investor impact. It refers to the concept of investor impact that is based on the academic literature.[59] Information on the measures that have been taken to enhance the impact of the financial product should be provided to retail clients along with the following disclaimer:

The EU Ecolabel is the official European Union label for environmental excellence aiming to capture the best products available on the Community market in terms of environmental performance. It is awarded to financial products that invest to a certain degree in environmentally sustainable economic activities as defined under the EU Taxonomy. However, the currently available methodologies and evidence do not allow to evaluate the environmental and social impacts of a particular fund.

The rational for including this disclaimer is that the EU Ecolabel does not carry out evaluation of environmental and/or social impacts and therefore not including a disclaimer could be misleading to the retail investors.

While the EU Ecolabel currently appears to be a means to (partially) integrate a better conception of investor impact into the regulatory framework, it is only a voluntary framework that will not apply to all financial products. Moreover, the ultimate outcome of the EU Ecolabel for financial products is currently on hold due to controversies in relation to the decision to classify nuclear and gas power as green activities under the Taxonomy Regulation.[60]

[57] Regulation EEC 880/92
[58] Joint Research Centre, 2021, Development of EU Ecolabel criteria for Retail Financial Products Technical Report 4.0: Draft proposal for the product scope and criteria
[59] As reviewed by Kölbel et al. 2020, Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact, Organization & Environment
[60] Responsible Investor, 2022, Nuclear, gas status in EU green fund label uncertain as project put on hold

2.3 Study of EU consumer protection regulation

The commentary below analyses the consumer protection regulation articulated in Table 2 above to define the scope and identify where there are rules that could be used to fight greenwashing linked to environmental impact claims in the finance sector.

As illustrated in Table 2 above, the consumer protection regulation consists of the following:

The directive on unfair commercial practices[61] (**UCPD**) is the overarching EU legislation regulating unfair commercial practices between businesses and consumers. In addition, the Commission gathered a multi-stakeholder group on environmental claims[62] which provided recommendations in relation to how these general provisions apply in the context of environmental claims (the **MDEC Principles**).[63] The MDEC Principles are not legally binding, however they are key for the interpretation and application of UCPD rules.[64] They also inform the new Commission Notice on the interpretation and application of the Unfair Commercial Practices Directive (**UCPD Guidance**).[65] [66]

Information Box: Interplay between EU consumer protection regulation and finance sector specific regulation

Retail investment services are subject to the UCPD insofar as there are no relevant and applicable finance sector specific regulatory provisions (such as MiFID II). Indeed, the UCPD can be considered to work as a wider *safety net* to provisions provided by finance sector specific regulation. Where sector-specific EU law overlap with the provisions of the UCPD, the corresponding provisions of the sector-specific EU law prevails.

The UCPD seeks to ensure that a common level of consumer protection against unfair commercial practices can be maintained in all sectors. Considering legislation specific to the finance sector only provides high-level rules, the safety net provided by UCPD proves useful.

UCPD rules applying to environmental impact claims

The UCPD prohibits unfair commercial practices[67] which include the following:

- *Misleading action*: A commercial practice shall be regarded as misleading if it contains false information or deceives or is likely to deceive the average consumer. The false information can notably relate to the main characteristics of the product (such as its benefits) or the extent of the trader's commitments.[68]

[61] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (Unfair Commercial Practices Directive). This was amended by Directive (EU) 2019/2161 of 27 November 2019 on better enforcement and modernisation of Union consumer protection rules.
[62] Composed of representatives of national authorities, European business and consumer organisations, and environmental NGOs
[63] Multi-stakeholder Dialogue on Environmental claims, 2016, Compliance Criteria on Environmental Claims: Multi-stakeholder advice to support the implementation/application of the Unfair Commercial Practices Directive 2005/29/EC
[64] Indeed, they are reflected in international standards and self-regulation, such as the ISO 14021- 2016 standard and the ICC Advertising and Marketing Communications Code.
[65] Commission Notice – Guidance on the interpretation and application of Directive 2005/29/EC of the European Parliament and of the Council concerning unfair business-to-consumer commercial practices in the internal market
[66] This Notice dated 17 December replaces the previous UCPD Guidance, the Commission Staff Working Document from 2016. The UCPD Guidance not only provides information on the application of UCPD principles to environmental claims but also details their articulation with other EU legislation.
[67] Art 5 UCPD
[68] Art 6 UCPD

- *Misleading omission*: A commercial practice shall be regarded as misleading if it omits material information that the average consumer needs to take an informed decision. There can be an omission when the information is hidden but also when the information is provided in an unclear, unintelligible, or ambiguous manner.[69]

The UCPD Guidance and MDEC Principles provide detail on how to apply these rules to environmental claims. They are soft law and operate without prejudice to the 'national courts and authorities […] case-by-case assessment of whether a claim is misleading either in its content or in the way it is presented to consumers.'[70] Nevertheless they are the most relevant means to assess how national courts and authorities would likely determine whether an environmental claim is misleading.

As a reminder, '"environmental claims" and "green claims" refer to the practice of suggesting or otherwise creating the impression (in a commercial communication, marketing, or advertising) that a good or a service has a positive or no impact on the environment or is less damaging to the environment than competing goods or services. […] When such claims are not true or cannot be verified, this practice is often called "greenwashing".'[71] A claim can relate to all types of statements, information, symbols, logos, graphics and brand names, and their interplay with colours, on packaging, labelling, advertising, in all media (including websites).[72]

The MDEC Principles apply to environmental claims in general and are not specific to the finance sector. Table 3 below[73] summarises the main principles developed in the MDEC Principles to understand detailed criteria steaming from UCPD rules that can apply to environmental impact claims of financial products.

Table 3: Summary of the MDEC Principles

	MDEC Principle	MDEC Criteria
Content of the claim	'In order not to be misleading, environmental claims should reflect a verifiable environmental benefit or improvement and this should be communicated in a precise manner to consumers.' (Section 2.1).	Focus on the main environmental impacts Clarity on which aspects of the product the claim relates to Benefit beyond what is already considered as a common practice in the relevant market or required by law
Presentation of the claim	'Once the content of the claim has been established (section 2.1), it should be presented in a way that is accurate, clear, specific and unambiguous to ensure consumers are not misled about the intended meaning, and are thus able to make informed purchasing choices.' (Section 2.2)	Truthful wording as to the benefit achieved Clear scope and boundaries of the claim Avoidance of vague, ambiguous and broad claims
Substantiation of the claim	'In accordance with the UCPD, any claim or information in advertising and marketing (whether it is environmental or not) must be	Clear and robust evidence measured using the most appropriate scientific methods

[69] Art 7 UCPD
[70] Disclaimer to MDEC Principles
[71] Section 4.1.1 UCPD Guidance. Please also refer to Section 1.2 Exposition of an environmental impact claim in the finance sector.
[72] It is interesting to note that the name of the financial product is also relevant when used for marketing purposes.
[73] Replicated from 2DII, 2021, Sustainable finance and market integrity: promise only what you can deliver

	correct and not misleading. As such, claims should be based on robust, independent, verifiable and generally recognized evidence which takes into account the latest scientific findings and methods.' (Section 2.3)	Avoidance of claims on future aspirations Availability to the public of information relevant to support the claim

Table 4: Summary of claims to be especially avoided

Practice to be avoided	Detailed explanation
Vague, ambiguous and broad "general environmental benefit" claims (MDEC, Section 2.2)	'Examples (not exhaustive) of general environmental benefit claims could include: "environmentally friendly" […] "good for the environment", "sustainable", "green", "carbon friendly", "carbon neutral" […] "an ethically correct choice".' 'In case traders choose to use general broad claims, they should be accompanied by clear and prominent qualifying language that limits the claim to a specific benefit or benefits.' 'The use of a general benefit claim (presented without further qualifications) may be justified […] if the life cycle assessment studies of the product have proven its excellent environmental performance. These studies should be made according to recognized or generally accepted methods applicable to the relevant product type and should be third-party verified. If such methods have not yet been developed in the relevant field, traders should refrain from using general benefit claims.'
Claims on scientifically uncertain environmental impacts (MDEC, Section 2.3)	'If expert studies give rise to significant disagreement or doubt over environmental impacts, the trader should refrain from marketing the message altogether.'
Claims on future aspirations (MDEC, Section 2.3)	'Traders should rather communicate about environmental achievements instead of aspirations of future environmental performance, which by definition are not eligible for substantiation by evidence. This does not prevent companies from communicating on future environmental efforts (via Corporate Social Responsibility reporting or also advertising) if they deem this necessary or useful. Nevertheless, in order to avoid the risk of being accused of greenwashing practices, companies should only do this when they have established a realistic plan with clear targets and timescales, involved relevant stakeholders and ensured third party monitoring of commitments.'

Additionally, the UCPD Guidance states that 'the information provided to clients should be clear and understandable for the average consumer. The complexity and technical nature of the information should not be used to mislead consumers about the veracity of the green claim.'[74] Therefore, the complexity and technicity of measuring and attributing the environmental impact of financial product should not be used to mislead investors.

[74] Section 4.1.1.4. UCPD Guidance

Information Box: Introduction of rules specific to environmental claims in EU legislation

On 30 March 2022 the European Commission proposed amendments to the UCPD.[75]

These amendments notably aim at better regulating environmental claims in Europe and fight greenwashing practices through:

- Ensuring that consumers are not misled about environmental and social impacts of products.
- Ensuring that environmental claims related to future environmental performance always involve clear commitments.
- Prohibiting the use of sustainability labels not based on a certification scheme or established by public authorities.
- Prohibiting the use of generic environmental claims used in marketing towards consumers, where the excellent environmental performance of the product cannot be demonstrated in accordance with officially recognised eco-labelling.
- Prohibiting environmental claim about the entire product, when it actually concerns only a certain aspect of the product.

These amendments will improve legal certainty and should facilitate enforcement of rules preventing greenwashing. They do not however provide additional detail on how to apply the rules to environmental impact claims in the finance sector.

The UCPD (together with the UCPD Guidance and MDEC Principles) provides a more detailed and complete framework to regulate environmental impact claims in the finance sector than EU finance sector specific regulation. Nevertheless, the application of consumer protection rules to the reality and specificity of environmental impact claims in the finance sector reveals several barriers which prevent an effective protection of investors against misleading claims.

Barriers to effective application of consumer protection regulation to environmental impact claims in the finance sector

Two key obstacles prevent an effective and efficient application of UCPD rules and MDEC Principles to environmental impact claims in the finance sector: (1) the lack of definition of investor impact in the legislation and (2) the difficulties associated with substantiating investor impact. EU consumer protection regulation thus reveals insufficient to properly regulate this type of claims and should be completed by provisions tailored to the specificity of environmental impact claims of financial products. Such rules should be provided at the EU level to ensure harmonisation of practices.

Lack of definition of investor impact

The concept of environmental impact claims or ‘impact investing’ is an industry term and not yet a legal concept recognised under existing EU law. No EU law or regulation defines impact, impact investing or other related terms. As such, there are no specific requirements which directly apply to a statement by a financial institution to carry out impact investing or which purport to be an ‘impact product’, including in relation to how such products are marketed, promoted or distributed.

[75] Proposal for a Directive amending Directives 2005/29/EC and 2011/83/EU as regards empowering consumers for the green transition through better protection against unfair practices and better information. The new legislation can be expected by end-2023/ beginning 2024. However, the new rules must also be transposed into the national laws before taking effect (application 24 months after adoption at the latest).

Moreover, the current legal and regulatory framework is not consistent with the theories of attribution discussed in *Section 1.2 Exposition of an environmental impact claim in the finance sector*. Specifically, the current framework does not distinguish between investee company impact and investor impact.

Hence, in the absence of definition of 'impact' in the regulatory framework, it may be difficult to argue that a financial institution has made a misleading/prohibited impact claim about a financial product under the UCPD where the FI can demonstrate that the product exhibits some investee company impact, even where it cannot attribute any of this impact to the investment/purchase of the product itself (i.e. demonstrate investor impact).

Difficulties associated with substantiating investor impact

Financial institutions are required to substantiate their claims[76] and 'claims should be based on robust, independent, verifiable and generally recognized evidence which takes into account the latest scientific findings and methods.'[77] In this context there must be scientific evidence to support the claim.[78]

This requirement to substantiate claims proves particularly difficult to meet in the case of environmental impact claims in relation to difficulties to demonstrate investor impact as explained in *Section 1.3 Difficulties demonstrating investor environmental impact*. Indeed, current stage of scientific research does not provide methodologies and evidence to evaluate the environmental and social impacts at the investor level.

2.4 Conclusion on the EU regulatory framework

General finance rules are applicable to environmental impact claims in the finance sector (MIFID II, CBDF Regulation and Prospectus Regulation), but these rules are too high level to provide effective governance of environmental impact claims.

Unfortunately, the sustainable finance rules do not provide further assistance in relation to the governance of environmental impact claims. The current sustainable finance regulation does not integrate the concept of investor impact. Therefore, it is not aligned with the theories of attribution differentiating investee company impact and investor impact. While the SFDR and the Taxonomy Regulation require that certain investments demonstrate a positive impact of the investee company (e.g. to be marketed as Article 9), there is no requirement to demonstrate the positive environmental impact of the investor (or the purchase of the financial product).

Therefore, current EU sustainable finance regulation is not adapted to regulate environmental impact claims. And an emerging trend of using SFDR categories as marketing labels create additional confusion and greater risk of greenwashing especially when combined with environmental impact claims.

In addition, the provisions of UCPD are not sufficient to regulate environmental impact claims in the finance sector. Indeed, the absence of a definition of investor impact and the difficulties to substantiate investor impact prevent the efficient application of UCPD rules in relation to environmental impact claims in the finance sector.

While the EU Ecolabel currently appears to be a means to (partially) integrate a better conception of investor impact into the regulatory framework, it is only a voluntary framework that will not apply to all financial products. Moreover, the ultimate outcome of the EU Ecolabel for financial products is currently unsure due to controversies in relation to the decision to classify nuclear and gas power as green activities under the Taxonomy Regulation.

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[76] Art 12 UCPD
[77] Section 2.3 MDEC Principles
[78] MDEC Principles

2.5 Lack of harmonisation at national level

Our analysis of national legislative and regulatory frameworks concerns Spain, Luxembourg, Germany, France, Belgium and Netherlands to provide an overview of the level of harmonisation at national level. As for the legal analysis at EU level, the following commentary distinguishes between finance sector specific regulation and consumer protection regulation.

Lack of integration of UCPD Guidance and MDEC Principles at national level

As a directive, the UCPD requires national implementing legislation in each Member State. All Member States covered in this paper have enacted national implementing legislation.[79] *Annex 1 Country specific rules* identifies the UCPD national implementing legislation in each Member State. Rules have been integrated either in competition law, consumer protection law, advertising law or economic law.

Although the UCPD appears to have been transposed in a harmonised way for the Member States covered by this paper, this does not necessarily ensure the harmonised *application* of the relevant rules and principles. Indeed, UCPD contains only high-level rules, and it is the MDEC Principles (and UCPD Guidance) which contains the most useful guidance about how to apply these rules and principles in the context of environmental claims. However, except as indicated below, most countries have not integrated the MDEC Principles into their national law.

Belgium has adopted its own guidance on environmental claims which is based on the UCPD Guidance and MDEC Principles, and various national guidance documents related to environmental claims.

France has not explicitly integrated the MDEC Principles into national law. However, the ARPP (French authority regulating advertisement) Sustainable Development Code[80] contains rules similar to certain MDEC Principles,[81] notably on the requirement to substantiate claims: 'The advertiser must be able to support its sustainable development claims by means of evidence that is objective, reliable, truthful and verifiable at the time of advertising. For any message based on a scientific claim, the advertiser must be able to present the origin of the findings and methodology used for the calculation. Advertisements may not resort to demonstrations or scientific conclusions that do not conform to generally approved scientific findings.'

To our knowledge, Spain, Germany, Netherlands and Luxembourg have not integrated the MDEC Principles at national level.

It is not compulsory for Member States to integrate the UCPD Guidance or MDEC Principles in their law, but considering the lack of detail of UCPD rules, the absence of transposition of UCPD Guidance and MDEC Principles leaves the responsibility for developing efficient rules against greenwashing to national bodies. As a result, there is a risk of heterogeneous regulation of environmental claims of financial products in the EU.

Limited comparability to finance sector specific regulation at national level

The UCPD allows Member States to set stricter rules in relation to financial services[82] and each Member State will have taken steps in relation to national implementation of the EU finance sector specific regulation. Table 5 below compares various national rules related to sustainability claims of financial products. It demonstrates that although EU level regulation seeks to provide a minimum level of harmonisation there are still significant

[79] For some Member States the transposition of 2019 amendments are still ongoing.
[80] ARPP Sustainable Development Code v3
[81] Such principles were not however expressed by AMF.
[82] Art 3(9) UCPD

differences between the national rulebooks which are potentially relevant to sustainability claims of financial products.

Table 5: Summary of national finance sector specific rules relevant to sustainable claims of financial products

Country	Summary of national rules relevant to sustainable claims of financial products
France	MIFID II rules on communication around financial products have been transposed in the Monetary and Financial Code.[83] The AMF (French authority of financial markets) adopted Doctrine DOC-2020-03 on information to be provided by collective investment schemes incorporating non-financial approaches. The Doctrine which is note legally binding sets out the following principle: 'the information sent to investors regarding consideration of non-financial characteristics should be proportionate to the actual consideration of these factors. Accordingly, only the approaches that are significantly engaging will be able to present non-financial criteria as a key aspect of product communication, e.g. in their name. Approaches based on a non-significant commitment may also adopt a "limited communication" proven that they comply with specific minimum standards.' The Doctrine also provides thresholds to determine whether the approach is based on significant commitments. Moreover, an advertisement by a financial institution is also subject to ARPP Recommendations. The ARPP Recommendations are the ethical rules applicable to advertising communication in France. The sustainable development recommendation (v3) has been in force since August 1, 2020, and applies to all products including the finance sector.
Netherlands	There are no finance-specific legal and regulatory requirements in respect of ESG. There are also no specific legal or regulatory rules on ESG marketing of products or services by a financial institution; marketing of ESG aspects is covered by the generic rules and regulations on marketing (e.g., article 24 of MiFID II). Specific rules on ESG aspects only relate to accountability and/or reporting on ESG matters by financial institutions.
Luxembourg	Specific finance sector rules only relate to the application of SFDR. The Commission de Surveillance du Secteur Financier (**CSSF**) requires market participants to submit an SFDR conformity confirmation letter for UCITS and AIFs. The confirmation letter requires sustainability claims made in pre-contract documentation to be underwritten by a statement which confirms the disclosures are accurate, clear and not misleading and that the remuneration policy and the risk management process have respectively been updated to be consistent with the integration of sustainability risks.
Belgium	In order to make a sustainability claim in relation to a financial product, the Belgian regulator (Financial Services and Markets Authority (**FSMA**)) has requested that financial institutions indicate the following on marketing documentation for such financial products: ● the sustainable selection criteria used for selecting investments; ● the methodology behind the sustainable selection criteria; ● the company responsible for assessing the sustainable selection criteria; and

[83] Art L 533-12 *Code Monétaire et Financier*

	• a reference to a webpage that provides more information about the inclusion of sustainability criteria in the investment objective.
Germany	The Federal Financial Supervisory Authority (**BaFin**) published their Draft Guidelines for Sustainable Investment Funds on 2 August 2021 to target misleading environmental claims. BaFin highlights that compliance with the transparency requirements of the SFDR alone is not sufficient for a fund to be described as 'sustainable' (whether in its name or otherwise) or to being marketed explicitly as a 'sustainable fund'. It then provides detailed criteria for a fund to qualify as sustainable investment fund.
Spain	The Comisión Nacional del Mercado de Valores (**CNMV**) has published criteria on the application of SFDR (the **Criteria**). The Criteria clarified that Collective Investment Schemes (**CIS**) that wish to qualify as an **ESG financial product**, may only include references to ESG elements in their commercial name only if the minimum percentage of investments in to achieve the environmental or social characteristics they promote exceeds 50%. In the case of general commercial communications for such products (outside the scope of their naming), references to ESG terms may be used provided that the communication content is aligned with the prospectus information in relation to ESG.

As illustrated in Table 5 above, it is difficult to compare the finance sector specific regulation between Member States. It is apparent that the rulebook at Member State level is quite different and what rules which do exist and are potentially relevant to sustainable claims of financial products are structured according to differing underlying logic. Certain jurisdictions have adopted rules related to the proportionality of the claim (see France), others focus on criteria to be considered as a sustainable fund and thus be allowed to make sustainable claims (see Germany) or on minimum information to be disclosed when making a sustainable claim (see Belgium) while others do not have any specific relevant provisions (Netherlands). All national finance sector specific regulation is similar on one point however in that no national regulation adheres to the notion of investor impact and the rulebook therefore suffers from the same problem as identified at EU level.

This heterogeneity of logic and approach at local level in relation to regulating environmental claims in the finance sector shows a lack of clear and sufficient guidance at EU level that is both detrimental for financial institutions and the level of protection of EU retail investors.[84]

[84] Differing rules on marketing according to each EU country oblige financial institution to have different marketing approaches and materials for each country of distribution. Moreover, considering local rules convey a different logic, the exercise creates legal uncertainty and risk for financial institutions. Heterogeneity of rules also creates inequalities in the level of protection of EU retail investors.

Information Box: Analysis of the practice in France, lack of compliance of environmental impact claims with UCPD rules and MDEC Compliance Criteria

In the second half of 2020, 2DII reviewed a sample of French funds marketed as having sustainability features and available to retail investors.[85] The objective was to identify trends in the use of impact claims that could not be substantiated i.e. claims in breach of UCPD rules and MDEC Principles. The analysis involved comparing the claims in marketing materials (brochure, website etc.) with available information on investment strategy and level of engagement in the regulatory documentation (KIID, prospectus). The database for the study included 521 French funds (representing USD 257 Billion AUM) with a sustainability-related focus and available to retail investors. The study showed that 68% of the funds were associated with environmental impact claims.

The analysis showed various ways in which environmental impact claims can be problematic in view of the MDEC Principles:

- Vague claims that are so broad in the benefit they refer to that no evidence could possibly support them on an objective basis. E.g. 'We aim at being responsible managers for our clients by ensuring that the way in which we invest assets creates societal positive impact and financial performance.'
- Unclear as to the aspect of the financial product that is supposed to generate the environmental impact. E.g. 'Green bonds give the investor certainty on the fact that its money will be beneficial on environmental terms.'
- Deceptive as they inaccurately link an investment in a fund to a specific environmental outcome in explicit terms which cannot rest on scientific evidence. E.g. 'Our sustainable funds have allowed us to realize this year: 430,000 tons of saved carbon emissions, which equates to 4 million trips from Berlin to Paris.'

This study showed that 12% of environmental claims were deceptive as they inaccurately linked an investment in a fund to a specific environmental outcome in explicit terms. 69% of environmental claims were unclear as to the aspect of the financial product that is supposed to generate environmental impact. 73% of environmental impact claims were too vague to be substantiated.[86] [87]

[85] 2DII, 2021, Sustainable Finance and Market Integrity: Promise only what you can deliver

[86] As for the previous research, 2DII was not able to find a single case where the impact claim could indisputably be deemed compatible with the MDEC Principles. This study has not been updated since 2020, however, considering legal framework has not evolved, it is most probable than wrongful practices have not disappeared. The fear of scandal could have however led certain financial institutions to be more caution about their impact claims (see development on Dekabank and DWS).

[87] A recent study analyzed 185 (so-called) impact funds based on an established classification scheme that outlines the requirements for factual impact investments. They found that only one third of the impact funds meet the outlined impact requirements. 'The Impact of Impact Funds – A Global Analysis of Funds With Impact-Claim', Lisa Krombholza, Timo Busch and Johannes Metzler, April 2022

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Section 3

Regulatory oversight and investor redress

This section analyses how the current procedure for regulatory oversight and enforcement and investor redress is not effective in the context of environmental impact claims in the finance sector.

While the previous section examined to what extent the regulatory framework governs the *content of an environmental impact claim* (or more broadly an environmental claim), this section analyses how the regulatory framework governs *what can happen in the event of an inaccurate or misleading environmental impact claim*. It focuses on two key aspects: (1) regulatory oversight and enforcement; and (2) investor redress. In the context of consumer distrust being a significant problem affecting the market for sustainable financial products[88] and an increasing awareness of the extent of greenwashing preventing sustainability minded consumers towards contributing to sustainability policy objectives (see *Section 1.4 The negative effects of greenwashing*), regulatory oversight and investor redress mechanisms are critical aspects to increasing retail investor trust and participation in financial markets.

Regulatory oversight and enforcement refer to the supervisory practices of financial regulators and other authorities to ensure market integrity and compliance with the regulatory framework. While there are many different regulatory tools which can be deployed to set supervisory expectations on a specific issue,[89] this section will focus on the extent to which regulators can take enforcement action in relation to a misleading environmental impact claim.

Investor redress refers to the enforcement of retail investor rights by demanding the cessation of an illegal activity or compensation for harm caused by misconduct.[90] As for regulatory oversight and enforcement, this section focuses on the extent to which investor redress is effective in the context of a misleading environmental impact claim.

3.1 Lack of comprehensive regulatory framework prevents efficient regulatory oversight and enforcement

Opportunities for regulatory oversight and enforcement

Where a financial institution makes an environmental claim which breaches the regulatory provisions articulated in the previous section of this paper then it may face regulatory action by different bodies.

Opportunities for action by financial regulators

In terms of finance sector specific regulation, the key sustainable finance regulations (e.g. SFDR, Taxonomy Regulation etc.) require that Member States provide competent authorities with all the supervisory and investigatory powers that are necessary for the exercise of their functions.[91] However, as demonstrated in the previous section, these sustainable finance regulations are of limited utility in the context of environmental impact claims.

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[88] 2DII, 2021, Sustainable Finance and Market Integrity, p.13.
[89] See our sister paper: 2DII, 2022, Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go
[90] CFA Institute, 2015. Redress in Retail Investment Markets: International Perspectives and Best Practices. Note that investor redress does not refer to compensation of losses resulting from market risk or other risks borne by the investor legitimately.
[91] Art 14 SFDR and Art 21 Taxonomy Regulation

MiFID II similarly provides a general provision that competent authorities 'shall be given all supervisory powers, including investigatory powers and powers to impose remedies, necessary to fulfil their duties'[92] but also provides a very detailed list of the minimum supervisory powers which competent authorities must have.[93] MiFID II specifically requires that Member States enact rules to ensure that competent authorities may impose administrative sanctions.[94] The range of sanctions which Member States must allow for includes: (1) a public statement indicating the natural person or the legal entity responsible and the nature of the infringement; (2) an order requiring the natural person or legal entity responsible to cease the conduct constituting the infringement; and (c) pecuniary sanctions against both individuals and corporate entities.[95]

Opportunities for action by other regulators and notably competition regulators

In addition to action taken by financial regulators, financial institutions may face investigation and sanction by other regulators if their environmental claims breach the requirements under UCPD. Competition regulators often have jurisdiction over consumer protection legislation in relevant jurisdictions.

The UCPD is largely silent on the nature of sanctions which Member States may impose for breaches of the UCPD requirements, but Member States must impose penalties for infringements of the UCPD which are effective, proportionate and dissuasive.[96] Further, Member States must ensure that the court of an administrative authority has the necessary powers to enable them to order the cessation and/or prohibition of a practice which has been determined to be an unfair commercial practice.

In addition, it is worth noting that for both finance sector specific regulation and consumer protection regulation, while there is a variety of regulatory sanctions, the imposition of such sanctions mainly rely on national regulators' willingness to act. Indeed, enforcement by the regulator is unlikely to be an effective route of recourse for retail investors because they must complain to the regulator and then wait for the regulator to decide to take action.[97]

The problem for regulatory enforcement: it is impossible to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions

The main problem for effective regulatory oversight and enforcement do not stem from inadequate supervisory powers or ability to impose sanctions. These aspects of the regulatory toolkit continue to evolve alongside financial regulation generally so that regulators can take measures which are effective and dissuasive in relation to breaches of the regulation.[98]

Rather the problem for effective regulatory oversight and enforcement is that the regulatory framework does not provide effective governance in the context of environmental impact claims in the finance sector (as demonstrated in Section 2 Critical analysis of the relevant regulatory framework). There is an absence of specific legislation or regulation that addresses environmental impact claims in the finance sector, and the current legal and regulatory framework is not consistent with the distinction between investor impact and investee company impact.

This means that the regulatory framework is not sufficiently comprehensive to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions. In this context, regulatory action may fail

[92] Art 69(1) MiFID II
[93] Art 69(2) MiFID II
[94] Art 70 MiFID II
[95] Art 70 MiFID II
[96] Art 13 UCPD
[97] While this is more likely in circumstances where many individuals raise a complain, the chance of success of such route remains uncertain.
[98] The scope of this paper does not include more holistic analysis as to whether regulators are furnished with all the necessary supervisory powers and ability to impose administrative sanctions which are necessary to ensure effective oversight.

regardless of the supervisory powers or ability to impose sanctions. Regulatory oversight and enforcement are simply not going to be possible when financial institutions are not in breach of a clear rule.

3.2 Obstacles to investor redress

Opportunities for legal claims by individual retail investors

In terms of judicial procedures, the court system functions as a tool of last recourse (e.g. when handling client complaints or alternative dispute resolution has not provided resolution). Retail investors can either bring individual actions or seek to be party to a collective action. The commentary below identifies the obstacles to a successful individual action before a national court in relation to a misleading environmental impact claim.

Opportunities for claims based on breaches of finance sector-specific regulation

None of the key finance regulations (MIFID II, SFDR, Taxonomy Regulation, EUGBS) contain specific requirements on Member States to provide a mechanism for individual retail investors to bring legal proceedings before a court.[99]

MiFID II requires Member States to set up complaints and redress procedures for out-of-court settlement of consumer disputes[100] and articulates various organisational requirements for keeping records etc. which can be used for handling client complaints.[101] These have not been examined in the scope of this paper which focuses on investor redress through judicial procedures (i.e. before a court).[102]

Opportunities for claims based on breaches of consumer protection regulation

The consumer protection regulation has a much more explicit focus on legal claims from consumers. Member States are required to put in place adequate and effective means to combat unfair commercial practices which 'shall include legal provisions under which person or organisations regarded under national law as having a legitimate interest in combating [sic] unfair commercial practices … may: (a) take legal action against such unfair commercial practices; and/or (b) bring such unfair commercial practices before an administrative authority competent either to decide on complaints or to initiate appropriate legal proceedings.'[103]

A consumer which has purchased a financial product on the basis of an environmental impact claim from a financial institution would likely amount to a person having a legitimate interest in combatting unfair commercial practices and should therefore be able to seek redress under the legal rights of the UCPD.[104]

Other opportunities for claims

Notwithstanding all of the above, it is theoretically possible, that an individual retail investor might be able to bring a legal claim on a tortious basis (e.g. negligence). For example, such a legal claim might be possible where a financial institution has failed to carry out sufficient due diligence on the accuracy of an environmental impact claim. Similarly, this could give rise to a claim on the basis of misrepresentation. Additionally, the terms of an investment agreement may provide investors with grounds to bring a legal claim for breach of contract

[99] Moreover, as demonstrated in the previous section, sustainable finance regulations are of limited utility in the context of environmental impact claims.
[100] Art 75 MiFID II
[101] Art 16 MiFID II
[102] In addition, considering the high level of MIFID II rules, their utility for the line of enquiry of this paper, and notably for supporting legal claims by individual retail investors, is limited.
[103] Art 11 UCPD
[104] It should be noted that the UCPD also states that Member States may decide whether prior recourse to other established means of dealing with complaints is required before taking legal action. For example, a Member State may require that complaints against regulated firms are directed first via a financial ombudsman service, or an equivalent.

where an environmental impact claim is inaccurate (and replicated in the contract). However, these types of legal claims are very much in the theoretical realm at this stage in the absence of case law.[105]

The problems for successful legal claims by individual retail investors

Exposition of common legal and evidential obstacles to any legal claim in European jurisdictions[106]

The prospect of a retail investor successfully bringing legal action or seeking redress from a financial institution can arise in several ways but will always have to overcome certain legal and evidential obstacles. These include aspects such as causation (the loss suffered must be caused by the representation in the environmental claim), remoteness (the type of loss must be reasonably foreseeable) and quantum (assessing the value of the loss). In some instances, retail investors may have to establish a duty of care. Moreover, in most instances, retail investors will have to demonstrate that (a) it was reasonable to rely on the environmental impact claim, and/or (b) that the degree of reliance was justified.

The ability to bring such a legal claim will be highly fact-specific and practically/evidentially difficult, especially in the absence of case law. Moreover, passing these legal and evidential obstacles will be extremely difficult due to two critical conceptual problems.

Conceptual problem 1: It is impossible to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions

The first conceptual problem relates to the discussion above that the regulatory framework is not sufficiently comprehensive to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions. In this context, just as regulatory action may fail, so too may a legal claim from investors.

The concept of environmental impact claims is an industry term and not a legal concept recognised under existing EU law. As such, there are no specific requirements which directly apply to a statement by an FI to carry out impact investing or which purport to be an ‘impact product’, including in relation to how such products are marketed, promoted or distributed. Therefore, those terms are useful short hand to describe the intended impression a given statement is intended to make but they do not speak to whether they are made in a misleading manner, judged against legal tests/thresholds.

Conceptual problem 2: It is difficult (or impossible) to prove the loss caused by the misleading environmental impact claim

The second conceptual problem relates to the form which the redress takes. Generally, most investor redress claims are likely to be compensatory through seeking to recover lost monies or another form of damages. Other investor redress claims (albeit less common) may seek to rescind or end the contract/investment. This would lead to the return of invested sums as well as any applicable interest.

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[105] Financial institutions may also face legal claims for breach of client duties (although these legal claims are less directly relevant to misleading environmental impact claims). The MiFID II Amendments (Delegated Regulation (EU) 2021/1253) (which introduce a mandatory assessment of client *sustainability preferences* in the suitability assessment so that advisors must include questions on client sustainability preferences and any financial product recommendation must take account of sustainability preferences expressed by the client) will have a significant impact on the likelihood of individual retail investors bringing claims in relation to their sustainability preferences. The MiFID II Amendments require a financial institution to ensure client sustainability preferences are taken into account in the universe of products that are made available to the client. Where client sustainability preferences do not match the universe of investments available to the client then the financial institution must revisit the client's sustainability preference until such time as the sustainability preferences and the potential investments available do match. Where no match is possible the client cannot be sold or enter into relevant financial instruments or transactions. See our sister paper: 2DII, 2022, Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go for further discussion.

[106] Such legal and evidential requirements may differ from one jurisdiction to another. Developments in this section aim at drawing a general view on legal and evidential requirements in Europe based on our sample of six countries.

By way of example: (a) in the context of an environmental claim that a financial product does not invest in coal, (b) which leads a retail investor to invest in the financial product, (c) but the financial product actually holds equities in a coal producer during the lifecycle of the product, the retail investor may try to bring an action on one of the following bases[107]:

- First, a retail investor may seek compensation on the basis that if the financial institution had ensured that the financial product followed the environmental claim (i.e. the financial product did not invest in coal) then the financial product would have achieved higher financial returns.
- Second, a retail investor may seek compensation on the basis that by investing in the coal producer, the financial institution has caused the retail investor to suffer a financial loss.
- Finally, a retail investor may seek compensation on the basis that the financial institution acted negligently in disregarding the retail investor's sustainability preferences by negligently investing in the coal producer (if the retail investor can establish a duty of care). If this led to the retail investor's investment being worth less than before the act of negligence occurred (i.e. it may not be possible to bring an action under negligence unless the financial product provides negative returns from the purchase date), it may seek compensation for the difference.

As illustrated above, the current legal framework does not provide opportunity for redress where an investor has not suffered a loss. And it is difficult to imagine how this loss could be considered outside the strict definition of personal financial loss (especially in the absence of case law or specific legal or regulatory provisions).

This means that, currently, a retail investor's legal claim against a financial institution because of a misleading environmental impact claim will not be successful unless that retail investor has suffered a financial loss. Proving the financial loss would be extremely difficult. [108]

Finally, in many cases there might not actually be any financial loss. The loss suffered by the retail investor may only be the lost opportunity to have a positive environmental impact (as initially promised by the marketing claim). But current legal redress framework does not cater for this type of loss. And if so, the question would remain on how to quantify and compensate it.

[107] Non-exhaustive basis

[108] Moreover, even where that retail investor has suffered a financial loss, this loss may not be commensurate to the environmental damage done by the retail investor's investment, which has been directed into an economic activity that they did not intend on the basis of the financial institution’s environmental claim.

3.3 Lack of harmonisation at national level

As demonstrated above, the articulation of regulator supervisory powers and administrative sanctions is broadly drafted at EU level. Generally, the legislation is drafted so that supervision by competent authorities is proportionate and considers the nature, scale, complexity and diversity of entities and circumstances falling within scope of the legislation.

And while a minimum degree of harmonisation is apparent in relation to the supervisory powers and ability to impose sanctions,[109] there is still plenty of scope for variable oversight practices. *Annex 1* sets out further details on the national regulators at Member State level. It is possible to discern a divergence in relation to the extent to which sustainable finance, climate risk etc. is integrated into each national financial regulators' general oversight mandate and supervisory activities. We hypothesise that this divergence is more pronounced when looking at all Member States across the EU. Currently, while financial regulators in some Member States have taken active steps in relation to environmental claims within their supervisory mandate,[110] financial regulators in other Member States have remained largely silent. This divergence is likely to stem from a number of factors - while organisational mindset is likely to be a factor, so too are aspects such as organisational capacity, funding etc. Even for those Member States who have taken active steps, these steps still lack the required level of comprehensiveness to deal adequately with environmental impact claims themselves (as opposed to environmental claims more generally).

Investor redress is similar – while there may be a degree of harmonisation[111] ultimately each national legal system is different and will have a unique body of caselaw and jurisprudence.[112] And in addition to different national legal systems the collective mindset of retail investors may be very different. 2DII research into client preferences for sustainable investment has revealed subtle differences in prioritisation of sustainability issues and other aspects.[113] It would be interesting for further consumer research to focus on the extent to which retail clients are aware of their rights of redress or would be happy to use these rights of redress in a claim against a financial institution.

Any retail investor action relating to a misleading environmental impact claim is likely to focus first on the national regulatory framework. However, due to the problems identified in this paper (most notably, that the regulatory framework is not sufficiently comprehensive to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions) it is perhaps not surprising that there is very little by way of caselaw in this area. There are two well-known examples of financial institutions providing potentially misleading claims in an environmental context discussed in the following Information Boxes but neither of these examples have come before a court to date.

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[109] As evidenced through the articulation of supervisory powers and ability to impose sanctions in MiFID II and the general articulation of supervisory powers in SFDR and Taxonomy Regulation (for example).
[110] For example, as referred to in Annex 1, BaFin has taken action to protect investor from greenwashing through developing the *Guidelines for Sustainable Investment Funds* to target misleading environmental claims.
[111] For example, in relation to the MiFID II requirements for Member States to set up complaints and redress procedures for the out-of-court settlement of consumer disputes investment firms being subject to various organisational requirements for keeping records etc. which can be used for handling client complaints.
[112] Even if ultimately, the national jurisdiction is subordinate to the Court of Justice of the European Union which is responsible for ensuring EU law is interpreted and applied the same in every EU country.
[113] See 2DII, 2020, A large majority of retail clients want to invest sustainably. And 2DII, 2022, What do your client actually want?

Information Box: Case commentary on DekaBank

DekaBank in Germany released an Impact Calculator on the information page for the Deka-Sustainability Impact fund.[114] Potential investors can enter the investment sum to find out the potential environmental and social impacts of their investments.[115]

Baden-Wurttemberg Consumer Centre (**BWCC**), a consumer protection agency located in the German state of Baden-Wurttemberg, brought a case in the Frankfurt District Court claiming that the Impact Calculator is misleading to retail investors and seeking 'judicial clarification' on the impact claims DekaBank made about its Deka-Sustainability Impact fund. BWCC argued that while DekaBank's website says that the effects are achieved 'indirectly by investing in listed companies that match the investment objective of the fund,' this could mislead potential retail investors. Furthermore, the figures for the positive ecological impact are only based on an estimate and not all of the companies in the fund were taken into account. As a result, there is no evidence for the promised effects.[116]On the face of the information available about BWCC cause of action, it appears directly relevant to the line of enquiry of this paper.

Initially DekaBank said it would fight the case, with a spokesperson saying the legal claim was unfounded and citing various arguments in relation to the data being provided by service providers with decades of experience in reporting ESG and climate data and the presentation method having received an independent award. However, DekaBank subsequently removed the Impact Calculator and formally recognised the BWCC's claims. As a result, the court proceedings were terminated.

Information Box: Case commentary on DWS

German asset manager DWS is facing regulatory investigations over accusations that it made misleading statements about its use of sustainability criteria. There is currently a coordinated investigation by BaFin in Germany and the Securities and Exchange Commission (SEC) in USA.[117]

A former Group Sustainability Officer declared in the Wall Street Journal that DWS had exaggerated its ESG claims. She said that her revisions and objections regarding the volume of assets under ESG integration in the 2020 annual report were never included.

The annual report explained that DWS had €459 billion in what was termed integrated ESG assets. This is more than half of the total asset management of DWS but an internal assessment of ESG capabilities said that 'only a small fraction of the investment platform applies ESG integration.' The allegations are firmly rejected by DWS who has hired a law firm to assess all environmental allegations and not only the ones that are the subject of investigation.[118]

This example illustrates the multiple risks for a financial institution when faced with actions of this kind. When news of the investigation broken DWS's share price fell by 13.7% and if found to have exaggerated ESG claims then DWS could be order to re-label funds and offer financial compensation to misled clients or be condemned to fines. While the investigation is still ongoing, it may also raise questions in relation to third party advisory services with PwC both advising DWS on its net-zero neutrality strategy while investing greenwashing allegations.[119]

[114] Citywire Selector, 2021, Deka fights lawsuit on misleading positioning of its impact equity fund
[115] Responsible Investor, 2021; DekaBank sued over 'misleading' fund impact calculator. The calculator gives five other metrics, including the amount of renewable energy produced and the amount of waste saved.
[116] Responsible Investor, 2021, DekaBank sued over 'misleading' fund impact calculator.
[117] Responsible Investor, 2021, UPDATED: BaFin and SEC investigate DWS over ESG allegations
[118] Bloomberg, 2021, Deutsche Bank's DWS orders fresh probe into greenwash claims.
[119] Natixis, 2021, Green-washing allegations are jolting the financial industry: heightened needs for cautiousness, integrity and guidance

Section 4

Recommendations

This section identifies recommendations to address the problems identified in this paper and ensure better market practice in relation to environmental impact claims in the finance sector.

There are several initiatives and activities which are apparent in the EU sustainable finance policy agenda which are relevant to the line of enquiry of this paper.

The *Strategy for Financing the Transition to a Sustainable Economy* takes up the mantle of the Commission's 2018 *Action Plan on Financing Sustainable Growth* in relation to developing a sustainable finance framework which reflects an evolved understanding of what is needed to meet EU sustainability goals and how the global context has changed. The Commission is currently developing the detail of the specific actions to be taken under this Strategy but has articulated the following areas of focus will be covered:

- *Addressing greenwashing:* With the support of the European Supervisory Authorities, the Commission will assess whether supervisory powers, capabilities and obligations are fit for purpose. Based on this assessment and the monitoring of greenwashing risks by the European Supervisory Authorities, the Commission will consider steps to ensure a sufficient, consistent level or enforcement and supervision to address greenwashing. Furthermore, the Commission will look to strengthen cooperation among all relevant public authorities, including Member States, the ECB, ESRB, the European Supervisory Authorities and the European Environment Agency, to work towards a common approach to monitor an orderly approach and ensure the double materiality perspective is consistently integrated across the EU financial system.

The *Strategy for Retail Investors* which is currently planned for the second quarter of 2022. While we are awaiting publication of this strategy to ascertain the precise actions and activities which will be included, the consultation which closed in August 2021[120] included various areas of focus:

- *Financial literacy:* Measures which the Commission can take to support and complement the financial education responsibilities of Member States to empower individuals to understand the risks and rewards surrounding retail investors, as well as the different options available.
- *Investor redress:* Examining aspects such as retail investor levels of knowledge in relation to redress procedures, effectiveness of existing out of court or alternative dispute resolution procedures at addressing consumer complaints relevant to retail investment and insurance-based investments, whether further efforts are needed to improve redress in the context of retail investment products and to what extent consumer redress is accessible to vulnerable consumers.

While these activities (either already articulated in relation to the *Strategy of Financing the Transition to a Sustainable Economy* or potentially indicated as an area of focus for the upcoming *Strategy for Retail Investors*) are highly relevant to the line of enquiry of this paper, there is no indication that the precise detail of these activities will extend to a specific focus on environmental impact claims of financial products.

In this context, the following recommendations are conceived so that they are either a standalone recommendation or so that the planned activities under each of the above strategies include a focus on their relevance to improving the regulatory framework which applies to environmental impact claims. In this regard, it would be highly beneficial to establish a body/working group at EU level to ensure coordination in the research activities and outputs.[121]

[120] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12755-Retail-Investment-Strategy/public-consultation_en
[121] 2DII intends to establish a working group built on the model of the EU Multi-Stakeholder Dialogue on Environmental Claims to address the issues identifies in this paper and identify clarifications and improvements needed to adapt the legal framework to the context of financial products as well as other measures to improve financial market practice in relation to environmental impact claims. These research outputs will be an invaluable starting point for the recommended body/working group at EU level.

4.1 Create an EU framework for environmental claims in the finance sector with a focus on environmental impact claims

The legal analysis in this paper reveals that it is difficult to map the legal rules applying to environmental impact claims in the finance sector and they are insufficient to provide effective governance.

At EU level, general finance rules which apply to marketing claims in the finance sector, such as MIFID II rules, are applicable to environmental impact claims, but these rules are too high level to provide effective governance of environmental impact claims.

Recent sustainable finance rules, such as those included in the SFDR or the Taxonomy Regulation, do not aim at regulating environmental impact claims of financial products. And an emerging trend of using SFDR categories (article 8 and article 9) as marketing labels create additional confusion and greater risk of greenwashing especially when combined with environmental impact claims. Indeed, SFDR does not adhere to the distinction between investor impact and investee company impact[122]. There is no requirement for Article 8 and Article 9 products to reveal investor impact[123], therefore the SFDR is not adapted to apply to environmental impact claims.

Furthermore, the provisions of UCPD are not sufficient for the finance sector context. While the consumer protection framework provides much more detailed guidance (in the form of the UCPD Guidance and MDEC Principles) about its application in the context of environmental claims, the absence of a definition of investor impact and the lack of recognised tools and methodologies to evidence investor impact (or impact potential) prevent the efficient application of UCPD rules in relation to environmental impact claims in the finance sector. The recent proposal to amend the UCPD[124] is a welcome initiative – but is likely to be insufficient to address the problems articulated in this paper. Indeed, it does not provide additional detail on how to apply the rules to environmental impact claims in the finance sector.

The lack of harmonisation of rules related to environmental claims at national level will also remain a problem. Indeed, the UCPD currently indicates that 'in relation to financial services […] Member States may impose requirements which are more restrictive or prescriptive.'[125] And furthermore, 'financial services and immovable property, by reason of their complexity and inherent serious risks, necessitate detailed requirements, including positive obligations on traders'. For this reason, in the field of financial services and immovable property, the UCPD is without prejudice to the right of Member States to go beyond its provisions to protect the economic interests of consumers.'[126]

We agree with the general principal that specific rules are required for the finance sector – and this need is particularly acute in the context of environmental impact claims in the finance sector. But the legal analysis in this paper reveals an urgent need for these rules at EU level rather than being written at Member State level. Finance specific rules at Member State level shows significant variability (in terms of areas of focus and underlying logic – see *Table 5: Summary of national finance sector specific rules related to sustainable claims*

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[122] See *Section 1.2 Exposition of an environmental impact claim in the finance sector* and *Section 2.2 Study of EU finance sector specific regulation.*
[123] Regarding Article 8, there is no regulatory criteria to specify eligible investment targets, investing styles, investing tools, strategies or methodologies to be employed. As a result, Article 8 products may apply various strategies (for example, screening and exclusion strategies) many of which are unlikely to have an environmental impact. The drafting of Article 9 merely refers to 'investing in an economic activity that has a positive impact.' As such, it fails to consider the causality angle i.e. what role the investor may have played in bringing about this positive impact. In addition, it fails to preserve the distinction between investor impact and investee company impact. Article 9 products refer to what might generally be understood as thematic investment more likely to fit the goals of investors looking for value alignment rather than impact. Despite the confusion created by Recital 21 of SFDR implicitly referring to article 9 as 'financial products which have as an objective a positive impact on the environment and society'.
[124] Proposal for a Directive amending Directives 2005/29/EC and 2011/83/EU
[125] Art 3(9) UCPD
[126] Recital 9 UCPD

of financial products thus resulting in legal uncertainty for financial institutions and unequal levels of protection for retail investors in EU.

To ensure a harmonised level of protection for retail investors against greenwashing, rules specific to environmental claims of financial products must be provided at EU level. This framework should particularly ensure the protection of retail investors against impact washing.

The Commission should provide specific rules at EU level to regulate environmental claims in the finance sector with a focus on environmental impact claims.

4.2 Create a category for impact-oriented financial products and provide methodologies and tools to evaluate the potential of impact

Alongside a framework at EU level for environmental claims (with a focus on environmental impact claims), further steps to integrate the notion of environmental impact in the finance sector are necessary. These include: (1) creating a category for impact-oriented financial products and (2) developing methodologies and tools to evaluate the impact potential at EU level.

Creating a category for impact-oriented financial products

There is a huge amount of uncertainty in relation to how impact-oriented financial products are accommodated (if at all) in the current approach to categorisation of sustainable financial products.

This uncertainty is apparent in terms of legal interpretation of the SFDR definitions of product categories, and it is also apparent in terms of market behaviour and how financial institutions are self-certifying their products according to SFDR.[127][128]

The work on the EU Ecolabel is a first step towards integrating the notion of investor impact, however, it is only a voluntary framework that will not apply to all financial products. Moreover, the EU Ecolabel for financial products is currently on hold due to controversies in relation to the decision to classify nuclear and gas power as green activities under the Taxonomy Regulation.

This uncertainty is detrimental to impact-oriented retail investors and financial institutions who are offering genuine impact-oriented financial products.

Improving the categorisation of sustainable product must include a separate category for impact-oriented financial products. This regulatory category should rely on a clear definition of the notion of impact distinguishing between investor impact and investee company impact.[129] *Furthermore criteria for this regulatory category should take into consideration the three pillars of impact: intentionality, additionality, and*

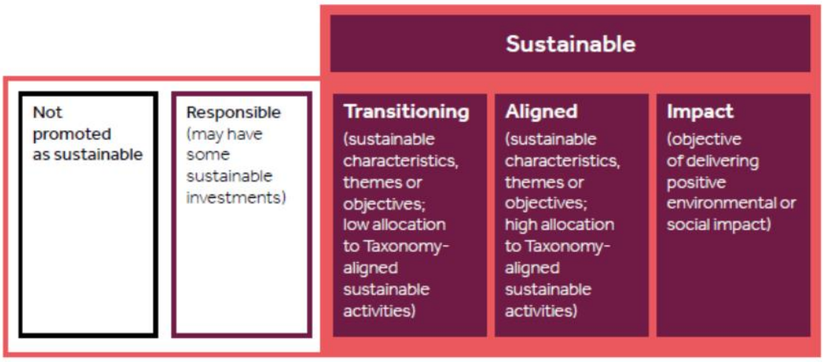
[127] As referred to in this paper, a confusion has developed in the market between Article 9 financial products and impact-oriented financial products. For more detail refer to 2DII, 2021, Does the SFDR help the impact-focused retail investor?
[128] It is also now apparent in the definition of sustainability preferences of clients in MIFID II. Please refer to sister paper: 2DII, 2022, Integrating client preferences for sustainable investment into financial institution legal duties…still a way to go
[129] It can build on academic research as per Kölbel et al. (2020): 'The impact of an investor is the change that the investor has caused in the activities of the company benefiting from his investment. In the context of climate change mitigation, this change can either take the form of a growth in a "green" company' activities (e.g. a growth of its green power production) or of a change in the quality of a company's activities (e.g. an increase in the energy efficiency of a plant).'

measurement.[130] Measurements should be done ex ante and ex post to assess if objectives have been achieved.

In this regard, 2DII's Climate Impact Management System (**CIMS**) provides a clear view on the notion of environmental impact of a financial product.[131] Another source of inspiration can be found in the work of the Paris Financial Centre Task force dedicated to Impact Finance launched in March 2021 by Finance for Tomorrow. The Paris Financial Centre Task force published a pledge for the development of Impact Finance in November 2021 that contains a definition of Impact Finance.[132] This option to create a specific category of impact-oriented products has already been proposed in the UK. The FCA has recently consulted on a proposed approach to a sustainable product classification and labelling system.[133] There are several aspects to the FCA's policy proposals which can serve as inspiration for how to clarify the confusion in the EU framework.

The potential labelling system differentiates between *Impact* financial products (that aim to deliver positive environmental or social impact) and other types of sustainable financial products such as *Transitioning* and *Aligned* investment products (which can have varying degrees of sustainability). According to this classification, impact-oriented products are clearly demarcated as a separate category – and therefore much easier to identify and recommend for an impact-oriented client. Second, the FCA is planning to develop detailed minimum criteria which are linked to tangible product features which determine how to categorise each financial product. For example, both *Sustainable-Transitioning* and *Sustainable-Aligned* are structured with underlying assets meeting sustainability criteria set out in the forthcoming UK Taxonomy, but the minimum proportion for *Sustainable-Aligned* is set at a higher level than for *Sustainable-Transitioning*.

Figure 2: FCA's proposed approach to sustainable product classification and labelling system



This approach to sustainable product classification (albeit in its early stages of development) appears to offer significant scope for a framework which effectively articulates impact products as a separate category and is easier to use for both financial institutions and clients (e.g. simplification through ensuring the proportion invested in suitable underlying assets is included in the product classification criteria rather than clients

[130] See F4T, 2021, Pledge for the development of Impact Finance: *'Impact Finance is an investment or financing strategy that aims to accelerate the just and sustainable transformation of the real economy, by providing evidence of its beneficial effects. It is based on the pillars of intentionality, additionality and impact measurement, to demonstrate:*
1. The joint search, over time, for an ecological and social performance and a financial return, while controlling the occurrence of negative externalities.
2. The adoption of a clear and transparent methodology describing the causal mechanisms through which the strategy contributes to the targeted environmental and social objectives, the relevant period of investment or financing, as well as the measurement methods – according to the concept of theory of change.
3. The achievement of environmental and social objectives aligned with frameworks of reference, in particular the Sustainable Development Goals, defined at the international, national and local levels.'
[131] 2DII, 2021, A Climate Impact Management System for Financial Institutions
[132] F4T, 2021, Pledge for the development of Impact Finance
[133] FCA, 2021, Discussion Paper (DP21/4) Sustainability Disclosure Requirements (SDR) and investment labels

choosing the minimum proportion to be invested in accordance with the criteria). Improving the approach to categorisation of sustainable financial products in a manner which accommodates impact-oriented financial products is a critical step to support the development of a framework at EU level for environmental claims (with a focus on environmental impact claims).

Developing methodologies and tools to evaluate impact potential

Currently there is no tool or methodology recognised at EU level to substantiate environmental impact of financial products. Indeed, allocating environmental impact in the finance sector is a challenge. Investigating investor impact is a nascent research field and as such numerous gaps and uncertainties remain about the effectiveness of different climate actions and impact mechanisms. A recent authoritative meta study on the topic[134] concluded that we do not have a consensus that any particular climate action or impact mechanism always has an impact under different conditions. It is thus currently near to impossible for a financial institution to provide scientific evidence to support environmental impact claims (contrary to what is required by the UCPD as interpreted by MDEC Principles).[135]

However, while there may be no robust or measurable link between climate actions/impact mechanisms and real-world impact in all cases, there is an emerging understanding of the conditions in which different climate actions/impact mechanisms would be more or less likely to influence investee company behaviour and generate real world impact (i.e. **impact potential**). Several methodologies are being developed to evidence and evaluate the impact potential of a financial product.[136] 2DII's own work in this area builds on previous studies of investor impact by the Impact Management Project and University of Zurich to develop a Climate Impact Potential Assessment Grid.[137] This includes four criteria to assess the climate impact potential of a financial instrument:

- Signalling a commitment to the green energy transition;
- Servicing new or undersupplied markets;
- Providing flexible capital;
- Pressuring funded organisations to align their climate strategy with a 1.5°C scenario.[138]

Developing methodologies and tools to evaluate impact potential can support harmonisation of approaches and contribute to improved understanding of the mechanisms for investor impact. This empirical evidence can support both the categorisation of sustainable financial products in a manner which accommodates impact-oriented financial products as well as the practice which develops under the framework at EU level for environmental claims (with a focus on environmental impact claims).[139]

The Commission should integrate the notion of environmental impact in the broader EU finance framework through (1) creating a category a category for impact-oriented financial products; and (2) developing methodologies and tools to evaluate the impact potential.

[134] Kölbel et al., 2020, Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact.
[135] 2.3. MDEC Principles
[136] 2DII, 2021, Climate Impact Management System for Financial Institutions and F4T, Grid to evaluate the potential of contribution to the transition
[137] 2DII, 2021, I've Got the Power! Really? Assessing the Impact Potential of Financial Products Supporting the Energy Transition
[138] 2DII, 2021, I've Got the Power! Really? Assessing the Impact Potential of Financial Products Supporting the Energy Transition and F4T Grid to evaluate the potential of contribution to the transition (draft grid only currently available in French and applicable to investment funds)
[139] This action would fit in the EU initiative on substantiating green claims and the environmental performance of products & businesses. Indeed, as underlined by the EU: 'There is a proliferation of methods to measure and assess environmental impacts and a proliferation of labels and claims related to environmental information, which goes hand in hand with a proliferation of misleading environmental, including climate-related, claims.' Inception impact assessment on a legislative proposal on substantiating green claims, 20 July 2020

4.3 Establish guidance for responsible environmental impact claims in the finance sector

To assist financial institutions with regulatory compliance, clear guidance for responsible environmental impact claims must be developed. This guidance can build upon the methodologies and tools to evaluate potential of investor impact and foster a harmonized approach across all Member States.

A straw man of relevant criteria which should be included in this guidance for responsible environmental impact claims is below.

Make reality-based claims
Financial institutions should ensure that all information reported and documented is built around fact-based assumptions in order to limit misleading communication, in particular they should:

- Avoid ambiguous statements equating the deployment of a sustainable investment strategy (the means) with environmental impacts in the real economy (the ends).
- Refrain from equating an evolution of the boundaries of their asset portfolio (e.g. divestment from an entity owning a coal-fired power plant) with environmental impacts in the real economy (e.g. closure of a coal-fired power plant replaced by renewables) as a direct consequence of their actions.
- Refrain from equating an increase in their allocation to certain financial assets (e.g. increase in green bond exposure, or assets under management in green funds) with an increase of investments in the real economy (e.g. increase in capital expenditure in green projects) as a consequence of their actions.

Claims should always use appropriate vocabulary. For example, avoid using inappropriate terms such as *financing*, which reflects a real cash flow, instead of *investment,* since it creates a confusion about the use of funds.

Substantiate claims (evidence-building)
Any institution that believes the deployment of an investment/lending approach (such as divestment from certain assets, the increase in allocation to other assets or the deployment of certain tools) will lead directly or indirectly to environmental impacts in the real economy should substantiate its claims by collecting evidence supporting the causal link between the financier's actions and the outcomes.

For this purpose, the institution should:

- Lay out each assumption made for the specific cause and the evidence available (ex-ante) to support the investment thesis.
- Collect further evidence (ex-post) and report how it supports—or contradicts—its thesis; This evidence-based approach aims to avoid any ambiguity between assumptions (i.e. divestment from coal mining companies prevents new coal projects from being financed) and facts and build evidence on an on-going basis to improve the investment thesis continuously.

Be transparent on additionality
An institution should refrain from suggesting that the environmental impacts of its investees and borrowers can automatically be credited to its investment/lending strategy and from reporting these impacts as if the financial institution itself was delivering them. A financier cannot automatically take credit for the investee's climate impact (i.e. low level and/or reductions of GHG emissions in the real economy) if there is no evidence that the financier's climate action was a key driver for the GHG emissions change. This involves refraining from suggesting that:

- The provision of financing to green activities brings a critical contribution to their development, if these activities do not face difficulties accessing finance in the first place;
- Its refusal to finance brown activities prevents the institution's access to finance, if the evidence suggests that the effect is fully offset by other finance sector players;

- Its strategy triggered the environmentally friendly practices of investees/borrowers if their decision were already made or have been primarily driven by other factors.

Be clear on the limits of the product
Investors should be clearly informed of the limits of the financial products. The use of disclaimers can be useful.

However, disclaimers should only be used to accompany fair, clear and not misleading communication complying with above principles and cannot be used to justify the use of unclear or ambiguous marketing claims. In other words, the retail investors should not have to read the content of the disclaimer to understand whether the financial products have a potential of positive impact on the environment.

Financial institutions should rely on solid marketing claims rather than over simplified and inaccurate ones in order to enhance trust and investment of retail investors in sustainable finance.

Constantly improve impact practices
The absence of scientific evidence on the effectiveness of various investment techniques in delivering real impact should not prevent leading financial institutions from implementing best practices and experimenting with new ones. Leading impact investors assess the effectiveness of their approach, acknowledge shortcomings, and learn from their mistakes to fine tune their investment thesis and approach.

Therefore, financial institutions should continue promoting their products with highest potential of positive impact as such.

Information Box: Next steps to advance the recommendations in this paper

To complement the theoretical review in this paper[140] 2DII is conducting an ongoing programme of interviews (with relevant stakeholders: EU and national policymakers, advertising SROs, financial institutions, competition and consumer protection authorities, judicial authorities, NGOs etc.). The purpose of this interview programme is to develop practical analysis of the specific challenges raised by the existing legal frameworks.

In addition, 2DII will be establishing a broad multi-stakeholder working group built on the model of the EU Multi-Stakeholder Dialogue on Environmental Claims. The goal of the working group is to develop further and advance the recommendations articulated in this paper. In particular: (1) assessing the clarifications and improvements needed to adapt the legal framework to the context of financial products; and (2) developing guidance for responsible environmental impact claims in the finance sector and integrating this guidance in existing rules and norms.

This working group will be coordinated by 2DII. The initiative will also be presented to the public and the sector through an inaugural public event, two workshops and a website.

[140] Together with the theoretical review in our sister paper: 2DII, 2022, Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go

4.4 Review investor redress mechanism in the context of environmental impact claims

The existing avenues for investor redress may prevent a retail investor from making a successful legal claim in respect of misleading environmental claims generally (and environmental impact claims more specifically). The prospect of a retail investor successfully bringing legal action or seeking redress from a financial institution can arise in several ways but will always have to overcome certain legal and evidential obstacles (such as demonstrating causation between the breach and the loss, remoteness and quantum of the loss etc.). Passing these legal and evidential obstacles will be extremely difficult in the context of environmental impact claims due to two critical conceptual problems: (1) it is impossible to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions; and (2) it is difficult (or impossible) to prove the loss caused by the misleading environmental impact claim.

Currently, a retail investor's legal claim against a financial institution because of a misleading environmental impact claim will not be successful unless that retail investor has suffered a financial loss. Proving the financial loss would be extremely difficult.[141] Moreover, in many cases there might not actually be any financial loss. The loss suffered by the retail investor may only be the lost opportunity to have a positive environmental impact (as initially promised by the marketing claim).

As indicated at the start of this section, the Commission's 2021 consultation on what to include in the *Retail Investment Strategy* included a section on investor redress. And the response from ESMA's *Securities and Markets Stakeholder Group* reveals various problems associated with the current framework for investor redress in the EU.[142]

The focus on investor redress which is apparent in the consultation relates to the MiFID II complaint handling procedure and ADR/out of court procedures. This focus is necessary[143] and policy changes in response should advance the consumer protection agenda. But while there have been multiple changes to the regulatory framework which are intended to ensure client preferences for sustainable investment are considered by financial institutions, there has been limited or no consideration of what rights of redress clients should have in case of greenwashing or impact washing.

It appears key to review investor redress mechanism to ensure an efficient protection of retail investors against misleading environmental impact claims. Such review should focus on solving the two main obstacles highlighted previously: demonstrating an environmental impact claim is in breach of a clear set of regulatory provisions[144] and addressing the issue of loss in the context of misleading environmental impact claims.

In anticipation of the forthcoming Retail Investment Strategy, the Commission needs to ensure there is no barrier in the redress framework to retail investors who want to bring a claim against financial institutions in respect of misleading environmental impact claims

[141] Moreover, even where that retail investor has suffered a financial loss, this loss may not be commensurate to the environmental damage done by the retail investor's investment, which has been directed into an economic activity that they did not intend on the basis of the financial institution's environmental claim.
[142] ESMA Securities and Markets Stakeholder Group, 2021, SMSG response to the European Commission's consultation on the EU Strategy for Retail Investors
[143] In this regard, the feedback in the consultation response from the SMSG is useful for alerting to the generalised weaknesses in the redress framework.
[144] This demonstration does not seem possible without the creation of an EU framework for environmental claims in the finance sector with a focus on environmental impact claims and the creation of a category for impact-oriented financial products and development of methodologies and tools to evaluate the potential of impact.

It is also worth noting that the Commission's 2021 consultation on what to include in the *Retail Investment Strategy* also included a focus on financial literacy and the scope for Commission initiative to support financial education responsibilities of Member States. This was identified as an area with main scope for improvement by far more respondents (69% in total). There is also reference in the *Strategy for Financing a Transition to a Sustainable Economy* to the Commission working with the OECD and its International Network on Financial Education to improve citizens' financial literacy.[145]

The strategy articulates that increased financial literacy can have several benefits such as helping retail investors to improve their understanding of financial products, creating realistic expectations about risk and performance, increasing participation in financial markets and making investment decisions that are in line with their investment needs and objectives. However, what is missing from the materials available about improving financial literacy is a focus on sustainable finance literacy (i.e. an understanding of the various sustainability features which a financial product might have) or knowledge of investor redress mechanisms (to address the fact that retail investors are not sufficiently aware of how to enforce their rights).

The Commission work plan in relation to improving financial literacy must include provision for sustainable finance literacy and knowledge of investor redress mechanisms

4.5 Improve regulatory oversight of environmental impact claims

The lack of comprehensive regulatory framework prevents efficient regulatory oversight and enforcement. Indeed, it is not possible to have regulatory oversight and enforcement against misleading environmental impact claims if financial institutions are in compliance with a (albeit deficient) regulatory framework. Or alternatively, it is not possible to have regulatory oversight and enforcement against misleading environmental impact claims where the regulatory framework is not sophisticated or detailed enough to enable it.

But even despite these problems with the regulatory framework, there is still a concern that regulatory scrutiny of environmental impact claims – and broader environmental claims – is variable according to each Member State. And further that regulator capacity and expertise to effectively scrutinise the specific nature of environmental impact claims is lacking.

As set out previously, the Commission has revealed a focus on addressing greenwashing in last year's *Strategy for Financing the Transition to a Sustainable Economy*. With the support of the European Supervisory Authorities, the Commission will assess whether supervisory powers, capabilities and obligations are fit for purpose. Based on this assessment and the monitoring of greenwashing risks by the European Supervisory Authorities, the Commission will consider steps to ensure a sufficient, consistent level or enforcement and supervision to address greenwashing.

In addition, ESMA's *Sustainable Finance Roadmap 2022-2024*[146] identifies tackling greenwashing and promoting transparency as one of three priority areas for ESMA's sustainable finance work. The proposed follow up categories of activity to address this priority include:

- Organising case discussion focused on greenwashing issues among NCAs to establish a share understanding of key concepts;
- Providing guidance to the market and NCAs on how to apply various rules in the sustainable finance single rulebook;

[145] They will publish joint financial competence frameworks for adults and young people reflecting the skills and knowledge individuals need to support their financial wellbeing and to further access sustainable finance.
[146] ESMA; 2022, Sustainable Finance Roadmap 2022-2024

- Developing a common understanding of NCAs supervisory role in the area of sustainable finance and specifically on greenwashing;
- Contributing to further completing the EU single rulebook on sustainable finance while promoting its consistency with international initiatives; and
- Collecting and studying empirical evidence regarding the functioning of ESG markets and ESG products as well as cases of greenwashing to better understand current and developing market practices.

These initiatives are timely, and look set to be transformative in terms of activating regulatory oversight and harmonising practices. However as currently conceived, they look to enhance oversight of the regulatory framework as it currently stands. This means that there is a risk that this will do little to assist where the regulatory framework is deficient i.e. these activities will do little to assist with environmental impact claims which the regulatory framework cannot currently accommodate.

The focus on greenwashing in the Commission's Strategy for Financing the Transition to a Sustainable Economy and ESMA's Sustainable Finance Roadmap 2022-2024 must address the specific issue of supervision of environmental impact claims

In addition, the *Strategy for Financing the Transition to a Sustainable Economy* also refers to the Commission seeking to strengthen cooperation between all relevant public authorities in relation to monitoring an orderly approach and ensuring the double materiality perspective is consistently integrated. The authorities which are currently listed include Member States, the ECB, ESRB, the European Supervisory Authorities and the European Environment Agency – but what is clearly missing from this list is the competition authorities which provide oversight under the UCPD. Considering the regulatory uncertainty revealed in this paper – where an environmental impact claim may fall under the jurisdiction of different regulators who must ascertain compliance with different regulatory provisions – these competition authorities should also be included in the coordination process.

The Commission should ensure that competition authorities are included in the coordination process for public authorities envisioned for monitoring an orderly approach and ensuring the double materiality perspective is consistently integrated

Section 5

Conclusion

With increasing retail investor expectations for sustainable investment and a concurrent increase in marketing claims by financial institutions relating to the environmental credentials of their financial products and services, addressing the problem of greenwashing is a key priority to ensure financial markets are genuinely responding to the changing profile of retail investor expectations for sustainable investment. For those retail investors who are interested in having an impact through their investments (nearly half of all retail investors) the nature of environmental impact claims (as a sub-category of environmental claims) is a particularly complex issue. Several pieces of EU legislation can apply to these claims though the analysis in this paper reveals that none are sufficient to prevent greenwashing based on environmental impact claims (i.e., impact washing).

While general finance rules are applicable to environmental impact claims in the finance sector, these rules are too general and high level to provide effective governance of environmental impact claims. In addition, the sustainable finance rules do not provide further assistance since they are not adapted to regulate environmental impact claims. Indeed, the current sustainable finance regulation does not integrate the concept of investor impact and consequently is not aligned with the theories of attribution differentiating investee company impact and investor impact. Even worse, market practices that use SFDR categories as marketing labels may create additional confusion and greater risk of greenwashing, especially when combined with environmental impact claims. Furthermore, the provisions of UCPD are not sufficient to regulate environmental impact claims in the finance sector. Indeed, the absence of a definition of environmental impact of the investor and the lack of recognised tools and methodologies to evidence impact prevent the efficient application of UCPD rules in the finance sector. All these issues are compounded by variability of approach at Member State level. National rules applicable to environmental impact claims show a lack of harmonisation not only in the content of the rules but also in their core logic, creating legal uncertainty for financial institutions and unequal level of protection for retail investors in Europe.

Further problems for effective governance of environmental impact claims are apparent when analysing regulatory oversight and enforcement and the legal framework for investor redress. Regulatory authorities and retail investors will be confronted with the fact that it is impossible to demonstrate an environmental impact claim is in breach of a clear set of regulatory provisions. Moreover, considering it is difficult (or impossible) to prove the loss caused by the misleading environmental impact claim, current investor redress mechanism cannot be efficient.

At EU level, addressing greenwashing is a key aim for the Commission and the recommendations in this paper are conceived so that they refine and improve the focus of several initiatives and activities which are already apparent in the EU sustainable finance policy agenda:

- As a first step, the Commission should provide specific rules at EU level to regulate environmental claims with a focus on environmental impact claims.
- Further steps to integrate the notion of environmental impact in the finance sector are necessary. These include: (1) creating a category for impact-oriented products; and (2) developing methodologies and tools to evaluate the impact potential.
- Developing guidance for responsible environmental impact claims can assist financial institutions with regulatory compliance.
- Further research is required to identify suitable adaptations to the redress framework to ensure it is not a barrier to retail investors who want to take action against financial institutions in respect of misleading environmental impact claims.
- Finally, an assessment of supervisory activities and capabilities in relation to the current regulatory framework to analyse where it impedes the effective discharge of oversight responsibilities in relation to environmental impact claims should assist with enhancing market integrity.

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Legislation

International Level

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Minamata Convention on Mercury, United Nations, 2019

EU Level

Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive

Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council ('Unfair Commercial Practices Directive') **(UCPD)**

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU **(MiFID II)**

Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups **(NFDR)**

Directive (EU) 2019/2161 of the European Parliament and of the Council of 27 November 2019 amending Council Directive 93/13/EEC and Directives 98/6/EC, 2005/29/EC and 2011/83/EU of the European Parliament and of the Council as regards the better enforcement and modernisation of Union consumer protection rules

Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC

Regulation (EU) 2019/1156 of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014 **(CBDF)**

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 **(SFDR)**

Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 **(Taxonomy Regulation)**

National Level

Belgium

Belgian Economic Law Code

France

Article L 533-12 French monetary and financial code

Article L 121-1 and the following of the Consumer Code

Article L 229-68 of the Environmental Code

French law n° 2019-486 (**Loi Pacte**)

French law n°2021-1104, Climate and resilience

Germany

Act against unfair Competition, Gesetz gegen den unlauteren Wettbewerb, (**UWG**)

German Investment Code, Kapitalanlagegesetzbuch, (**KAGB**)

German Securities Prospectus Act, Wertpapierprospektgesetz, (**WpPG**)

German Capital Investment Act, Vermögensanlagengesetz, (**VermAnlG**)

German Securities Acquisition Act, Wertpapierübernahmegestz, (**WpÜG**)

German Civil Code, Bürgerliches Gesetzbuch (**BGB**):

Draft Act on Corporate Due Diligence in Supply Chains, Lieferkettensorgfaltspflichtgesetz, (**LkSG** or **Supply Chain Act**).

Luxembourg

Luxembourg law of 29 April 2009 on unfair commercial practices

Law of 8 April 2011 introducing a Consumer Code

Luxembourg law of 25 November 2005 on Public Access to Environmental Information

Netherland

Dutch Civil Code

Spain

Unfair Competition Law 3/1991

Antitrust Law 15/2007 regarding unfair contractual terms

General Consumer and User Protection Law 1/2007

General Law on Advertising 34/1988

Retail Trade Law 7/1996

Law 11/2018 on non-financial disclosure and diversity information

Annex 1: Country specific rules

Spain

Finance specific legal and regulatory requirements

The Comisión Nacional del Mercado de Valores (**CNMV**) has published criteria on the application of SFDR (the **Criteria**).[147]

The Criteria clarified that Collective Investment Schemes (**CIS**) that wish to qualify as an "ESG financial product", may only include references to ESG elements in their commercial name only if the minimum percentage of investments in to achieve the environmental or social characteristics they promote exceeds 50%. Therefore, CIS in Spain must achieve this threshold of sustainable investments in order to make an environmental claim that they are an ESG financial product.

It is unclear from the Criteria what an underlying asset which achieves "environmental or social characteristics" is.

In the case of general commercial communications for such products (outside the scope of their naming), references to ESG terms may be used provided that the communication content is aligned with the prospectus information in relation to ESG. As such, CIS must only make environmental claims which are aligned with their investment objective, investment policy and/or investment process as set out in the relevant fund documentation.

Transposition of UCPD

Directive 2005/29/EC (**UCPD**) has been implemented in Spain by, amongst others, means of the following main Acts:

- Unfair Competition Law 3/1991;
- Antitrust Law 15/2007 regarding unfair contractual terms (Article 3);
- General Consumer and User Protection Law 1/2007;
- General Law on Advertising 34/1988; and
- Retail Trade Law 7/1996.

Adoption of MDEC guidance on environmental claims

We are not aware of the MDEC guidance being implemented in Spain.

Statements by local regulators in relation to environmental claims

We are not aware of any statements by local regulators in relation to the issuance of misleading environmental claims. However, there are statements in relation to the enhancement of supervision regarding sustainability practices more generally, in particular:

- **CNMV- Program of Activities 2022**: contains some declarations stating that the CNMV it will carry out a horizontal review regarding the implementation of ESG regulation within the financial institutions.[148]

[147] The publication is only available in Spanish but can be found here: https://www.cnmv.es/docportal/Legislacion/FAQ/PyR_Sostenibilidad_pdtos_financieros.pdf
[148] https://www.cnmv.es/DocPortal/Publicaciones/PlanActividad/Plan_Actividades_2022.PDF

- **Bank of Spain- Strategic Plan 2024**: mentions that research priorities will focus, firstly, on analysing the sustainability information content being published in corporate reports. Secondly, they will deepen their knowledge of the market for "green" financial products. Thirdly, it will assess the extent to which public debt markets are taking sustainability factors into account.[149]

Grounds for retail action in relation to environmental claims

With regards to the transposition of the UCPD, the Spanish legislator decided to implement a combination of civil and administrative system for the punishment of the practices contained in this Directive. Typically, clients can bring a claim in courts based in civil liability: contractual and tort liability.

Given the public-legal interest pursued in repressing these practices, consumer authorities can also carry out an administrative sanctioning procedure which can be initiated by the authority or on the basis of a complaint. In this case, the decisions of these authorities are subject to review by the administrative courts.

In these legal acts, civil action initiated by clients (either individual or collective action) can include, among others: declaration of disloyalty; action of cessation of the unfair conduct or prohibition of its future repetition; action to remove the effects produced by the unfair conduct; action to rectify misleading, incorrect or false information; action for compensation for damages and losses caused by the unfair conduct, if the agent has acted with malice or negligence.

General Consumer and User Protection Law 1/2007 (also in line with UCPD) foresees the out of court system for resolving disputes between consumers and users and entrepreneurs known as the Consumer Arbitration System, provided that the dispute does not involve intoxication, injury or death or there are reasonable indications of a crime.

Finally, with regards to non-Financial Information published by companies, investors could seek misrepresentations (including that contained in the **NFRD** implemented in Spain through Law 11/2018 on non-financial disclosure and diversity information).

[149] https://www.bde.es/f/webbde/INF/MenuVertical/AnalisisEconomico/PRIORIDADES.pdf

Germany

Finance specific legal and regulatory requirements

Although not currently in force, the Federal Financial Supervisory Authority (**BaFin**) published their Draft Guidelines for Sustainable Investment Funds' on 2 August 2021 (the **Draft Guidelines**) to target misleading environmental claims. The consultation period for the Draft Guidelines closed on 6 September 2021 and the Draft Guidelines are expected to apply in the near future.

The Draft Guidelines apply only to public (retail) funds, while special funds for institutional investors remain subject to the European requirements for sustainability for the time being. They also apply to all public funds which either have a particular reference to sustainability in their name or are being distributed and marketed as primarily and explicitly sustainable.

The Draft Guidelines do not affect the obligations under the SFDR and the Taxonomy Regulation.

However, BaFin highlights that compliance with the transparency requirements of the SFDR alone is not sufficient for a fund to be described as 'sustainable' (whether in its name or otherwise) or to being marketed explicitly as a 'sustainable fund'. Instead, a relevant fund can only qualify as a sustainable investment fund, if it falls within one of the following categories:

- (a) maintains investment holdings of above a threshold level of "sustainable investments";
- (b) pursuit of a sustainable investment strategy; or
- (c) replication of a sustainable index.

An investment fund shall only be regarded as sustainable under category (a) above if its investment restrictions explicitly require that a minimum of at least 75% of the investments of the fund are invested in 'sustainable investments'. BaFin refers to Article 2(17) SFDR for a definition of 'sustainable investments' and additionally expects that certain minimum thresholds (e.g. minimum proportion of revenue generated from renewables) and certain negative screening criteria (e.g. no acquisition of fossil fuel electricity suppliers) are taken into consideration in order for an investment fund to make a claim to be 'sustainable'.

In addition, private equity funds and other public funds investing in financial instruments must comply with additional requirements. They are required to implement in their investment policy that their portfolio-companies:

- (a) make a material contribution to the environmental and social objectives of the Taxonomy Regulation;
- (b) the governance requirements of Art. 2(17) SFDR are realised; and
- (c) no significant harm is done to the environmental and social objectives of the Taxonomy Regulation.

BaFin provides explicit thresholds which automatically lead to the consequence that an investment and the corresponding fund no longer qualify as sustainable, and therefore prevent in-scope FI's making an environmental claim that it is sustainable. At portfolio-company level, the revenue must not be generated from:

- (a) more than 10% from energy production or other utilization of fossil fuels or nuclear power, (noting that natural gas is excluded);
- (b) more than 5% from mining of coal or oil;
- (c) any extension, exploration or services regarding tar sands and shale oil.

Real estate and other funds investing in physical assets are required to ensure in their investment policy that a material contribution to the environmental and social objectives of the Taxonomy Regulation is made at the portfolio-level is made whilst also complying with the 'do no significant harm' principle, in order for an FI to make an environmental claim that the fund is 'sustainable'.

This principle also applies funds which have a ‘sustainable investment strategy without fixed investment restrictions’ and to funds which replicate a sustainable index. These funds then qualify as ‘sustainable’ funds as well.

Finally, BaFin provides some examples of statements which do not comply with the requirements contained in the Draft Guidelines, for example: ‘The special funds (Sondervermögen) is composed of debt chosen on the basis of aspects of sustainability in a proportion of 75 %’ is considered as having an investment strategy too broad to be eligible to be described as ‘sustainable’. It does not fall into either of the other categories as it does not follow a sustainable index or invest in 75% of "sustainable investments" (as defined in SFDR).

Transposition of UCPD

UCPD has been transposed in German law by amending the Act against unfair Competition in 2008 and 2015 (*Gesetz gegen den unlauteren Wettbewerb*, **UWG**). The German legislator did not establish a separate legal framework for the protection of retail clients from unfair competition practices, but rather included the UCPD into its existing competition framework for market participants. Therefore, the UWG covers both business-to-business and business-to-consumer relationships.

The German legislator follows a principal-based approach and relies on general clauses with a broader scope. Importantly, there are no finance or ESG specific elements to UCPD's implementation in Germany **(UWG)**.

In Germany, further specifications and interpretations compliant with UCPD are ensured by case law. As the EU requires full harmonisation of UCPD, there is no gold plating. Necessary imitations to the general clauses are ensured by German harmonised jurisdiction.

Adoption of MDEC guidance on environmental claims

There is no adoption of the MDEC guidance on environmental claims. Environmental claims are treated under the general rule of Section 5 UWG and the corresponding general case law on unfair commercial practices. Similarly, the German regulator for competition Bundeskartellamt has not referred to the MDEC.

Statements by local regulators in relation to environmental claims

BaFin issued a general statement that it intends to target greenwashing in its supervisory practice in the upcoming years (e.g. as a medium-term target to protect consumers from irritating marketing practices in relation with sustainability).[150]

Grounds for retail action in relation to environmental claims

Consumer claim under competition law

In order to implement inter alia Article 11a of UCPD (and Directive (EU) 2019/2161) into German law, the German legislator amends the UWG with effect of 28 May 2022. A newly introduced claim pursuant to Section 9 (2) UWG for damages caused by and limited to unfair commercial practices within the meaning of the UCPD. Competitors can also raise compensation claims under Section 9 (1) UWG and the consumer claim is by design and wording rather limited in its scope of application and is of less practical relevance.

General civil law claims

General civil law claims that could potentially be leveraged in this context include:

[150] Bafin Medium-term objectives

- Section 306 (1) German Investment Code (Kapitalanlagegesetzbuch, "**KAGB**") regarding UCITS-funds and if applicable Section 307 (3) for (semi-)professional investors regarding AIFs: If information in the sales prospectus that is material to the assessment of the shares or stock is incorrect or incomplete;
- Section 306 (2) KAGB: If information contained in the key investor information is misleading, incorrect or inconsistent with the relevant parts of the sales prospectus;
- Further product-specific liability provisions, such as Section 8 et seq. German Securities Prospectus Act (Wertpapierprospektgesetz, WpPG; the German complementation of Prospectus Regulation (EU) 2017/1129). Section 20 et seq. German Capital Investment Act (Vermögensanlagengesetz, VermAnlG), Section 12 German Securities Acquisition Act (Wertpapierübernahmegestz, WpÜG);
- Sections 280 (1), 311 (1) and (2) German Civil Code (Bürgerliches Gesetzbuch, **BGB**): If precontractual (disclosure/information) obligations are breached (e.g. by misleading ESG information), and the breach is both material and causal for the investor to enter into the transaction. (Note: This is the general rule for civil claims based on breach of precontractual (prudence) obligations.)
- Section 823 (2) BGB: This would be the case if ESG related disclosure obligations are considered as "protective laws"; this has not yet been decided by court and is highly debated.
- Section 826 BGB: If the investor is intentionally and immorally harmed. We consider a liability risk under this provision as low. Liability is more likely to be established by this if an entity (e.g. investment firm or credit institution) is purposefully using information that is misleading the investor that the financial product is taxonomy-compliant / SFDR-compliant.

There is still great legal uncertainty concerning consumer claims based on failed ESG disclosure obligations, as these obligations are new and subject to case law yet to come.

The German government agreed on the draft Act on Corporate Due Diligence in Supply Chains (Lieferkettensorgfaltspflichtgesetz, **LkSG** or **Supply Chain Act**). The LkSG generally enters into force as of 1 January 2023. This Supply Chain Act obliges large companies located in Germany to better fulfil their responsibility in the supply chain with regard to respect for internationally recognized human rights by implementing the core elements of human rights and environmental due diligence obligations. For example, affected companies have to consider potential infringements of environmental related international treaties such as Minamata Convention on Mercury, or Basel Convention to reduce the movements of hazardous waste. Companies subject to the LkSG are required to conduct appropriate human rights and environmental due diligence in their supply chains. However, the Act provides for a liability provision (the nature of which is not fully clear at this time) according to which "a breach of the obligations arising from this Act shall not give rise to civil liability. Any civil liability established independently of this Act shall be unaffected."

Belgium

Finance specific legal and regulatory requirements

In order to make a sustainability claim in relation to a financial product (including retail funds and structured products), the Belgian regulator (Financial Services and Markets Authority (**"FSMA"**)) has requested[151] that FIs indicate the following on marketing documentation for such financial products:

- the sustainable selection criteria used for selecting investments;
- the methodology behind the sustainable selection criteria;
- the company responsible for assessing the sustainable selection criteria; and
- a reference to a webpage that provides more information about the inclusion of sustainability criteria in the investment objective.

Transposition of UCPD

The UCPD is transposed in Belgian law by article I.8, article VI.38 and article VI.92 to article VI.103 of the Belgian Economic Law Code without any gold-plating provisions.

Directive (UE) 2019/2161 which amends the UCPD has not yet been transposed in Belgian law (legislative process is ongoing). The articles implementing the UCPD into Belgian law do not contain ESG specific elements.

Adoption of MDEC guidance on environmental claims

Belgium has adopted its own guidance on environmental claims which is based on the European Commission's guidance on the implementation of the Unfair Commercial Practices Directive 2005/29/EC, the multi-stakeholder group's guide to the implementation of the Unfair Commercial Practices Directive, and various national guidance documents related to environmental claims (e.g. the English and the French guidance).

Statements by local regulators in relation to environmental claims

We are not aware of any statements from the Belgian financial services regulator **(the FSMA)** and we are not aware of any enforcement action by the FSMA in relation to environmental claims.

The FSMA talks about greenwashing generally and the fact that information about a financial product should not be misleading in its 2020 annual report, but solely in the context of the SFDR and not in the context of the UCPD.

Grounds for retail action in relation to environmental claims

Based on article VI.38 of the Belgian Economic Law Code and general civil law, consumers which have been misled can ask for damages and for the reimbursement of part or all of the sums that they have paid. In certain cases, pursuant to article VI.38, judges may order a seller, when they estimate it proportionate, to reimburse in full a consumer without requesting that consumer to return the product.

[151] FMSA 2020 Annual Report, pp28-29, accessible here: https://www.fsma.be/fr/rapports-anuels/rapport-annuel-2020-version-pdf

Luxembourg

Finance specific legal and regulatory requirements

The Commission de Surveillance du Secteur Financier (**CSSF**) requires market participants to submit an SFDR conformity confirmation letter for UCITS and AIFs.

The confirmation letter requires sustainability claims made in pre-contract documentation to be underwritten by a statement which confirms the disclosures are accurate, clear and not misleading and that the remuneration policy and the risk management process have respectively been updated to be consistent with the integration of sustainability risks. From a practical perspective, the CSSF has adopted a lighter touch approach when reviewing the disclosure included in the pre-investment information for regulated AIFs, compared to the disclosure included in the prospectus of UCITS.

General administrative penalties may apply to FIs under relevant sectoral legislation for failure to comply with disclosure requirements under SFDR. Penalties for non-compliance include injunctive relief without proof of actual loss/damage or of intention/negligence on the part of the advertiser, publication of a finding of such unfair practices in the newspapers and fines (ranging between EUR 251-120,000). An FI may have a defence to such findings if they can show evidence to prove the factual accuracy of the sustainability claim.

Transposition of UCPD

The UCPD was transposed into Luxembourg law by the Luxembourg law of 29 April 2009 on unfair commercial practices.

However, this law was abolished (by the law of 8 April 2011 introducing a Consumer Code) and its provisions were included in Articles L. 121-1 to L. 122-8 and L 320-2 of a new Consumer Code. We are not aware of any gold-plating of the UCPD.

Adoption of MDEC guidance on environmental claims

As far as we are aware, the MDEC guidance has not been adopted in Luxembourg.

Statements by local regulators in relation to environmental claims

As far as we are aware, the local regulators have not made any statements of taken enforcement action in relation to misleading or false environmental claims.

Grounds for retail action in relation to environmental claims

On the basis of the Luxembourg law of 25 November 2005 on Public Access to Environmental Information, a retail client has the right to obtain access to environmental information held by or on behalf of public authorities.

In this context, in one of the most significant climate change related cases in Luxembourg to date, Greenpeace Luxembourg had in 2019 requested the Minister for Social Security supervising a public pension fund to obtain information on, among other things, the fund's compliance with the targets of the Paris Agreement.

So far, there are no general provisions on class actions and group litigation under Luxembourg law. However, there is a draft bill of law aiming to introduce a class action on consumer law.

France

The French rules applying to the environmental impact claims in the finance sector are scattered in different regulations and codes. The consumer protection regulation applies in a suppletive manner to financial regulations (i.e. if there are no financial regulations on the subject, we will look into commercial law). Moreover, the hard law does not currently take into consideration environmental claims in the finance sector. Thus, we need to refer to the soft law for such matter.

Finance specific legal and regulatory requirements

In relation to the communication of financial products, MIFID II (directive 2014/65/UE[152]) has been transposed in the French monetary and financial code at the article L 533-12[153]**: '**All information, including promotional communications, addressed to investors shall be accurate, clear and not misleading'*.* [154]

There are several finance-specific legal and regulatory requirements in respect to ESG, they are however not related to marketing claims, for example:

- Asset managers must specify in their annual report how criteria relating to compliance with social, environmental and governance objectives are considered in their investment policy.[155]
- In 2019, the French law n° 2019-486 (**Loi Pacte**) created the obligation to propose in life insurance products at least one unit labelled Greenfin, SRI, or Finansol. Moreover, every year the client must receive information concerning the policy for integrating environmental and social impacts into the management of the contract's euro fund, as well as the amounts invested in labelled funds.

Transposition of UCPD

Transposition of the directive 2005/29/EC[156] as known as UCPD in the Consumer Code at the article L 121-1 and the following[157]:

'Unfair commercial practices are prohibited.
A commercial practice is unfair if it is contrary to the requirements of professional diligence and materially distorts or is likely to distort the economic behaviour of the consumer who is reasonably well informed and reasonably observant and circumspect with regard to a good or service.
The unfairness of a commercial practice aimed at a particular category of consumers or group of consumers who are vulnerable by reason of mental or physical infirmity, age or credulity shall be assessed in the light of the average capacity of discernment of the category or group.'

Adoption of MDEC guidance on environmental claims

MDEC Compliance Criteria have not explicitly been integrated into French law. However, a Sustainable Development Code updated in 2020 by the Self-regulatory organization that oversees advertising practices in France (ARPP) contains principles similar to MDEC principles and criteria[158]**.** It focuses on advertising practices and provides guidelines for 'ecological argumentation, whether or not it refers to the concept of sustainable development' among which:

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[152] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU
[153] Transposition order n° 2017-1107
[154] Also see article 314-6 of the general regulation of the French financial market authority
[155] L 533-22-1 et D 533-16-1 du code monétaire et financier
[156] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council
[157] Transposition order n°2016-301
[158] ARPP, 2020, Sustainability Code V3

‘2. Truthfulness of actions
2.1 Advertisements must not mislead the public about the actual actions of the advertiser or the properties of its products in terms of sustainable development.
2.2 The actions of advertisers and the properties of their products in this area should be significant before a claim can be made.
2.3 The advertiser must be able to support its sustainable development claims by means of evidence that is objective, reliable, truthful and verifiable at the time of advertising. For any message based on a scientific claim, the advertiser must be able to present the origin of the findings and methodology used for the calculation. Advertisements may not resort to demonstrations or scientific conclusions that do not conform to generally approved scientific findings (…).’

‘3. Proportionality of messages
3.1 The advertisement must accurately express the action of the advertiser or the properties of its products, in accordance with the available and communicable evidence. The reality of these actions or properties may be assessed in the light of the different pillars of sustainable development, the different types of impacts and the various stages of a product’s life cycle.
3.2 The advertising message must be commensurate with the scale of the advertiser’s action(s) in terms of sustainable development and the properties of the product(s) he is promoting.
3.3 In particular
a. The advertisement should not be presented in such a way as to imply that it relates to more pillars of sustainable development, more stages of a product’s life-cycle or more impacts than can be justified by the evidence (…)’

‘9. Complex systems
Some recognized systems may be based on highly technical argumentations or complex schemes, whose benefits in terms of sustainable development are indirect (e.g., systems known as “green electricity”, “carbon offset”, “socially responsible investments”, etc.).
When an advertisement refers to these types of systems:
9.1 It should take care not to mislead the public about the true scope of the mechanism.
9.2 If it uses simplified language for educational purposes it must provide the public with the necessary explanations, as per the conditions defined in article 3-4 of this Code.
9.3 The advantage of using systems to indirectly compensate the negative impact of a product or an activity should not be referred to in the ad as being a direct quality of the product or activity’.

The ARPP Sustainable Development Code is not specific to the finance sector.

Statements by local regulators in relation to environmental claims

AMF adopted a doctrine (position/recommendation) concerning the information to be provided by collective investment schemes incorporating extra-financial approaches.[159] This doctrine concerns managers and distributors of collective investments authorized for marketing in France to non-professional investors. It sets out the following principles:

- The information provided on the consideration of extra-financial criteria must be proportionate to the objective and the effective impact of the consideration of these extra-financial criteria in the management of collective investments.
- Funds that take extra-financial criteria into account in their management without making them a significant commitment within the meaning of this doctrine will be able to include them in their communication without making them a central element.

[159] AMF DOC-2020-03

- The logic of this doctrine is therefore to make a central environmental claim (which appears in the name, the DICI, the marketing documentation, and the prospectus) conditional on a significantly engaging investment strategy.

However, it should be noted that this doctrine does not deal with the subject of impact funds. The doctrine does not, therefore, specify the criteria for considering that an environmental impact claim is accurate, clear, and not misleading. *Ex-ante*, AMF has the power to decide, regarding its position, whether information to be provided by collective investment schemes incorporating extra-financial approaches is appropriate or not. *Ex post*, AMF has the power to decide whether an environmental claim in a commercial document is appropriate or not. To date, we are not aware of any use of these enforcement powers in relation to impact environmental claims.

A Practical Guide to Environmental Claims, published in 2012 by the National Consumer Center:

This publication presents different types of claims and provides guidance on how they should be used, around the following principles (not specific to the finance sector):

‘What rules apply to environmental claims?
Any environmental claim must be explicit and precise so as not to mislead or generate doubt in consumers' mind. It must aim to inform consumers fairly about the environmental characteristics of the product or service. An environmental claim must be based on scientific evidence or accepted methods. Whatever the claim, it must focus on an environmental aspect that is significant in light of the impacts generated by the product. The benefit claimed by this claim should not also lead to pollution displacement, i.e. to create or aggravate other environmental impacts of the product, at any stage of its life cycle.’[160]

An Anti-greenwashing guide published in 2012 by the Agency for Ecological Transition (ADEME)

This publication provides self-assessment principles to avoid greenwashing, which is identified though nine criteria which cover aspects such as disproportionate promises, vague words, absence of evidence etc.[161] It is not specific to the finance sector.

A periodic report on “Advertising & environment”, released in partnership by the ARPP and ADEME. The latest version has been published in 2020[162]

This report assesses a sample of advertisements and their compliance with applicable rules (especially against the self-regulatory principles set out in the Sustainability Code mentioned above). It is not specific to the finance sector. Importantly, this version notes that ‘the poor results of this 10th review question the ability of actors to really promote, in accordance with ethical rules, products/services and mindsets compatible with the ecological transition and the fight against climate change. They push us more than ever to strengthen our vigilance with regard to brands and their agencies and to encourage all actions to raise awareness and support professionals, in education institutions, training centres and on a daily basis in companies and agencies. Compliance with ethical rules is a central element of advertising credibility, which must be consolidated’.

Grounds for retail action in relation to environmental claims

Grounds for action include breach of transposed rules of MIFID II and UCPD in the French Monetary Code and Consumer Code. AMF Doctrine can be used as an interpretative tool.

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[160] Centre National de la Consommation, 2012, Guide pratique des allégations environnementales p.41
[161] ADEME, 2012, Guide Anti-Greenwashing
[162] ARPP, ADEME, 2020, Bilan 2019 Publicité & Environnement p.5

Moreover, new rules specific to environmental claims have been passed in France. The Climate and resilience law[163] creates new obligation and restriction notably in relation to green advertising. The law creates a section in the environmental code which is named “environmental claims”. In this section, the article L 229-68 forbids to present a service or a product carbon neutral unless certain conditions are met:

‘It is prohibited to state in an advertisement that a product or service is carbon neutral or to use any wording of equivalent meaning or scope unless the advertiser makes the following information readily available to the public:
‘1° A greenhouse gas emissions balance sheet integrating the direct and indirect emissions of the product or service;
‘2° The process by which the greenhouse gas emissions of the product or service are first avoided, then reduced and finally offset. The greenhouse gas emission reduction trajectory is described using quantified annual progress targets;
‘3° The methods for offsetting residual greenhouse gas emissions that comply with minimum standards defined by decree.’

[163] Law n°2021-1104

Netherlands

Finance specific legal and regulatory requirements

There are no Dutch finance-specific legal and regulatory requirements in respect of ESG. There are also no specific legal or regulatory rules on ESG marketing of products or services by a financial institution; marketing of ESG aspects is covered by the generic rules and regulations on marketing (e.g., article 24 of MiFID II).

Specific Dutch rules on ESG aspects relate to accountability and/or reporting on ESG matters by financial institutions. For example:

- Dutch pension funds are required under the Dutch Pension Act to account for, in their board reports, the manner they take ESG matters into account in their investment policies. This requirement does not specifically aim at preventing greenwashing.
- Dutch institutional investors and asset managers (i.e., (re)insurance companies, pension funds, portfolio managers, alternative investment fund managers, management companies and self-managed collective investment undertakings) are required under the Dutch Act on financial supervision to publish their engagement policies on their websites, including a description of the manner oversight is performed in respect of portfolio companies, also in respect of non-financial performance and ecological effects. An engagement report must be published at least annually. This requirement does not specifically aim to prevent greenwashing.
- Institutional investors in Dutch listed companies that have voluntarily adhered to the Dutch Stewardship Code, must have a stewardship policy relating to their engagement with Dutch listed companies invested in. Stewardship includes (engagement on and monitoring of) environmental aspects. This requirement does not specifically aim to prevent greenwashing.

Transposition of UCPD

The UCPD has been implemented in line with the Directive. There is no gold-plating nor are there any specific additional rules in respect of financial services as allowed for by article 3(9) of the UCPD.[164]

Adoption of MDEC guidance on environmental claims

There has been no adoption of the MDEC guidance in the Netherlands. As far as we are aware, there is no reference to the MDEC guidance in Dutch rules and regulations and by Dutch regulators.

Statements by local regulators in relation to environmental claims

There have been statements by the Netherlands Authority for the Financial Markets (*Stichting Autoriteit Financiële Markten*) (**AFM**) in relation to ESG claims but there has not been enforcement action in this respect yet, at least no enforcement action has become public (it is possible that there is action that is still ongoing and that is not subject of public disclosure yet).

The AFM has issued guidance letters to the financial industry about properly dealing with the new EU regimes on ESG. These letters are informative in nature.

The AFM has performed an exploratory industry wide investigation into SFDR compliance by the funds industry in 2021. The outcome show that compliance is sub-standard in respect of transparency (often too generic) and in respect of sustainability (indicating the potential of greenwashing). While this is not yet to be classified as enforcement action by the AFM, enforcement action often starts with industry wide investigations

[164] Directive 2019/2161, also amending the UCPD, has not been implemented in the Netherlands yet. Implementation is expected for 28 May 2022.

that indicate non-compliance, following which the AFM targets specific parties which may result into enforcement action if individual non-compliance is established. It may therefore be expected that this exploratory investigation will be followed-up by further AFM action which may include enforcement action, also because the AFM has indicated that its 2022 priorities include taking on greenwashing.

Grounds for retail action in relation to environmental claims

The principal ESG rules and regulations (notably the SFDR and the Taxonomy Regulation) applicable in the Netherlands have a mandatory, public law character, meaning that they comprise of prohibitions and regulations to refrain from, or force certain action, which prohibitions and regulations can be enforced by the AFM only. As a result, direct action by retail clients cannot be based on these rules and regulations. Indirect action may however be brought by retail clients by addressing the AFM if non-compliance is discovered. However, it is at the AFM's discretion to follow-up on this or not.

Therefore, the principal grounds for clients to bring direct action for inaccurate environmental claims against a financial institution are based on Dutch civil law. The two main grounds for action are claims based on error or tort. This is based on the assumption that Dutch civil law applies to the relation between the parties, e.g., because the contract is subject to Dutch law or because the damage is suffered in the Netherlands:

- Error: A claim based on error requires that the contract would not have been entered into if the client was duly informed, the financial institution was required to inform the client and did not do so, or if both parties based themselves on incorrect information, unless the error shall be for the account of the client. A successful claim allows the client to (partially) nullify the contract which normally requires both parties to undo all performance under the contract (e.g., repay payments made).
- Tort: Dutch law provides for a general concept of tort and a specific section of tort which was implemented further to the UCPD. Tort requires damages being suffered as a result of an unlawful act. The unlawful act may be found in non-compliance with mandatory law, acting in violation of a particular right or acting in violation of unwritten law. The specific section of tort includes provisions on unfair practices towards retail clients that are deemed to be unlawful and are hence a basis for a claim for damages based on tort. Inaccurate and missing information can be misleading and hence unfair.