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Recent Law Reforms in EU Sustainable Finance: Regulating Sustainability Risk and Sustainable Investments

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RECENT LAW REFORMS IN EU SUSTAINABLE FINANCE: REGULATING SUSTAINABILITY RISK AND SUSTAINABLE INVESTMENTS

FÉLIX E. MEZZANOTTE[*]

Responding to increasingly degrading environmental and social conditions, the European Commission has fostered important legal and regulatory reforms to achieve sustainable finance objectives in Europe. However, these reforms are numerous, complex, and fast-paced. They have proved difficult to grasp and contextualize, while adding to the intricacies of an already highly sophisticated EU legal and regulatory regime. This Article outlines and examines such reforms with the purpose of providing necessary insights into the current state of EU law and regulation in the area of sustainable finance. The first part of the Article conceptualizes the meaning of sustainability risk and of sustainable investments. Understanding these two concepts is crucial as they underlie the entire reform process, from climate risk management to the development of sustainable markets and products. The second part of this Article provides an overview and analysis of key sustainability-related reforms. Changes to the non-financial information disclosure regime are outlined covering the Corporate Sustainability Reporting Directive, the Sustainable Finance Disclosure Regulation, and the EU Taxonomy Regulation. Emphasis is placed on the "double materiality" principle in sustainability reporting. Modifications to EU financial services law are also examined with focus on changes made to the Markets in Financial Instruments Directive (MiFID II), which is the central legislation governing securities regulation in Europe. Finally, a brief overview of the evolving prudent person rule contained in the Institutions for Occupational Retirement Provision Directive is offered. The Article concludes by shedding light on key challenges afflicting

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reform implementation.

I. Introduction 216
II. Sustainability Risk and Sustainable Investments........................224
A. The Meaning of Sustainability Risk 224
B. The Meaning of Sustainable Investments 228
1. Sustainable Investments as a Market Trend 228
2. The Need to Regulate Sustainable Investments..........231
3. The Classification of Activities and Preferences in Terms of Sustainability 235
III. Corporate Sustainability Reporting and Other Information Disclosure Obligations..240
IV. Sustainability-Related Reforms in EU Financial Services Law.247
A. General Overview 247
B. MiFID II Regime: The Integration of Sustainability Risk, Factors and Preferences 250
1. Disclosing Information to Clients..............................250
2. Suitability Requirements 252
3. Conflict of Interest Requirements..............................256
4. Product Governance Requirements 258
V. Fiduciary Duty, Pension Funds and the IORP II Directive..........262
VI. Final Considerations...269

I. INTRODUCTION

In recent years, the European Commission (Commission) has implemented a new legal and regulatory framework for the development of sustainable finance in Europe.[1] The rationale underlying this policy points to a new world reality characterized by increasingly degrading

1. *See Action Plan: Financing Sustainable Growth*, at 2, COM (2018) 97 final (Mar. 8, 2018) [hereinafter EU Action Plan]. The EU Action Plan builds upon recent policies promoted by the 2015 Paris Agreement on Climate Change and the United Nations 2030 Agenda for Sustainable Development. *UN Sustainable Development Goals*, UNITED NATIONS (2015), https://sdgs.un.org/goals [hereinafter UN Sustainable Development Goals]. It has been part of the EU's Capital Markets Union (CMU) project and the EU "green deal" policies. *A Capital Markets Union for People and Businesses-New Action Plan*, COM (2020) 590 final (Sept. 24, 2020); *Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions*, COM (2019) 640 final (Dec. 11, 2019).

environmental and social conditions.[2] The growing capacity of environmental and social phenomena, such as climate change or social inequality, to damage people and property has become more apparent.[3] Moreover, scientific evidence has more robustly than ever before exposed the detrimental effects of human conduct — especially business activity — on factors that are essential to a sustainable economy, society and planet.[4] In addition to acknowledging these problems, the EU policy on sustainable finance has sought to tackle them by creating adequate conditions for the financial sector to take up a paramount role in advancing Europe's economic, environmental and social policy agenda.[5] As stated by the Commission: "As we are increasingly faced with the catastrophic and unpredictable consequences of climate change and resource depletion, urgent action is needed to adapt public policies to this new reality. The financial system has a key role to play here."[6] Within this policy framework, financial market participants in Europe have been sought, among other strategies, to integrate environmental, social, and governance factors in their business models, services and products.[7]

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2. *Strategy for Financing the Transition to a Sustainable Economy,* at 1, COM (2021) 390 final (July 6, 2021) [hereinafter *Strategy for Financing*] ("The EU also aims to strengthen its resilience to climate change, to reverse biodiversity loss and the broader degradation of the environment and to leave nobody behind in the process.").

3. *The Implications of Climate Change for Financial Stability*, FINANCIAL STABILITY BOARD (Nov. 23, 2020), https://www.fsb.org/wp-content/uploads/P231120.pdf (last visited Dec. 09, 2021) [hereinafter FSB] ; *see also A Call for Action: Climate Change as a Source of Financial Risk*, NETWORK FOR GREENING THE FINANCIAL SYSTEM (NGFS) (Apr. 2019), https://www.ngfs.net/sites/default/files/medias/documents/synthese_ngfs-2019_-_17042019_0.pdf [hereinafter NGFS 2019]; *Overview of Environmental Risk Analysis by Financial Institutions*, NETWORK FOR GREENING THE FINANCIAL SYSTEM (NGFS) (Sept. 2020), https://www.ngfs.net/sites/default/files/medias/documents/overview_of_environmental_risk_analysis_by_financial_institutions.pdf [hereinafter NGFS 2020]. The NGFS is an association composed largely of central banks and financial regulators. *See Membership*, NGFS (June 14, 2022), https://www.ngfs.net/en/about-us/membership (last visited Dec. 09, 2021).

4. An authoritative report in relation to the impact of climate change is the IPCC, CLIMATE CHANGE 2021: THE PHYSICAL SCIENCE BASIS. CONTRIBUTION OF WORKING GROUP I TO THE SIXTH ASSESSMENT REPORT OF THE INTERGOVERNMENTAL PANEL ON CLIMATE CHANGE (Valérie Masson-Delmotte et al. eds., Cambridge University Press 2021).

5. *See* EU Action Plan, *supra* note 1, at 1 (stating that reforms in the area of sustainable finance have been largely viewed as vital to ensure the stability of the financial sector and sustainable economic growth in Europe).

6. *Id.*

7. *Id.*

The Commission has defined sustainable finance as "the process of taking due account of environmental and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities."[8] In building an institutional architecture for sustainable finance, the Commission has aspired to erect the necessary legal and regulatory tools for the proper management of climate risk and for the development of sustainable finance markets and products across Europe. Unsurprisingly, the achievement of such an objective has required multiple and substantial reforms.[9] The EU Action Plan has laid down the goals of these reforms in terms of integrating sustainability risk in decision-making, accelerating sustainable investments, and promoting transparency and long-term thinking in the financial sector.[10] Thus far, the reforms undertaken have been relevant and conducive. However, they have also been numerous, complex, and fast-paced. They have proved difficult to grasp and contextualize, while amplifying the intricacies of an already highly sophisticated EU legal and regulatory regime.

Contributing to a better understanding of the current state of EU law and regulation in sustainable finance, this article outlines and examines recent sustainability-related reforms in the area of (1) information disclosure obligations—including the newly enacted Sustainable Finance Disclosure Regulation (SFDR),[11] the EU Taxonomy Regulation,[12] and the draft Corporate Sustainability Reporting Directive (CSRD)[13] — and in the area of (2) EU financial services law, with focus on the Markets in Financial Instruments Directive (MIFID II).[14] In addition, a brief overview of the

8. *Id*. at 2.

9. *See id.*

10. *See id.* at 1 (identifying the objectives of sustainable finance policy and the proposed reforms corresponding to each one of these objectives).

11. 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, 2019 O.J. (L 317)) [hereinafter SFDR].

12. 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, 2020 O.J. (L198) [hereinafter EU Taxonomy Regulation].

13. Proposal for a Directive of the European Parliament and of the Council Amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as Regards Corporate Sustainability Reporting, Brussels, COM (2021) 189 final (April 21, 2021) [hereinafter Draft CSRD].

14. 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, art. 24(1), 2014 O.J. (L 173/349) [hereinafter MiFID II]; *see also* Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May

evolving prudent person rule contained in the Institutions for Occupational Retirement Provision Directive (IORP II Directive) is also offered as this rule is relevant to the discussion on sustainability and investments in the context of pension funds.[15]

Sustainable finance policy requires that companies and financial market participants adequately identify and manage at least two crucial factors: first, sustainability risk and, second, the sustainability properties of economic activities and investments.[16] Consequently, this Article examines the meaning of sustainability risk and sustainable investments upfront in Section II.1 and Section II.2, respectively.[17] From the vantage point of financial analysis, sustainability risk denotes a type of financial risk.[18] As the Commission put it: "Including environmental and social goals in financial decision-making aims to limit the financial impact of environmental and social risks."[19] In this sense, sustainable finance aims to "manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues."[20] This type of events, and the financial risk they embody can affect, negatively and in large scale, corporate financial performance, the real economy, and ultimately the stability of the financial sector.[21] With these severe implications, this subject has become a top policy

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2014, on Markets in Financial Instruments and Amending Regulation (EU) No 648/2012 [hereinafter MiFIR]; 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 Organisational Requirements and Operating Conditions for Investment Firms and Defined Terms for the Purposes of That Directive, 2017 O.J. (L 87/1) [hereinafter MiFID II DR].

15. Directive (EU) 2016/2341, of the European Parliament and of the European Council of 14 December 2016 on the Activities and Supervision of Institutions for Occupational Retirement Provision (IORPs), art. 19(1) 2016 O.J. (L 354/37) [hereinafter IORP II Directive]. Following the publication of the IORP II Directive in the Official Journal of the European Union, Member States had 24 months to transpose this Directive into national law. *Id.*

16. *See* EU Action Plan, *supra* note 1, at 1–4 (stating that a large fraction of the reforms proposed in the EU Action Plan are meant to address problems generated by the presence of sustainability risk and by the adequate classification and treatment of the sustainability properties in investments).

17. *See infra* Sections II.1–2.

18. EU Action Plan, *supra* note 1, at 3–4; *see also* FSB, *supra* note 3; *Recommendations of the Task Force on Climate-Related Financial Disclosures*, TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (June 2017), https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf [hereinafter TCFD]; NGFS 2019, *supra* note 3.

19. EU Action Plan, *supra* note 1, at 3–4.

20. *Id.*

21. *See* NGFS 2019 *supra* note 3; NGFS 2020 *supra* note 3.

priority especially among central bankers, financial regulators and other actors influencing financial policy.[22]

As explained in Section II.2 of this Article, the Commission has also made the promotion of sustainable investments a policy priority.[23] According to the EU Action Plan, a critical objective of sustainable finance has been to "reorient capital flows towards sustainable investments in order to achieve sustainable and inclusive growth."[24] This objective has built upon existing trends in markets across the globe showing that values in sustainable investment assets are mounting, from nearly USD 22.9 trillion in 2016 to USD 30.7 trillion in 2018 and USD 35.3 trillion in 2020.[25] Similar trends have been observed in European markets, which have witnessed a strong surge in investors' demand for sustainable investment products.[26] In light of this reality, the Commission acted to consolidate and accelerate these market trends across the EU yet making sure that the EU internal market and the rights of investors are protected.[27] After exploring the Commission's justifications for reform in the sustainable investment arena, including concerns of greenwashing,[28] the section outlines key definitions, criteria and classification tools designed to determine the extent to which an economic activity or financial product is or is not sustainable.[29]

Section III examines key reforms aimed at improving the availability and quality of non-financial—or more recently denominated as 'sustainability'—information.[30] Recent European regulations, namely the SFDR[31] and the EU Taxonomy Regulation,[32] have mandated the disclosure of sustainability-related information. Furthermore, the CSRD will also impose mandatory disclosure requirements on companies for them to disclose, side by side,

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22. *See* NGFS 2019 *supra* note 3; NGFS 2020 *supra* note 3.

23. *See infra* Section II.2.

24. EU Action Plan*, supra* note 1, at 3.

25. *See* Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2020*, http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf (covering sustainable investment assets in Europe, the United Stated, Canada, Australia, New Zealand, and Japan) [hereinafter GSIR 2020].

26. *Id.* For further discussion on this trend in European Markets, see *infra* Section II.2A.

27. *See, e.g.*, SFDR, *supra* note 11, at 3.

28. *See infra* Section II.2.A–B.

29. *See infra* Section II.2.C.

30. *See infra* Section III.

31. SFDR, *supra* note 11, at 3.

32. *See* EU Taxonomy Regulation, *supra* note 12, at 3.

sustainability and financial information.[33] The CSRD is of vital importance to sustainable finance insofar as sustainability reporting at the corporate level constitutes the primary source of sustainability information spilling over the whole investment chain.[34] For this reason, a central tenet of the EU sustainable finance reform has been to increase the supply of corporate sustainability information.[35] In this specific context, particular attention is drawn to the "double materiality" principle in sustainability information disclosure.[36] Although this principle will ultimately delineate the scope of the corporate sustainability reporting obligation, there has been little discussion about it in the legal scholarship.[37]

Section IV of this article is dedicated to EU sustainable finance reforms modifying the obligations of providers of investment services.[38] Amendments have been made to rules relating to MIFID II,[39] the Alternative Investment Fund Managers Directive (AIFMD),[40] the Undertakings for the Collective Investment of Transferable Securities Directive (UCITS

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33. Draft CSRD, *supra* note 13.

34. *See* ENVIRONMENTAL RESOURCES MANAGEMENT, STUDY ON SUSTAINABILITY-RELATED RATINGS, DATA AND RESEARCH, PUBLICATIONS OFFICE OF THE EUROPEAN UNION (Nov. 2020), https://www.consob.it/documents/46180/46181/CE_Study_Nov-2020.pdf/81ab8351-1554-44b3-9b53-f21f355b0012 ("Data sources utilized by providers across all of their sustainability-related products and services fall into three major categories: Data directly from the company covered, unstructured company data from alternative sources, and third-party data that has already flowed through a different provider. Though the primary source of information identified by most providers is self-disclosed company data, providers commonly utilize data from all three sources with distinctions depending on the methodology, approach and product or service offered.").

35. *See* Draft CSRD, *supra* note 13, at 5.

36. *Id.* at 2 (explaining the double materiality principle); *see also* 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, 2014 O.J. (L 330) [hereinafter NFRD].

37. *See generally* Joseph Baumüller & Michaela-Maria Schaffhauser-Linzatti, *In Search of Materiality for Nonfinancial Information—Reporting Nonfinancial Information—Reporting Requirements of the Directive 2014/95/EU,* 26 SUSTAINABILITY MGMT. FORUM 101 (2018) (examining materiality in both financial and non-financial disclosure in Europe).

38. *See Sustainable Finance Package,* EUROPEAN COMMISSION (Apr. 21, 2021), https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en (listing the Commission's delegated acts commanding these reforms).

39. *See* MiFID II, *supra* note 14, at 138.

40. 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 2011 O.J. (L 174/1, 1.07.2011) [hereinafter AIFMD].

Directive),[41] and the Insurance Distribution Directive (IDD).[42] A key goal pursued by these changes has been to bring in sustainability-related requirements into the current regime of investor protection. Investors, especially retail investors, face increasingly complex investment products in a context characterised by asymmetries of information and of expertise.[43] Nowadays, investors are more prone to make mistakes,[44] and greater exposed to abuses from mis-selling[45] and agency costs.[46] Markets in sustainable finance products are not exempted from such hazards, and investors may

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41. Commission Proposal for a Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of laws, Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS) and Directive 2011/61/EU on Alternative Investment Fund Managers, COM (2011) 747 final (Nov. 15, 2011) [hereinafter UCITS Directive].

42. Directive 2016/97, of the European Parliament and of the Council of 20 January 2016 on Insurance Distribution, 2016 O.J. (L 26/19).

43. *See* JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 205–25 (2016).

44. *See* Ann-Francoise Lefevre & Michael Chapman, *Behavioral Economics and Financial Consumer Protection OECD Working Papers on Finance, Insurance and Private Pensions*, OECD (Dec. 14, 2021), http://dx.doi.org/10.1787/0c8685b2-en (discussing, among other items, that consumers of financial services make mistakes as a result of literacy problems, limited amount of time dedicated to financial decisions, overwhelming amount of information, product complexity and behavioral biases, etc.); *see also* EUROPEAN COMMISSION, FINAL REPORT OF THE CONSUMER VULNERABILITY ACROSS KEY MARKETS IN THE EUROPEAN UNION, at 340–42 (2016) (explaining that consumers' difficulty processing complex information concerning financial products and services results in sub-optimal choices in the marketplace and citing cognitive limitations and inexperience with financial services to explain this difficulty).

45. Arjan Reurink, *Financial Fraud: A Literature Review*, 32 J. ECON. SURVS. 1292, 1307–08 (2018); *see also* JONATHAN KIRK ET AL., MIS-SELLING FINANCIAL SERVICES (2019).

46. Evidence has shown that problems of conflict of interest and of self-dealing curtail investors' protection and the performance of investments. *See, e.g.*, Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 58 J. FIN. 3, 4–15 (1999); Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 430 (2008); R. David McLean et al., *Why Does the Law Matter? Investor Protection and Its Effects on Investment, Finance, and Growth*, 67 J. FIN. 313, 314 n.1 (2012); VERONIKA K. POOL ET AL., IT PAYS TO SET THE MENU: MUTUAL FUND INVESTMENT OPTIONS IN 401 (K) PLANS, 5 (Nat'l. Bureau. Econ. Rsch. 2013); Thomas W. Doellman & Sabuhi H. Sardarli, *Investment Fees, Net Returns, and Conflict of Interest in 401(k) Plans*, 39 J. FIN. RSCH. 5, 6 (2016). In the U.S. context, see, e.g., 17 C.F.R. § 276 (2019) (producing an interpretation of the fiduciary duty of investment advisers under section 206 of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21); Marianne M. Jennings, *A Literature Review: Investment Professionals and Fiduciary Duties*, CFA INSTITUTE RESEARCH FOUNDATION, Sept. 17, 2014, at 1–2 (explaining that different standards apply to investment advisers compared with broker/dealers); Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors Under the Law of Agency*, 27 J. FIN. PLAN. 42, 43 (2014) (addressing these same issues but in the E.U. context).

suffer damage from abusive business conduct such as the practice of greenwashing in investment products.[47] After offering a general description of the sustainability-related changes made in the area of EU financial services law, the focus of this section turns to the specific reforms affecting the MiFID II's conduct obligations.[48] Amendments have been introduced to the obligation to disclose information to clients,[49] the suitability requirements,[50] conflict of interest rules,[51] and product governance rules.[52]

Finally, the extent to which managers of pension funds are able to pursue sustainable investment strategies, in the absence of a specific mandate provided by the group of beneficiaries, has also been the subject of debate in sustainable finance. This debate has been particularly vigorous in the United States in the context of the fiduciary duties of pension fund trustees.[53] In the early stages of this debate, fiduciary duties were viewed as creating barriers for trustees to engage in sustainable investment strategies. However, this conventional view of fiduciary duties is evolving.[54] In search for answers, scholars have examined the meaning and scope of the phrase "the best interest," or even "the sole interest," of beneficiaries as well as the role that

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47. STEVEN MAIJOOR, SUSTAINABLE FINANCIAL MARKETS: TRANSLATING CHANGING RISKS AND INVESTOR PREFERENCES INTO REGULATORY ACTION 4 (Feb. 12, 2020) [hereinafter ESMA].

48. In its package of sustainable finance reforms, the Commission has labelled the changes in EU financial services law as "Amending Delegated Acts on sustainability preferences, fiduciary duties and product governance." *See* EUROPEAN COMMISSION, *supra* note 38.

49. MiFID II, *supra* note 14, at art. 24(3)–(6).

50. *Id.* at art. 25(2); MiFID II DR, *supra* note 14, at art. 54–55; Eur. Sec. Mkt. Auth. Guidelines on Certain Aspects of the MiFID II Suitability Requirements ESMA35-43-1163, 5–29, 2018 [hereinafter Guidelines on Suitability]; Eur. Sec. Mkt. Auth. Questions and Answers on MiFID II and MiFIR Investor Protection and Intermediaries Topics ESMA35-43-349, 2020 [hereinafter ESMA Q&A Document].

51. MiFID II, *supra* note 14, at art. 16(3), 23.

52. *Id.* art. 16(3), 24(2); Commission Delegated Directive (EU) 2017/593 of 7 April 2016, art. 9–10, 2017 O.J. (L 87) (EU) [hereinafter MiFID II DD]; Eur. Sec. Mkt. Auth. Guidelines on MiFID II product governance requirements ESMA35-43-620, 5–21, 2018 [hereinafter ESMA Product Governance Guidelines].

53. *See, e.g.*, Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 382 (2020); Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 785 (2019); Max M. Schanzenbach & Robert H. Sitkoff, *ESG Investing: Theory, Evidence, and Fiduciary Principles*, J. FIN. PLAN. 42, 42 (2020); William Sanders, *Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing*, 35 PACE L. REV. 535, 564–65 (2014); Benjamin J. Richardson, *Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?,* 22 BANKING AND FIN. L. REV. 145, 169–85 (2007).

54. Richardson, *supra* note 53, at 169–85.

the "prudent investor rule" plays in enabling sustainable investing.[55] Such problems, predominantly discussed in the setting of US rules and experience, are nevertheless echoed in the context of pension funds in Europe. In this light, Section V of this Article looks at the prudent person rule contained in the IORP II Directive,[56] and briefly analyzes the implications of this rule for sustainability within the EU Action Plan framework, including the plan's objective of fostering long-termism in financial and economic activity.[57]

Final considerations are offered at the end of this Article shedding light on the shortcomings, largely challenges of implementation, that EU sustainable finance policy has faced, and will face, as reforms start confronting and shaping the reality of business practices.

II. SUSTAINABILITY RISK AND SUSTAINABLE INVESTMENTS

A. The Meaning of Sustainability Risk

At the core of EU sustainable finance policy is the management of sustainability risk. Sustainability risk under the SFDR is defined as "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."[58] This definition serves as a central reference to define the concept in the EU sustainable finance regime. In a way, such events or conditions have been conceived as belonging to the category of "sustainability factors" defined in terms of "environmental."[59] As we will examine in this section, companies (and their economic and financial value) are exposed to sustainability risk, and so are, more generally, investments (e.g. equity portfolios) and the stability of the financial system.

Currently, the most evident source of sustainability risk has been climate-related phenomena, especially global warming.[60] A review of studies and reports produced in this area shows that current knowledge has largely concentrated on the sustainability risk caused by climate change.[61] Formally,

55. *Id.*

56. IORP II Directive, *supra* note 15, at art. 19.

57. EU Action Plan, *supra* note 1, § 1.3–4. Another reform underpinning long-termism in the field of corporate strategy will address "rules according to which directors are expected to act in the company's long-term interest." *Id.* § 4.2, Action 10.

58. SFDR, *supra* note 11, at art. 2(22).

59. *Id.* at art. 2(24).

60. *See generally* TCFD, *supra* note 18.

61. FSB, *supra* note 3, at 4; *see also* TCFD, *supra* note 18, at 5–7; NGFS 2019, *supra* note 3, at 4, 11; Julia Anna Bingler & Chiara Colesanti Senni, *Taming the Green Swan: How to Improve Climate-Related Financial Risk Assessments*, at 11 (ETHzürich,

climate-related sustainability risk has been decomposed into physical and transition risks. "Physical risks" have been defined as "the possibility that the economic costs of (1) climate-change related extreme weather events or/and (2) more gradual changes in climate, might erode the value of financial assets and/or increase liabilities."[62] Increasingly observed in everyday life and widely reported in news outlets, physical risks identify the negative impact of climate-related phenomena such as bushfires, ice melting causing rising sea levels, floods in agriculture land and urban areas, droughts, hurricanes, and the gradual change in weather patterns, among other events.[63] These events have become a serious concern to persons and businesses.[64] They are detrimentally affecting life on the planet and property such as damaging plants and animal ecosystems, food and water supply, housing and other basic infrastructure in towns and cities.[65] Harm to businesses trickles down to falling values of corporate assets and weaker financial performance.[66]

"Transition risks" constitute the other component of sustainability risk.[67] These risks arise from changes in government policy towards low-carbon practices, the advancement of new technologies as well as shifts in market preferences.[68] For instance, public policy globally has been strongly disrupted by the Paris Agreement, adopted under the United Nations

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Working Paper No. 20/340, 2020) (showing the status quo and areas for improvement of climate transition risk tools and metrics).

62. FSB, *supra* note 3, at 4.

63. NGFS 2019, *supra* note 3, at 12.

64. IPCC, *supra* note 4. For comments on the economic impact of climate change, see Ian Smith, *Extreme Weather Blows out Catastrophe Insurance Losses to $40bn*, FIN. TIMES (Aug. 12, 2021), https://www.ft.com/content/1053aebb-474f-4f35-9034-2475272404e1; Martin Arnold, *ECB Stress Test Reveals Economic Impact of Climate Change*, FIN. TIMES (Mar. 18, 2021), https://www.ft.com/content/7b734848-1287-4106-b866-7d07bc9d7eb8; Michael S. Derby, *Fed's Brainard: Climate Change Already Affecting Economy, Financial System*, WALL ST. J. (Feb. 18, 2021), https://www.wsj.com/articles/fed-s-brainard-climate-change-already-affecting-economy-financial-system-11613653221; NGFS 2019, *supra* note 3, at 13 ("Overall, worldwide economic costs from natural disasters have exceeded the 30-year average of USD 140 billion per annum in 7 of the last 10 years.").

65. IPCC, *supra* note 4, at 8, 25.

66. *See* FSB, *supra* note 3, at 5–6, 8; NGFS 2019, *supra* note 3, at 14 n.12; NGFS 2020, *supra* note 3, at 4.

67. FSB, *supra* note 3, at 4, 12–16; TFCD, *supra* note 18, at 5–7; NGFS 2019, *supra* note 3, at 11, 15–17

68. FSB, *supra* note 3, at 1; TFCD, *supra* note 18, at 5–7; NGFS 2019, *supra* note 3, at 15–17.

Framework Convention on Climate Change.[69] The Paris Agreement has been conceived as a response to mounting evidence indicating that global temperatures are rapidly increasing due to excessive greenhouse gas emissions. Among other estimations, global surface temperatures "will continue to increase [relative to the 1850–1900 period] until at least the mid-century [2050] under all emissions scenarios considered. Global warming of 1.5°C and 2°C will be exceeded during the 21st century unless deep reductions in CO2 and other greenhouse gas emissions occur in the coming decades."[70] In this light, the Paris Agreement seeks to strengthen the response of signatory countries to climate change and global warming by setting reduction targets in greenhouse gas emissions. The objective has been to limit global warming to well below 2° C, preferably 1.5° C, compared to pre-industrial levels.[71]

In line with the Paris Agreement, the European Union (EU) set out its Green Deal policy. By way of this policy, the EU committed "to increase the EU's greenhouse gas emission reductions target for 2030 to at least 50% and towards 55% compared with 1990 levels in a responsible way."[72] This commitment, however, requires profound reforms in regulation, law and policy. As stated by the Commission, "[t]o deliver these additional greenhouse gas emissions reductions, the Commission will, by June 2021, review and propose to revise where necessary, all relevant climate-related policy instruments."[73] Among other repercussions, the EU Green Deal reforms have triggered a process of decarbonization in industries.[74] As well as creating new investment opportunities, this decarbonization process is also costly for businesses to the extent that companies are impelled to deploy a great deal of resources to meet new emission reduction targets.[75] On a

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69. *See The Paris Agreement*, U.N. CLIMATE CHANGE, https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement (last visited July 24, 2022) ("The Paris Agreement is a legally binding international treaty on climate change. It was adopted by 196 Parties at COP 21 in Paris, on 12 December 2015 and entered into force on 4 November 2016.").

70. IPCC, *supra* note 4, at 14.

71. *See* Paris Agreement art. 2, Dec. 12, 2015, T.I.A.S. 16-1104.

72. *Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions*, at 4, COM (2019) 640 final (Dec. 11, 2019).

73. *Id.* at 4–5.

74. *See* Mark Leonard et al., *The Geopolitics of the European Green Deal*, EUR. COUNCIL ON FOREIGN RELS. (Feb. 3, 2021), https://ecfr.eu/publication/the-geopolitics-of-the-european-green-deal/.

75. *See* Dickon Pinner, *Decarbonizing Industry Will Take Time and Money—But Here's How to Get a Head Start*, MCKINSEY SUSTAINABILITY (Dec. 14, 2018),

global basis, estimates indicate that reaching the Paris Agreement global warming targets could amount to USD 830 billion yearly until 2050.[76] Decarbonization costs will require investments "ranging from USD 1 trillion to USD 4 trillion in constant terms when considering the energy sector alone, or up to USD 20 trillion when looking at the economy more broadly."[77]

In order to accommodate new climate-related reforms, economic sectors may face structural changes especially as they implement decarbonization objectives. This is most likely the case in carbon-intense industries.[78] In these industries, decarbonization has generated new uncertainty, augmented costs, and created profitability problems, as reflected by the emergence of new business risks, increased production and distribution costs (including the costs of transitioning to cleaner — and at the time being more costly — technology and processes), the risk of assets becoming stranded, and shifts in consumer preferences towards low-carbon options.[79] As the Federal Stability Board noted, "the market value of equities of firms in some heavily polluting industries is being impacted by policy measures and market trends related to a transition to a low-carbon economy."[80] In support of this statement, the report points to evidence of poor performance in the coal industry: "the Dow Jones Coal Index fell by 85% in 2011-2018 in line with a significant increase in the use of natural gas for power generation and climate-related policy measures."[81] Unless they commit to a credible plan to decarbonize, companies facing high transition risk will inevitably face greater investor activism towards change[82] and become a less attractive investment due to high sustainability risk and, as we will examine in the next subsection of this Article, their negative environmental impact.[83]

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https://www.mckinsey.com/business-functions/sustainability/our-insights/sustainability-blog/decarbonizing-industry-will-take-time-and-money-but-heres-how-to-get-a-head-start.

76. EUROPEAN SYSTEMIC RISK BOARD, POSITIVELY GREEN: MEASURING CLIMATE CHANGE RISKS TO FINANCIAL STABILITY 10 (2020).

77. *Id.*

78. *See* NGFS 2020, *supra* note 3, at 15.

79. *See id.*; *see also* TFCD, *supra* note 18, at 5–8.

80. FSB, *supra* note 3, at 12.

81. *Id.*

82. *See, e.g.*, Sarah McFarlane & Christopher M. Matthews, *Oil Giants Are Dealt Major Defeats on Climate-Change as Pressures Intensify*, WALL ST. J. (May 26, 2021), https://www.wsj.com/articles/oil-giants-are-dealt-devastating-blows-on-climate-change-as-pressures-intensify-11622065455; Anjili Raval et al., *Shell Verdict Sets Scene for More Corporate Climate Cases*, FIN. TIMES (May 28, 2021), https://www.ft.com/content/f18269ee-c9d8-45c4-bbee-28561b065e6b.

83. *See infra* Section II.2.A.

Sustainability risk has raised the alarm among key actors in the financial sector because this risk undermines a company's financial position (by increasing costs, downgrading the valuation of corporate assets, and reducing the company's profitability and creditworthiness) and can spread widely across whole industries.[84] Central bankers, financial regulators, government officials, and finance-related business associations are increasingly aware that this problem, if ignored or mismanaged, will pose a credible threat to the real economy and ultimately, to the stability of the financial sector.[85] Realizing the importance and strength of financial markets to change corporate behavior, these actors have provided strong support to the EU policy of managing sustainability risk by way of integrating this risk into investment decision-making and by introducing adequate prudential regulations.[86]

B. The Meaning of Sustainable Investments

1. Sustainable Investments as a Market Trend

From the vantage point of the investment management industry, sustainable investments refer to an "investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management."[87] Underlying this definition lies a characterization of the investor as a person conscious of societal and/or environmental investment objectives. This type of investor, which in the past was mostly circumscribed to marginal niches, has grown in size and importance in recent years, as has market demand for sustainable investment products.[88] In major financial centers, an increasingly rich variety of sustainable investment options are available to investors by mainstream financial market participants.[89] At the level of portfolio design, for example, the adoption of sustainable investment strategies such as negative screening, best in class, norms-based screening, sustainability themes, engagement, impact investing, and engagement,

84. FSB, *supra* note 3, at 12–13.

85. *See id.* at 28.

86. Although the need for prudential regulation has been identified as an increasingly important theme in sustainable finance policy, this Article will not cover this theme. Central references to planned policy measures in this area can be found in *Strategy for Financing the Transition to a Sustainable Economy*, *supra* note 2, at 3.

87. GSIR 2020, *supra* note 25, at 7.

88. *Id.* at 5.

89. *See* CFA Institute, *Future of Sustainability in Investment Management: From Ideas to Reality*, at 11–12 (2020).

among others, has skyrocketed.[90]

With this market for sustainable investment products being investor-driven, it has become apparent that sustainability themes are influencing investors' choices.[91] The presence of a "sustainable" investor has become increasingly felt and established. A recent study conducted by 2° Investing Initiative found that a large majority of retail investors in France and Germany are interested in sustainable investing.[92] Judged by the value growth in sustainable investments, investors in US markets are also showing preferences evolving towards sustainability. The SIF Foundation calculated US$17 trillion in investments considering environmental, social and governance factors in 2020, up 42 percent from 2018.[93] In the first semester of 2018, European sustainable funds received net inflows of €32.1 billion, up from €28.8 billion in the previous six months.[94] More globally, the GSIR reported that global sustainable investments reached US$ 35.3 trillion in early 2020 (a 55 percent increase from the past four years), with one quarter of the investments made by retail investors and the rest by institutional investors.[95]

Investors would choose to invest sustainably even if this strategy entailed foregoing profits. A recent study conducted by the University of Cambridge Institute for Sustainability Leadership found that the median saver prefers a sustainable fund even if it connotes a sacrifice of up to 2.5 per cent of annual

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90. *See* GSIR 2020, *supra* note 25, at 7, 10–12; *see also* EUROSIF, EUROPEAN SRI STUDY 2018, at 16–17 (2018); SWISS SUSTAINABLE FINANCE, SWISS SUSTAINABLE INVESTMENT MARKET STUDY 2021 4–5 (2021).

91. *See* Aisha I. Saad & Diane Strauss, *The New "Reasonable Investor" and Changing Frontiers of Materiality: Increasing Investor Reliance on ESG Disclosures and Implications for Securities Litigation*, 17:2 BERKELEY BUS. L. J. 397, 398–400 (examining the extent to which the current notion of materiality in information disclosure guards consistency with the new "sustainable" investor).

92. 2° INVESTING INITIATIVE (2DII), A LARGE MAJORITY OF RETAIL CLIENTS WANT TO INVEST SUSTAINABLY 5 (Mar. 2020).

93. US SIF Foundation, *Report on US Sustainable and Impact Investment Trends* 1 (2020), https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf; *see also* Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. FIN. 2789, 2789–92 (describing how, in the US market, mutual fund investors collectively value sustainability as shown by more money being allocated to highly sustainable funds and less money to funds that perform poorly on sustainability).

94. UNITED NATIONS ENVIRONMENTAL PROGRAMME, SUSTAINABLE FINANCE PROGRESS REPORT 9 (2019), https://wedocs.unep.org/bitstream/handle/20.500.11822/34534/SFPR.pdf?sequence=1&isAllowed=y.

95. GSIR 2020, *supra* note 25, at 9, 12–13.

returns.[96] Among funds with similar past returns, 75 percent of savers chose the more sustainable fund.[97] Sustainability preferences were stronger among younger people (less than 35 years old) and less experienced investors.[98] Focusing on pension funds, the UNPRI finds that "[v]arious surveys globally indicate that beneficiaries increasingly expect their money to be invested responsibly and, in some cases, express a willingness to forego financial returns to achieve sustainability impact."[99] Similarly, a survey conducted by the Department of International Development among nearly 2000 people in the United Kingdom (with the aim of understanding whether they want to invest their money in ways that support the UN sustainable development goals), concluded that "[m]ore than 50% of people say they are interested in investing sustainably now or in the future," and that "28% of people would make a responsible and impactful investment even if the returns they received were lower than other investments if they knew the investment made a difference to something they really care about."[100]

These are only a few among an increasing number of studies indicating a shift in investors' preferences. It is thus unsurprising that the definition of the average investor as denoting a rational man whose sole aim is to reap financial returns has been challenged.[101] The evolving market reality suggests that a broader investor's profile, which includes the "sustainable investor," has gained substantial traction within the investment community. As well as searching for financial returns, this new investor cares about sustainability reporting and the performance of investments and companies in terms of social, environmental and governance factors.[102] The well-

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96. CAMBRIDGE INSTITUTE FOR SUSTAINABILITY LEADERSHIP, WALKING THE TALK: UNDERSTANDING CONSUMER DEMAND FOR SUSTAINABLE INVESTING 14 (2019), https://www.cisl.cam.ac.uk/system/files/documents/cisl-vie-report-single-pages.pdf.

97. *Id.*

98. *Id.* at 16.

99. U.N. PRINCIPLES OF RESPONSIBLE INVESTMENTS, UNDERSTANDING AND ALIGNING WITH BENEFICIARIES SUSTAINABILITY PREFERENCES 9 (2021), https://www.unpri.org/download?ac=13321.

100. UNITED KINGDOM DEPARTMENT FOR INTERNATIONAL DEVELOPMENT, INVESTING IN A BETTER WORLD: SURVEY RESULTS, 6, 11 (2019), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/834208/Investing-in-a-better-wold-survey-results.pdf.

101. *See generally* Saad & Strauss, *supra* note 91, at 392–413 (focusing "on challenging the interpretation of the reasonable investor currently enshrined in legal doctrine and advances that a revised consideration of this legal reference must take into account contemporary investor concerns regarding corporate ESG performance").

102. *See id.* at 393–94 ("These dual trends-the increased demand for ESG disclosures by mainstream investors and the expanding investment market share claimed by sustainability-minded investors-challenge a traditional characterization of the

known "socially responsible investor" integrates this broad category of sustainability-minded investors whose strategies combine profits and sustainability goals.[103] These mixed investment strategies are distributed widely, however, and they are not driven by a single motivation. Profit-driven mainstream investors may look at social, environmental or governance investment objectives only if they contribute to the overarching goal of maximizing the short-term returns of their portfolios.[104] At the other extreme, the purpose of an investor's choice may be largely driven by moral- or ethical-based principles in relation to society and the environment.[105]

2. The Need to Regulate Sustainable Investments

Responding to this new reality, the European Commission proposed reforms with the purpose of facilitating the development of markets in sustainable investment products.[106] Over the last decades, such markets

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'reasonable investor' that sits at the heart of American securities doctrine. The reasonable investor archetype, which arose from early 20th century case law, conceives of the investor as an economically rational actor who relies solely on financial disclosures in making decisions about the purchase and sale of securities. A widening rift between this reasonable investor archetype and contemporary investors who make demands for and rely on nonfinancial information, including corporate ESG performance, challenges doctrinal precedent that deems non-financial ESG disclosures to be immaterial.").

103. *See id.* Data on use and performance of mixed investment strategies are typically reported by organizations involved in sustainable investment. *See, e.g.*, GSIR, *supra* note 26; Eurosif, *supra* note 91; SWISS SUSTAINABLE FINANCE, SWISS SUSTAINABLE INVESTMENT MARKET STUDY (2021), https://www.sustainablefinance.ch/upload/cms/user/2021_06_07_SSF_Swiss_Sustainable_Investment_Market_Study_2021_E_final_Screen.pdf.

104. *See* Gary, *supra* note 53, at 750–54 (looking at evidence indicating that ESG portfolios have performed equal or better than traditional portfolios); *see also* Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies* 5 J. SUSTAINABLE FIN. & INV. 210, 226 (2015) (finding a positive correlation superior ESG performance with superior equity performance).

105. Schanzenbach & Sitkoff, *supra* note 53, at 398. Depending on the purpose of the investment, the authors differentiate between "collateral benefits" or "improved risk-adjusted returns." In collateral benefits, the "ESG investing [is] motivated by providing a benefit to a third party or otherwise for moral or ethical reasons," whereas risk-adjust return investment "entails the use of ESG factors as metrics for assessing expected risk and return with the aim of improved return with less risk. A typical risk-return ESG strategy is to use ESG factors to pick stocks or other securities on the theory that those factors can identify market mispricing and therefore profit opportunities (we'll call this active investing). For example, a risk-return ESG analysis of a fossil fuel company might conclude that the company's litigation and regulatory risks are underestimated by its share price, and therefore that reducing or avoiding investment in the company will improve risk-adjusted return." *Id.*

106. *See, e.g.*, SDFR, *supra* note 11 (requiring certain environmental disclosures in the financial services sector in the EU).

developed on a self-regulatory basis.[107] In the views of the Commission, however, self-regulation cannot warrant market development across the European Union in ways that promote transparency, stability, and investor protection. The Commission has articulated such concerns in various documents. Stressing on the need to harmonise information disclosure rules across the EU, the Commission has claimed that the various business practices observed in mainstream markets for sustainable finance had shown "commercially-driven priorities that produce divergent results," and these outcomes would end up fragmenting the internal market and creating inefficiencies.[108] The Commission also noted that the investors' choice of sustainable finance products would be distorted in the presence of "divergent disclosure standards and market-based practices [that] make it very difficult to compare different financial products, [and that] create an uneven playing field for such products and for distribution channels."[109]

Another critical justification for regulation has been the serious concerns arising from greenwashing practices undertaken by companies or financial intermediaries. According to Lyon and Montgomery, a "[p]opular usage of the term greenwash encompasses a range of communications that mislead people into adopting overly positive beliefs about an organization's environmental performance, practices, or products."[110] Involving the manipulation of information content, greenwashing may take various forms including, among other types, the use of slight exaggeration or vague claims, the misuse of visual imagery, or the full fabrication about environmental (or social) performance.[111] Selective disclosure has proved particularly worrisome. It denotes the "[s]elective disclosure of positive information about a company's environmental or social performance, without full disclosure of negative information on these dimensions, so as to create an

107. A valuable study on the state of law in various countries in relation to ESG investing was produced early on by the Nations Environmental Programme in cooperation with Freshfields law firm—the Freshfield Report. *See* UNITED NATIONS ENVIRONMENTAL PROGRAMME, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTING 36–39 (2005), https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (describing the minimal pan-EU ESG initiatives enacted prior to 2005 and evaluating legal standards applicable to sustainable investing).

108. SFDR, *supra* note 11, at 9.

109. *Id.* at 9–10.

110. Thomas P. Lyon & A. Wren Montgomery, *The Means and End of Greenwash*, 28 ORG. & ENV'T 223, 225 (2015).

111. *Id.*

overly positive corporate image"[112] Greenwashing practices, at the level of corporate disclosure and/or product disclosure (e.g. misleading product advertisements or labels) may provide short-term benefits to companies yet at the expense of society. Among other sources, societal costs may arise from undermined trust in corporate environmental impacts, greater consumer cynicism and mistrust, as well as consumers being overwhelmed and confused about a company's claims in relation to its corporate social responsibility activities and impacts.[113]

In a legal and regulatory context, concerns over greenwashing have been clearly stated in the explanations justifying the need for the EU Taxonomy Regulation as follows:

> Making available financial products which pursue environmentally sustainable objectives is an effective way of channeling private investments into sustainable activities. Requirements for marketing financial products or corporate bonds as environmentally sustainable investments, including requirements set by Member States and the Union to allow financial market participants and issuers to use national labels, aim to enhance investor confidence and awareness of the environmental impact of those financial products or corporate bonds, to create visibility and to address concerns about 'greenwashing'. In the context of this Regulation, greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met.[114]

Similarly, the Chair of the European Securities and Markets Authority (ESMA) has explained greenwashing conduct from an enforcement perspective when he stated that:

> [Greenwashing] refers to a wide variety of practices that range from mislabelling to misrepresentation and mis-selling of financial products. As the number of products that claim to be linked to the sustainability performance of firms increases, driven by market demand, we need to be careful to ensure that investors do not end up buying products which are marketed as sustainable when in reality they are not. Here, we should not be nai The many risks that can lead to misleading financial information are also valid in the case of non-financial information.[115]

The problem of greenwashing has been reported widely in the business media. In the asset management industry, concerns have been identified in

112. *Id.*
113. *See id.* at 238–39 (citing various sources).
114. EU Taxonomy Regulation, *supra* note 12, at 11.
115. ESMA, *supra* note 47, at 5.

relation to the opaque composition of investment funds branded as "sustainable."[116] The Financial Times reported that "many of the funds that use the ESG label . . . are not as sustainable as they first appear. Several popular ESG funds, for example, invest in the world's largest carbon emitters."[117] Finding out which managers are or are not committed to sustainability has proved difficult for investors who "have struggled to find out what funds were invested in and just how seriously asset managers were thinking about issues such as climate change."[118] Comparability between sustainable products has also been difficult, "[s]ome [financial advisers] are saying almost every fund is marketed as sustainable now. How do they determine which are the most sustainable?"[119] Issues related to costs and fees have also proved contentious. Exchange-Traded Funds (ETFs) labelled as "sustainable ETFs" have charged higher fees than non-ESG ETFs in spite of the fact that both groups of funds have shown a similar asset composition.[120]

In addition, concerns of greenwashing have emerged in the context of corporate claims or pledges about their environmental strategies. The Financial Times has recently reported that "[t]he deluge of corporate climate pledges are yet to translate to meaningful action, as only a handful of the 159 companies responsible for more than 80 per cent of global industrial emissions have set adequate targets"[121] and that "almost all of the pledges

116. Greenwashing concerns in the banking industry have been reported widely as in the Financial Times. *See, e.g.*, Billy Nauman & Stephen Morris, *Global Banks' $750bn in Fossil Fuels Finance Conflicts with Green Pledges*, FIN. TIMES (Mar. 24, 2021).

117. *See* Attracta Moony, *Greenwashing in Finance: Europe's Push to Police ESG Investing*, FIN. TIMES (Mar. 10, 2021), https://www.ft.com/content/74888921-368d-42e1-91cd-c3c8ce64a05e; *see also* REGINA SCHWEGLER ET AL., SUSTAINABILITY FUNDS HARDLY DIRECT CAPITAL TOWARDS SUSTAINABILITY: A STATISTICAL EVALUATION OF SUSTAINABILITY FUNDS IN CH AND LUX (May 3, 2021), https://www.greenpeace.org/static/planet4-luxembourg-stateless/2021/06/ac190a73-inrate-study-on-sustainability-funds-for-greenpeace.pdf (finding that sustainable investment strategies used in investment funds are failing to channel private funds to sustainable activities).

118. *See* Moony, *supra* note 117.

119. *Id.* (quoting James Alexander, the chief executive of the UK Sustainable Investment and Finance Association).

120. *See* Jason Zweig, *You Want to Invest Responsibly. Wall Street Smells Opportunity,* WALL ST. J. (Apr. 16, 2021), https://www.wsj.com/articles/you-want-to-invest-responsibly-wall-street-smells-opportunity-11618586074.

121. Camilla Hodgson, *Powerful Investor Group Finds Net Zero Pledges Distant and Hollow*, FIN. TIMES (Mar. 22, 2021), https://www.ft.com/content/12fd1c09-61fb-444e-a9cc-0b50fe0ea411.

[made by such companies] are both distant and hollow."[122] This dissociation between sustainability-related pledges and business action — firms failing to walk the talk — has often displayed evidently in the investment industry: "New bonds sold by fossil fuel companies were being snapped up by leading exchange traded fund (ETF) providers including BlackRock and State Street even as these managers were preparing to pledge to slash their carbon emissions exposure, researchers have found."[123]

EU sustainable finance policy has therefore been driven, on the one side, by the goal of further developing markets for sustainable investment products and on the other side, by the imperative of achieving this goal without undermining, or in ways that strengthen, the EU internal market and investor protection standards. In this context, an important question has been how to identify the sustainability properties of an investment or economic activity, and how to do this in a way that is objective and systematic while averting divergent criteria across EU member States. Reforms in this area have been aimed at creating classification tools, including the enactment of the EU Taxonomy Regulation, to determine whether an investment or economic activity is or is not sustainable, or whether investor preferences do or do not contain sustainability objectives. Key tools are briefly outlined in the next subsection.

3. The Classification of Activities and Preferences in Terms of Sustainability

The EU sustainable finance policy has engineered a regime that includes a new set of definitions and of tools for the classification of sustainable investment activities. As mentioned earlier in this section, the SFDR has defined key terminology, notably the meaning of sustainability risk and factors.[124] In addition, it has provided a definition of "sustainable investment" as follows:

> [A]n investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource

122. *Id.*

123. *See* Chris Flood, *ETF Providers Have Been Misleading Buyers of New Fossil Fuel Bonds, Finds Study*, FIN. TIMES (Jun. 14, 2021), https://www.ft.com/content/5f35f3b4-4509-4dc6-985c-46af5187c27d ("About 14 percent of the value of new bonds bought by 35 of the largest US corporate bond ETFs between 2015 and 2020 were issued by carbon-intensive companies in the oil and gas, utilities and coal mining sectors were, according to a new analysis by the Oxford Sustainable Finance Programme at the University of Oxford's Smith School of Enterprise and the Environment.").

124. *See* SFDR, *supra* note 11, at art. 2(22), (24).

> 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, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.[125]

Drawing from this definition, a necessary condition for an investment to be sustainable is that the economic activity underlying the investment contributes to an environmental and/or social objective along the lines depicted in the definition.[126] Other conditions have added restrictions to this definition of sustainable investment, notably, the "do not significantly harm" and the "good governance" conditions.[127] From a conceptual and operational perspective, this definition has been instrumental for classifying financial products in terms of sustainability. As a matter of fact, three categories of sustainable financial products have currently been defined, all these categories finding its conceptual foundation in the SFDR.[128]

The first type of product category refers to financial instruments that have as objective a sustainable investment.[129] Strictly speaking, this type of investment — referred to as "dark green" products — satisfies the definition of sustainable investments under Article 2(17) SFDR and the falls within the scope of Article 9 of the SFDR. The second type of product category, defined in Article 8 of the SFDR, encompasses those financial instruments that promote environmental or social characteristics, or a combination of those characteristics.[130] This category of financial products, so-called "light green" products, is wider in scope; it allows for a rich variety of instruments that are capable of promoting or ameliorating environmental and social

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125. *Id.* at art. 2(17).

126. *See id.*

127. *See id.*

128. *See generally id.* (acknowledging that the distinction between these two groups of products corresponded to an existing industry reality, and that disclosure requirements have been adjusted accordingly).

129. *See id.* at art. 2(1), 9.

130. *See id.* at art. 8(1).

outcomes.[131] More recently, industry practice has defined a third category of investment products, namely Article 6 SFDR products. This third category can be seen as a residual one because it encompasses products that are neither dark green nor light green.[132] However, Article 6 SFDR products do consider sustainability risk if relevant to the product and may consider principal adverse impact on sustainability factors.[133]

Another way by which an investment can be classified as sustainable is by reference to the criteria laid down in the EU Taxonomy Regulation.[134] In basic terms, the EU Taxonomy Regulation has designed a classification tool in order to guide the task of determining whether an economic activity is or is not environmentally sustainable.[135] Its objective is to provide a baseline reference for green activities for use across the European Union.[136] According to the Commission, the Taxonomy Regulation "is an important enabler for scaling up sustainable investment and implementing the European Green Deal as part of the EU's response to the climate and environmental challenges."[137] This taxonomy "provides uniform criteria for companies and investors on economic activities that can be considered environmentally sustainable . . . and thus, aims to increase transparency and consistency in the classification of such activities and limit the risk of greenwashing and fragmentation in the EU internal market."[138]

This Taxonomy lays down the criteria for an economic activity to qualify as environmentally sustainable.[139] Under these criteria, all four requirements must be met as follows. Firstly, the activity contributes substantially to one or more — out of a total of six — of the "environmental objectives" enumerated by the Taxonomy Regulation.[140] Currently, the first two environmental objectives to be implemented are the climate change mitigation objectives and the climate change adaptation objectives (starting January 2022).[141] Secondly, the activity does not significantly harm (DNSH)

131. *See id.*

132. *See id.* at art. 6(1).

133. *See id.*

134. *See* EU Taxonomy Regulation, *supra* note 12.

135. *See id.* at art. 3(1).

136. *See id.* at art. 1(1).

137. Commission Regulation 2020/852, 2021 O.J. (C 2800) 1 [hereinafter DA Taxonomy Regulation].

138. *Id.*

139. *See* EU Taxonomy Regulation, *supra* note 12, at art. 3.

140. *Id.* at art. 3(a), 9–16 (listing and describing the six environmental objectives).

141. *Id.* at art. 9.

any of the other environmental objectives.[142] An economic activity should not qualify as environmentally sustainable, the rationale goes, if it causes more harm to the environment than the benefits it brings. Thirdly, the activity is carried out in compliance with the minimum safeguards identified in Article 18 of the Taxonomy Regulation.[143] And, fourthly, the activity complies with the technical screening criteria as established by the Commission.[144] For each economic activity considered, the Technical Screening Criteria specifies environmental performance requirements that, assuming they are met, lead to the conclusion that the activity makes a substantial contribution to the environmental objective in question and does not significantly harm other environmental objectives.[145] In relation to climate change mitigation and adaptation objectives, these Technical Screening Criteria have been released recently by way of delegated act.[146]

These two ways of classifying investments as sustainable, namely the criteria in article 2(17) SFDR (along with Articles 6, 8 and 9 SFDR) and the criteria in Article 3 of the EU Taxonomy Regulation, have been incorporated into the MiFID II regime.[147] More specifically, modifications to the MiFID II DR have been introduced through the draft DA MiFID II, a key item of this reform being the recognition that clients may show "sustainability preferences."[148] More particularly, the draft DA MiFID II has defined, for the very first time, the meaning of a client's "sustainability preferences" in terms of a choice, exercised by the client or potential client, of financial instruments. This choice requires the client or potential client to decide:

> . . . whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment:
> (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 Regulation (EU) 2020/852 of the European Parliament and of the Council;
> (b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable

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142. *Id.* at art. 3(b), 17.

143. *Id.* at art. 3(d).

144. *Id.* at art. 3(d).

145. *Id.* at art. 11.

146. *See* DA Taxonomy Regulation, *supra* note 137.

147. *See* SFDR, *supra* note 11, at art. 2(17), 6, 8–9; *see also* EU Taxonomy Regulation *supra* note 12, at art. 3.

148. Commission Delegated Regulation Amending Delegated Regulation (EU) 2017/565, 2021 O.J. (C 2021) 1 [hereinafter Draft DA MiFID II].

> investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;
> (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;[149]

In the definition above cited, three categories of financial instruments are included. The first category (subparagraph (a)) refers ultimately to instruments able to meet the criteria in Article 3 of the EU Taxonomy Regulation. The second category (subparagraph (b)) refers to instruments pursuing sustainable investments (Article 2(17) and Article 9(1) SFDR). Although the interpretation of the third category (subparagraph (c)) is not completely settled, this category seems to be broad enough to contain financial instruments that promote environmental or social characteristics (Article 8(1) SFDR — light green products) and even products making no positive contribution to the environment or society (Article 6 SFDR products), provided that such instruments consider principal adverse impact on sustainability factors.[150] The consideration of principal adverse impact is intended to show to actual or prospective investors the extent to which and how the instrument has, or may have, a negative impact on sustainability factors relating to environmental, social and employee matters, respect for human rights, anti-corruption, and anti-bribery matters.[151]

Before concluding this section, it is worth noting that the EU Taxonomy, as a classification tool, can, and likely will, find multiple uses. In relation to transitional finance, companies may rely on the EU Taxonomy to design a plan for their climate and environmental transition and raise finance for this transition.[152] Manufacturers of financial products may opt to use the EU Taxonomy as a basis to design credible green financial instruments. In this

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149. *Id.* at art. 1.

150. *See* SFDR, *supra* note 11, at art. 6, 8. In the situation whereby an Article 6 SFDR product or Article 8 SFDR product did not consider principal adverse impact (consideration that works on a comply or explain basis), it is the opinion of this author that, according to the current state of law, such products would be unsuitable to meet a client's sustainability preferences under MiFID II. *See* discussion *infra* Section IV.2.B. There is therefore a clear incentive to disclose principal adverse impact in Article 8 SFDR and Article 6 SFDR insofar as, without such disclosure, these products may not be used to service clients with sustainability preferences. *See* SFDR, *supra* note 11, at art. 6, 8.

151. *See* SFDR, *supra* note 11, at art. 2(24) (outlining sustainability factors).

152. EU PLATFORM ON SUSTAINABLE FINANCE, TRANSITION FINANCE REPORT (March 2021), https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210319-eu-platform-transition-finance-report_en.pdf.

sense, the Commission has already profited from the EU taxonomy to propose green bond criteria that require, among other factors, that the totality of the funds raised through the green bond be allocated to economic activity aligned with the EU taxonomy.[153] Similarly, the Commission's recent efforts to establish criteria for EU Eco-levels and EU climate benchmarks rely on the EU Taxonomy.[154] Furthermore, taxonomy-aligned information disclosure will be a valuable resource for investors and shareholders having sustainability preferences.[155]

As the next section of this Article will explain, the EU Taxonomy Regulation has also created mandatory disclosure obligations on companies and Financial Market Participants (FMPs).[156] Broadly speaking, such information disclosure will indicate the extent to which the economic activity of a company, or the economic activity underlying investment products (e.g., portfolios), satisfies the taxonomy classification. Finally, the Commission is working on the design of a social taxonomy, which will serve as basis to classify sustainable investments driven by social investment objectives.[157]

III. CORPORATE SUSTAINABILITY REPORTING AND OTHER INFORMATION DISCLOSURE OBLIGATIONS

Without the availability of quality and sufficient data, it is difficult, if not unfeasible, to adequately manage sustainability risk and realise an investment's sustainability properties and impact.[158] The critical value of sustainability-related information has been rightfully upheld by the Commission in its Action Plan, which has proposed, among other measures,

153. Proposal for a Regulation Of The European Parliament and of The Council on European Green Bonds, COM (2021) 391 final (June 7, 2021); *see* EUROPEAN GREEN BOND STANDARD, EUROPEAN COMMISSION, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en.

154. *See Strategy for Financing*, *supra* note 2 at 4, 6–7 (planning to expand the use of the EU Ecolabel to financial products in order to provide retail investors with a "credible, reliable and widely recognized label for retail financial products").

155. *See id.* at 15.

156. *See* EU Taxonomy Regulation, *supra* note 12, at art. 8; *see also* EUROPEAN SECURITIES AND MARKETS AUTHORITY, FINAL REPORT: ADVICE ON ARTICLE 8 OF THE TAXONOMY REGULATION (2021) https://www.esma.europa.eu/sites/default/files/library/esma30-379-471_final_report_-_advice_on_article_8_of_the_taxonomy_regulation.pdf.

157. PLATFORM ON SUSTAINABLE FINANCE, DRAFT REPORT BY SUBGROUP 4: SOCIAL TAXONOMY (2021) https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf.

158. *See* Draft CSRD, *supra* note 13, at 24–25.

the overhaul of the current regime governing corporate non-financial information reporting.[159] The current EU rules based on the NFRD[160] will soon be fully replaced by a new legal framework for corporate sustainability reporting enshrined in the CSRD.[161]

The CSRD expands the scope of application of the reporting obligation, which will reach out to a larger number of companies.[162] Unlike the NFRD, which has imposed reporting obligations on a comply or explain basis,[163] the CSRD has introduced mandatory reporting standards.[164] Those standards — that will be designed by the European Financial Reporting Advisory Group (EFRAG) — are conceived to provide a flow of sustainability-related information which "is understandable, relevant, representative, verifiable, comparable, and is represented in a faithful manner."[165] Available to shareholders, investors and other corporate stakeholders, the information contained in sustainability reports will be externally audited.[166] This step is crucial to the extent that auditors shall provide, among other elements, an expert opinion as to the report's compliance with the CSRD rules and the applicable EU common reporting standards.[167] Mandatory and audited reporting standards, along with other changes introduced by the CSRD, are expected to tackle the most pressing information disclosure problems found in the operation of NFRD, problems that threaten to derail the successful

159. *See* EU Action Plan, *supra* note 1, at 3.

160. *See* NFRD, *supra* note 36.

161. *See* Draft CSRD, *supra* note 13 (amending four EU legislative instruments: the Accounting Directive (2013/34/EU); the Transparency Directive (2004/109/EC); the Audit Directive (2006/43/EC); and the Audit Regulation (537/2014)).

162. *Id.* at art. 1(3) (replacing art. 19(a) of the Accounting Directive 2013/34/EU). For the scope of application of the new regime of sustainability reporting under the draft CSRD, see Directive 2013/34/EU of The European Parliament and of The Council of 26 June 2013 On the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings, Amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, art. 1, 2013 O.J. (L. 182) 19; *see also* Draft CSRD, *supra* note 13, at art. 1(3).

163. *See* NFRD, *supra* note 36, at art. 1(1) (inserting art. 19(a) in the Accounting Directive 2013/34/EU).

164. *See* Draft CSRD, *supra* note 13, at art. 1(3)–(4) (replacing art. 19a and introducing articles 19b, 19c and 19d to the Accounting Directive 2013/34/EU).

165. *See id.* at art. 1(4) (introducing art. 19b(2) to the Accounting Directive 2013/34/EU).

166. *See id.* at arts. 2–4 (amending the Transparency Directive 2004/109/EC, Audit Directive 2006/43/EC and Audit Regulation (EU) No 537/2014; ordering the creation of new "independent assurance provider services" in the field of sustainability reporting).

167. *Id.* at recitals 53–55.

development of EU sustainable finance policy.[168]

Importantly, both the NFRD and the CSRD have adhered to the principle of "double materiality" in order to delimit the boundaries of the sustainability reporting obligation.[169] According to this principle, the disclosure of information shall duly account for not only the impact of sustainability factors on the company's financial position and performance (outside-in effect) but also for the impact of the company's economic activity on sustainability factors (inside-out effect).[170] The first pillar of the double materiality principle orbits around the identification, measurement and more generally, management of sustainability risk to which the company is exposed, whereas the second pillar captures the concept of sustainable investments and their impact on sustainability factors, such as the environment or the community.[171] These two pillars together determine a company's sustainability performance. The materiality principle utilized in the NFRD and CSRD derives from the more conventional principle of materiality long established in financial reporting.[172] As such, and without disregarding their distinctive definitions and features, it can reasonably be argued that the shortcomings arising from the operation of materiality in the context of corporate financial reporting will, to an extent, also be present in the realm of corporate sustainability reporting.

Widely used in corporate financial reporting, materiality in information disclosure refers to "the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking."[173] As a

168. *See id*. at recitals 11–14 (emphasizing the negative implications flowing from a non-financial data gap created by the NFRD between users' information needs and the sustainability information reported by undertakings).

169. *See id*. at recital 25; *see also* NFRD*, supra* note 36, at art. 1(1) (inserting art. 19a(1) in the Accounting Directive 2013/34/EU); European Commission, *Guidelines on Reporting Climate-Related Information*, at 6–8, 4409 final (July 17, 2019) [hereinafter EC Reporting Guidelines].

170. *See* Draft CSRD, *supra* note 13, at art. 1(3) (replacing art. 19(a)(1) of the Accounting Directive 2013/34/EU); *see also* SFDR, *supra* note 11, at art. 2(24) (defining "sustainability factors").

171. *See* Draft CSRD, *supra* note 13, at 5.

172. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, 2013 O.J. (L 182), art. 2(16) [hereinafter Accounting Directive 2013/34/EU]. *See generally* Baumüller & Schaffhauser-Linzatti, *supra* note 37, at 101–11 (examining materiality in both financial and non-financial disclosure).

173. *See* Accounting Directive 2013/34/EU, *supra* note 172, at art. 2(16).

legal requirement, the evaluation of materiality has been essential for companies to manage serious risks associated with financial information disclosure. More particularly, the disclosure may omit relevant information, contain misstatements concerning relevant information and/or overflood investors with irrelevant or useless information.[174] By assessing the materiality status of information, companies have been able to draw a line and realise what information is or is not relevant to users, and therefore, what information shall or shall not be reported. Deciding on the materiality status of information, however, involves discretionary judgment on the part of corporate officers who must determine whether a piece of information can reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking.[175] Subjective judgment may deliver sound decisions; nevertheless, it may also prove opportunistic or erratic.[176] Ultimately, the materiality requirement delineates the scope of the financial information disclosure obligation[177] and, to this extent, enforcement agencies and investors (especially in the United States) have actively monitored due compliance with this principle.[178]

Building upon this experience, the legal framework for corporate sustainability reporting in Europe has also adopted the materiality principle, yet shaped in a different conceptual format, namely the 'double materiality' principle.[179] Pursuant to Article 19(a)(1) of the NFRD, companies are required to disclose information "to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters . . . ."[180] This provision has been construed as containing not only a

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174. *See* Baumüller & Schaffhauser-Linzatti, *supra* note 37, at 101–03.

175. *See* Accounting Directive 2013/34/EU, *supra* note 172, at art. 2(16).

176. *See* Baumüller & Schaffhauser-Linzatti, *supra* note 37, at 101–03; *see also* Ernest L. Hicks, *Materiality*, 2 J. Acct. Rsch. 158, 159 (1964) ("Determining whether something is material remains, in most instances, completely subjective — a matter of judgment."); Shane Moriarity & F. Hutton Barron, *A Judgment-Based Definition of Materiality*, 17 J. ACCT. RSCH. 114, 114–35 (1979).

177. *See* Baumüller & Schaffhauser-Linzatti, *supra* note 37, at 101–03.

178. *See*, *e.g.,* European Securities and Markets Authority (ESMA), Feedback Statement: Considerations of Materiality in Financial Reporting, ESMA/2013/218 (Feb. 14, 2013).

179. *See* Draft CSRD, *supra* note 13, at art. 19a(1), recital 25; *see also* NFRD, *supra* note 37, at art. 1(1) (inserting art. 19a(1) in the Accounting Directive2013/34/EU); European Commission, *Guidelines on Reporting Climate-Related Information*, supra note 169, at 6–8.

180. NFRD, *supra* note 36, at art. 19a(1).

requirement for financial materiality ("to the extent necessary for an understanding of the company's development, performance and position") but also a requirement for environmental and social materiality (impact of the company's activities relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters).[181] It is worth noting that, according to the Commission, these two dimensions of materiality operate independently.[182]

On the one hand, financial materiality encompasses sustainability-related information that is relevant to corporate value and, concomitantly, to data users' decision-making, these users being primarily shareholders, investors and/or creditors.[183] Crucially, financial materiality in sustainability information accounts for the exposure of a company to sustainability risk. That is, it reports on the impact of sustainability factors on the company's value (outside-in effect).[184] On the other hand, social or environmental materiality refers to the impact on society or the environment, respectively, of the company's activities in carrying on business (inside-out effect). This information may, but need not, relate to the company's financial value.[185] An increasing number of users, such as NGOs, workers, consumers and other stakeholders, have shown to be less sanguine about corporate value but more interested in the company's behavior — leading to positive or negative implications—towards the environment and society.[186] The Commission's guidelines have associated the term 'impact' included in art 19(a)(1) NFRD with social or environmental materiality as follows:

> The reference to "impact of [the company's] activities" indicates environmental and social materiality. Climate-related information should be reported if it is necessary for an understanding of the external impacts of the company. This perspective is typically of most interest to citizens, consumers, employees, business partners, communities, and civil society organisations. However, an increasing number of investors also need to know about the climate impacts of investee companies in order to better

181. *Guidelines on Reporting Climate-Related Information*, *supra* note 169, at 6–7; *see also*, Mathilde Bossut et al., *What Information is Relevant for Sustainability Reporting? The Concept of Materiality and the EU Corporate Sustainability Reporting Directive*, Sustainable Finance Research Platform Policy Brief, July 2021, at 5–6, https://wpsf.de/wp-content/uploads/2021/09/WPSF_PolicyBrief_7-2021_Materiality.pdf.

182. *See* Bossut, *supra* note 181, at 10.

183. EC Reporting Guidelines, *supra* note 169, at 6–7

184. *Id.*

185. *Id.*

186. *Id.*

understand and measure the climate impacts of their investment portfolios.[187]

Nevertheless, the Commission's guidelines recognize that in future the two perspectives of the "double materiality" principle may, and likely will, increasingly overlap: "As markets and public policies evolve in response to climate change, the positive and/or negative impacts of a company on the climate will increasingly translate into business opportunities and/or risks that are financially material."[188] The assessment of the materiality of sustainability climate-related information should consider a long-term time horizon and "[w]hen assessing the materiality of climate-related information, companies should consider their whole value chain, both upstream in the supply-chain and downstream."[189]

The "double materiality" principle in corporate sustainability disclosure is critical for the adequate management of sustainability risk (e.g., to address the effects of climate risk on financial performance and on the stability of the financial system) and for the development of sustainable investment markets and products.[190] Consistently with these objectives, the CSRD has not only maintained this principle but also articulated it in a more accurate way relative to the NFRD: "Undertakings . . . shall include in the management report information necessary to understand the undertaking's impacts on sustainability matters, and information necessary to understand how sustainability matters affect the undertaking's development performance and position."[191] The rationale underlying the double materiality principle, as well as the Commission's vision in this policy area, is that information disclosure on sustainability risk is a necessary yet insufficient condition for the development of sustainable finance, in general, and in particular, or sustainable investment markets and products.[192] A description of, and metrics on, the impact of the company's economic activity on sustainability factors (inside-out effect) has also been deemed as a necessary, vital piece of information to end users, including company financiers (investors and banks) and other company stakeholders.[193]

187. *Id. But see* Baumüller & Schaffhauser-Linzatti, *supra* note 37, at 105–10 (discussing an alternative interpretation).

188. Communication from the Commission, 2019 O.J. (C 2019) 1, 4.

189. *Id.* at 5.

190. *See id.*

191. *See* Draft CSRD, *supra* note 13, at art. 1(3) (replacing art. 19(a)(1) of the Accounting Directive 2013/34/EU).

192. *See id.*

193. *See id.* at recital 12 (noting that organizations involved in sustainability must include "a report" that details "information necessary to understand how sustainability

Corporate sustainability reporting obligations are but one piece of the wider, comprehensive information disclosure regime engineered under the EU sustainable finance policy. Other key sustainability-related information disclosure obligations have been enshrined in the SFDR[194] and in the EU Taxonomy Regulation.[195] The Commission has envisioned an ambitious information disclosure regime that encompasses multiple actors including, among others, large companies, financial market participants (FMPs) and investment advisors (IAs). As the Commission noted, "the NFRD [that will be replaced by the incoming CSRD], together with the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation, are the central components of the sustainability reporting requirements underpinning the EU's sustainable finance strategy. The purpose of this legal framework is to create a consistent and coherent flow of sustainability information throughout the financial value chain."[196] From the vantage point of investors, this comprehensive disclosure regime aims to provide them with sufficient and relevant information to determine what investment is or is not sustainable, how much sustainable the investment is, and how the sustainability level of an investment compares across investments.[197]

Under the SFDR, FMPs (such as MiFID investment firms) and IAs are subject to new sustainability-related reporting requirements.[198] More particularly, these actors shall disclose information on the entity's policy to integrate sustainability risk,[199] as well as information, at product level, on how sustainability risk has been integrated in the product and the extent to

matters affect the undertaking's development, performance, and position").

194. SFDR, *supra* note 11.

195. EU Taxonomy Regulation, *supra* note 12.

196. Draft CFRD, *supra* note 11; *see also* Cadwalader, Wickersham & Taft LLP, *Investors and Regulators Turning Up the Heat on Climate-Change Disclosures: Attempting to Make Sense of the State of Play in the US, EU, and UK*, JDSUPRA (Sept. 14, 2021), https://www.jdsupra.com/legalnews/investors-and-regulators-turning-up-the-6538549/.

197. *See, e.g.*, EU Taxonomy Regulation, *supra* note 12, at recitals 13, 19 (explaining the role of information and uniform standards in supporting comparisons across financial products by investors).

198. *See* SDFR, *supra* note 11, at art. 1 (seeking "transparency with regard 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").

199. *Id.* at art. 3; *see also* EUROPEAN SECURITIES AND MARKETS AUTHORITY, ESMA'S TECHNICAL ADVICE TO THE EUROPEAN COMMISSION ON INTEGRATING SUSTAINABILITY RISKS AND FACTORS IN MIFID II' FINAL REPORT (Apr. 30, 2019).

which this risk impacts on the product's financial return.[200] On the sustainable investment side, FMPs and IAs disclose information on the sustainability properties of their investment products[201] and, at the level of both entity (mandatory for firms with more than 500 employees) and product (on a comply and explain basis), information on the principal adverse sustainability impact (PAI) of their investment strategies on sustainability factors.[202] As well as the positive contribution to sustainability derived from the activity and products of FMPs and IAs, the SFDR has made clear that the negative impacts on sustainability also matter and shall be disclosed.

Additional sustainability-related disclosure obligations arise from the EU Taxonomy Regulation.[203] This regulation provides a classification framework whereby the economic activities of investee companies are categorised as environmentally sustainable.[204] In turn, both companies and FMPs, among other actors, are obliged to disclose information organized in accordance with this classification framework, thereby showing the extent to which their economic activity and investments (including investment products made available to customers) are taxonomy compliant.[205]

IV. SUSTAINABILITY-RELATED REFORMS IN EU FINANCIAL SERVICES LAW

A. General Overview

Recent legislative reforms in the context of EU financial services law, have created additional obligations on financial market participants (FMPs) to integrate sustainability risk in decision-making and to account for the sustainability preferences of investors. Amendments have been introduced

200. *See* SDFR, *supra* note 11, at art. 6

201. *Id.* at arts. 1–9. The SFDR has introduced the requirement of principal adverse sustainability impact (PAI) to be disclosed by FMPs at both entity level (mandatory for firms with more than 500 employees) and product level (on a comply and explain basis), *Id.* at art. 3, 7). It thus matters the positive contribution that an investment product can make to the environment or society as well as the fact that such a product may cause material, or likely material, negative effects on sustainability factors.

202. *Id.*

203. See *infra* Section II.2.C of this article offering a basic introduction to the EU Taxonomy Regulation as a tool to classify activities and investments as environmentally (or socially) sustainable.

204. EU Taxonomy Regulation, *supra* note 12, at arts. 3, 9–16.

205. *Id.* at arts. 1, 5–8.

to the AIFMD,[206] the UCITS Directive,[207] MIFID II,[208] and IDD.[209] As a result, sustainability-related obligations have now become part of the existing body of law regulating the investment and financial services industry in Europe.

According to the amendments to the AIFMD and the UCITS Directive, managers of alternative investment funds and UCITS management companies must consider and manage sustainability risk, evaluate principal adverse impact of investment decisions on sustainability factors and evaluate sustainability-related conflict of interest in their business operations.[210] Senior management is responsible for ensuring due compliance with these new requirements.[211] Changes to the MiFID II and IDD regimes have included the obligation of investment firms to integrate sustainability risk in the firm's organization, risk management and decision making. Moreover, the clients' sustainability preferences shall be duly accounted for,[212] as shall the new requirements relating to conflict of interest[213] and to product governance.[214]

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206. AIFMD, *supra* note 40.

207. UCITS Directive, *supra* note 41.

208. MiFID II, *supra* note 14, at art. 24(1); *see also* MiFID II DR, *supra* note 14, at art. 54–55.

209. IDD, *supra* note 42.

210. Commission Delegated Regulation (C(2021) 2615 final / 21.04.2021), art. 1 [hereinafter Draft DA AIFMs] (amending/replacing several articles of the MiFID II DR); Commission Delegated Directive (C(2021) 2617 final / 21.04.2021), art. 1 [hereinafter Draft DD UCITS] (amending/replacing several articles of Directive 2010/43/EU).

211. Draft DA AIFMs, *supra* note 211, at art. 1(7) (adding this item as art 60(2)(i) of Delegated Regulation (EU) 231/2013); Draft DD UCITS, *supra* note 211, at art. 1(5) (adding this item as art 9(2)(g) of Directive 2010/43/EU).

212. Draft DA MIFID II, *supra* note 148; Commission Delegated Regulation (*EU) Amending Delegated Regulation (EU) 2015/35 as Regards the Integration of Sustainability Risks in the Governance of Insurance and Reinsurance Undertakings,* art. 1, COM (2021) 2628 final (May 21, 2021) [hereinafter Draft DA Insurance]; Commission Delegated Regulation *Amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as Regards the Integration of Sustainability Factors, Risks and Preferences into the Product Oversight and Governance Requirements for Insurance Undertakings and Insurance Distributors and Into the Rules on Conduct of Business and Investment Advice for Insurance-Based Investment Products*, art. 1, COM (2021) 2614 final (May 21, 2021) [hereinafter Draft DA IDD].

213. *E.g.*, Draft DA MIFID II, *supra* note 148, at art. 1(4) (replacing art. 33 MiFID II DR).

214. *Commission Delegated Directive (EU) Amending Delegated Directive (EU) 2017/593 as Regards the Integration of Sustainability Factors Into the Product Governance Obligations*, art. 1, COM (2021) 2612 final (May 21, 21 2021) [hereinafter Draft DD Product Governance].

In order to delve deeper into these reforms, and for the sake of brevity, the rest of this chapter will be dedicated to the reforms amending the MiFID II regime, which constitutes the backbone of securities regulation in the European Union.[215] Modifications to MIFID II have been completed largely through amendments to the Commission Delegated Regulation (EU) 2017/565 (MiFID II DR) and to the Commission Delegated Directive (EU) 2017/593 (MiFID II DD).[216] Most of these reforms have involved changes to the operating conditions of investment firms, in two areas. The first area looks at the firms' organization and management systems.[217] The Commission acknowledged that the current version of the MiFID II DR has not explicitly referred to sustainability risk, and that the integration of sustainability risk would demand reform at the level of processes, systems and internal controls of investment firms, and at the level of the technical capacity and knowledge necessary to analyze sustainability risk.[218] In this light, changes to the MiFID II DR have been proposed—changes undertaken through the draft DA MiFID II—in order to make sure that investment firms account for sustainability risk as they set up, execute, and monitor their organization requirements, internal controls and reporting.[219]

The second area of sustainability-related reforms of MiFID II has concentrated on the investment firm-client relationship and, especially on the need to preserve investor protection.[220] It is known that investors, particularly retail investors, are exposed to problems of information, including asymmetries of information, that affect investors negatively when forming preferences and making investment choices.[221] Such problems, compounded by product complexity and cognitive limitations, have rendered investors more prone to making mistakes.[222] Investors are also exposed to

215. For further reading on MiFID II, see MATTHIAS LEHMANN AND CHRISTOPH KUMPAN, *Part 1: Securities Markets and Services in* EUROPEAN FINANCIAL SERVICES LAW: ARTICLE-BY-ARTICLE COMMENTARY (1st ed. 2019); Niamh Moloney, EU SECURITIES AND FINANCIAL MARKETS REGULATION (3d ed. Oxford University Press 2016).

216. *See* e.g., Draft DA MIFID II, *supra* note 148; Draft DD Product Governance, *supra* note 215.

217. *See* Draft DA MiFID II, *supra* note 148, recital 3.

218. *Id*.

219. *See* Draft DA MiFID II, *supra* note 148, at arts. 1(2)(a), 1(3), 1(6)(c) (amending art. 21 (para 1), replacing art. 23(1)(a) and modifying art 54(9) of MiFID II DR).

220. *See* EU Action Plan, *supra* note 1, at 2; *see also* discussion *supra* Section II.2.B.

221. Armour, *supra* note 43, at 205–25.

222. Lefevre & Chapman, *supra* note 44 and accompanying text.

problems of conflict of interest[223] and of abusive conduct from providers including the mis-selling of financial services. Mis-selling occurs where financial intermediaries sell to their clients' products that do not adequately fit the client's needs or expectations.[224] Retail investors are more vulnerable to abuse due to their relative ignorance and poor literacy as these factors aggravate asymmetries.[225] It is reasonable to estimate that such dangers to investors, which have been long observed in the context of traditional investment products, are also likely to emerge from and taint the provision of sustainable investment products (e.g., greenwashing conduct).[226]

Keeping investor protection concerns in mind, the reform of the MiFID II regime has consisted of several amendments to the rules setting out the conduct standards applicable to investment firms. These conduct standards have included, among others, the obligation to provide information to clients (section IV.2.A below), suitability requirements (section IV.2.B below), conflict of interest requirements (section IV.2.C below), and product governance requirements (section IV.2.D below).[227] The rest of this section will look at these amendments insofar as they are crucial to investor protection in the realm of sustainability.

B. MiFID II Regime: The Integration of Sustainability Risk, Factors and Preferences

1. Disclosing Information to Clients

In MiFID II, the obligation to disclose information to clients (as well as the other obligations examined in this section IV.2) derives from the more general duty born by investment firms under article 24(1) MiFID II to act "honestly, fairly and professionally in accordance with the best interests of its clients."[228] Within this framework, investment firms shall disclose information to their clients about the firm (e.g., address, contact information, etc.), the services offered (e.g., brokerage, investment advice, portfolio management, etc.) the client category (e.g., retail, professional investor or eligible counterparty), the characteristics of the financial instruments offered, the costs and charges of products and services, the custody of assets,

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223. *Supra* note 46 and accompanying text.

224. Reurink, *supra* note 45, at 1302–03.

225. *Id*.

226. *See* discussion *supra* Section II.2.B.

227. *See* discussion *infra* Section IV.2.

228. MiFID II, *supra* note 14, art. 24(1); Danny Busch, *MiFID II: Stricter Conduct of Business Rules for Investment Firms 12* CAP. MARKETS *L.J.* 340, 350 *(2017)*.

and the firm's status in relation to the independence of the services it provides.[229]

Importantly, the information that the investment firm furnishes to their actual or potential clients shall be "fair, clear and not misleading."[230] This means that the information must be accurate and give "a fair and prominent indication of any relevant risks when referencing any potential benefits of an investment service or financial instrument."[231] Moreover, the investment firm must use "a font size in the indication of relevant risks that is at least equal to the predominant font size used throughout the information provided, as well as a layout ensuring such indication is prominent."[232] The firm shall also make sure that "the information does not disguise, diminish or obscure important items, statements or warnings."[233]

Sustainability-related reforms in this context have been limited to article 52(3) MiFID II DR relating to information on financial instruments and advice. This provision seeks that investment firms provide to their clients' information about the selection of financial instruments as well as about the content of the advisor's recommendation.[234] As amended, sustainability considerations have been added to article 52(3)(c) MiFID II DR as follows:

> 3. Investment firms shall provide a description of: (a) the types of financial instruments considered; (b) the range of financial instruments and providers, analyzed per each type of instrument according to the scope of the service; (c) where relevant, the sustainability factors taken into consideration in the selection process of financial instruments; (d) when providing independent advice, how the service provided satisfies the conditions for the provision of investment advice on an independent basis, and the factors taken into consideration in the selection process used by the investment firm to recommend financial instruments, including risks, costs and complexity of the financial instruments.[235]

The Commission has recognised that the industry has thus far developed "[f]inancial instruments with various degrees of sustainability-related ambition".[236] For this reason, investment managers and advisors are expected to explain to the client the sustainability properties embedded in such

229. MiFID II, *supra* note 14, art. 24.
230. *Id*. art. 24(3).
231. MIFID II DR, *supra* note 14, art. 44(2)(b).
232. *Id*. art. 44(2)(c).
233. *Id*. art. 44(2)(e).
234. *Id.* art. 52(3).
235. Draft DA MiFID II, *supra* note 148, art. 1(5) (replacing art. 52(3) MiFID II DR).
236. *Id.* recital 6.

financial instrument and the extent to which such properties match the client's sustainability preferences. From the perspective of information disclosure, the policy objective is to make sure that the client or potential client "understand those different degrees of sustainability and take informed investment decisions in terms of sustainability".[237]

Early in the reform process, it became clear that the Commission had intended a broader scope of changes. It had proposed amendments to Article 47 MiFID II DR (information about the investment firm and services offered), Article 48 MiFID II DR (information about financial instruments) and Article 52 of MiFID II DR (information about investment advisory services).[238] But since the enactment of the SFDR had addressed these information points, the Commission limited the changes and went ahead only with changes to Article 52(3) MiFID II DR.[239] On top of the already meaningful sustainability-related disclosure requirements introduced by the SFDR and the EU Taxonomy Regulation, this modification to the MiFID II DR has added a further layer of sustainability information that will operate within the client-firm relationship.

2. *Suitability Requirements*

It is known that information disclosure is often an insufficient tool to mitigate investors' mistakes and exposure to abuse.[240] That investors read, if at all, the information furnished to them has not been apparent.[241] Moreover,

237. *Id*. On the definition of sustainability preferences and the type of instruments capable of satisfying such preferences, see Section II.2.C of this Article.

238. Draft DA MiFID II (early 2018 version), art. 1(2)–1(4).

239. Draft DA MiFID II (early 2019 version), Explanatory Memorandum, 5 ("As Article 4 of the legislative proposal for a Disclosure Regulation lays down that financial market participants (including IDD and MiFID firms providing investment advice and portfolio management) must include pre-contractual disclosure information on how they incorporate sustainability risks, the pre-contractual disclosure requirements in Articles 47 and 48 have been removed from this delegated regulation. This shall ensure a harmonised application of pre-contractual disclosure rules amongst financial market participants. However, at a later stage, the Commission could revise the Regulation (EU) 2017/565 accordingly.").

240. ARMOUR, *supra* note 43, at 205–25.

241. *See, e.g.*, Thomas S. Ulen, *A Behavioral View of Investor Protection*, 44 LOY. U. CHI. L.J., 1357, 1370 (2013) ("It is expensive to comply with mandated disclosure plans. Consumers, who are presumed to benefit from the information disclosures, often find themselves overwhelmed by the amount of information with which they must deal. Consumers have a limited ability to retain the information in working memory (typically retaining no more than a third of information disclosed to them); and the mandatory information can have undesirable unintended consequences (for instance, crowding out useful information, harming competition, and fostering inequity)." (citing Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV.

behavioral biases may distort the process by which investors process and integrate information and make decisions.[242] These problems, compounded by the risk of mis-selling conduct on the part of service providers,[243] have motivated more interventionist approaches to investor protection based on the notion that investors will be better off if the conduct of service providers is restricted.[244] The MiFID II suitability requirements have precisely served this purpose, as have product governance requirements.[245] The statutory basis governing the suitability obligation is provided by Article 25(2) MiFID II, supplemented by Articles 54 and 55 of MiFID II DR and ESMA's relevant guidelines.[246] The obligation applies to advisors and portfolio managers, and it requires that they gain a reasonable understanding of the profile and characteristics of the client before providing services to that client. In procuring, the provider must perform an assessment that consists of the following three core steps.[247]

The first step consists of collecting data about the client.[248] Data collection is often done through a questionnaire that the clients fill out as well as other data search tools internally utilized by the service provider.[249] The second step involves the product due diligence conducted by the service provider in

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647 (2011)).

242. *See generally* ARMOUR, *supra* note 43, at 212; RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (New Heaven, Yale University Press 2008) (examining how failures in human reasoning, so called "behavioral market failures" contribute to suboptimal decision-making in several contexts including financial decisions);Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"* 151 U. OF PA. L. REV. 1211 (2003); H. KENT BAKER,ET AL., FINANCIAL BEHAVIOR: PLAYERS, SERVICES, PRODUCTS, AND MARKETS (1st ed. 2017).

243. Reurink, *supra* note 45.

244. *See* ARMOUR, *supra* note 43, at 222–23, 233–44.

245. Product governance rules are examined *infra* Section IV.2.D of this Article. Suitability requirements are also prescribed by the IDD in the context of insurance industry. *See* Draft DA IDD, *supra* note 213. In this Article, however, only MiFID II suitability requirements are analyzed.

246. *See* MiFID II, *supra* note 14, at art. 25(2); MiFID II DR, *supra* note 14, at art. 54–55; Guidelines on Suitability, *supra* note 50.

247. MiFID II, *supra* note 14, at arts. 25(2),25(6); MiFID II DR, *supra* note 14, at art. 54(2). *See generally* Félix E. Mezzanotte, *Accountability in EU Sustainable Finance: Linking the Client's Sustainability Preferences and the MiFID II Suitability Obligation*, 16 CAP. MARKETS L.J. 482, (2021); Félix E. Mezzanotte, *The EU Policy on Sustainable Finance: A Discussion on the Design of ESG-Fit Suitability Requirements*, 40 REV. BANKING & FIN. L. 249 (2020).

248. MiFID II, *supra* note 14, at art. 25(2); MiFID II DR, *supra* note 14, at art. 54(2).

249. MiFID II DR, *supra* note 14, at arts. 54–55; Guidelines on Suitability, *supra* note 50, no.2 to no.5.

order to make sure that the selected products match the client's profile. More particularly, the products recommended by advisor or invested in by the portfolio manager on behalf of their clients must meet the client's (a) investment objectives, (b) financial situation, and (c) investment knowledge and experience.[250] In the third step, a suitability report is prepared by the advisor or the portfolio manager in order to inform and explain to the retail client how the recommendation or portfolio suits the client.[251] Placed at the center of the client-provider relationship, this assessment of suitability creates an optimal space for interaction where sustainability preferences can be identified and serviced.

Since the suitability assessment creates a valuable setting for the client-provider interaction, the Commission has viewed such an assessment as an adequate vehicle to identify a client's sustainability preferences and integrate them in the investment chain.[252] Ideally, investors should be able to explicitly state their sustainability preferences to the asset manager or advisor. But evidence from industry practices has pointed to a different reality: these providers have often failed to ask clients about their sustainability preferences.[253] Whether caused by problems of data availability,[254] product complexity and poor financial incentives,[255] clients' inertia,[256] or inadequate training,[257] it remains to be seen the extent to which this reform will steer the client-provider interaction in the right direction. One of the objectives of the

250. MiFID II DR, *supra* note 14, at arts. 54–55

251. MiFID II, *supra* note 14, at art. 25(6).

252. EU Action Plan, *supra* note 1, § 2.4 (proposing the reform of the suitability requirements by the European Commission in the 2018 Action Plan).

253. EU Action Plan, *supra* note 1, § 2.4, 3.2; EUROPEAN COMMISSION, *Feedback Statement: Public Consultation on Institutional Investors and Asset Managers' Duties Regarding Sustainability*, at 9–10 (2018), https://ec.europa.eu/info/sites/default/files/2017-investors-duties-sustainability-feedback-statement_en.pdf [hereinafter Commission Feedback Statement]; 2DII, *supra* note 92, at 5 (finding the presence of a large disconnect between the questions posed by the advisers and the actual, non-financial investment objectives of retail clients).

254. Commission Feedback Statement, *supra* note 254. A reason that may have precluded advisers and portfolio managers from discussing ESG issues with their clients is the lack of "convincing and easily available data clearly showing the importance of ESG factors". *Id.*

255. *Id.* at 13–14.

256. EU Action Plan, *supra* note 1, §§ 2.4, 3.2.

257. Ulf Schrader, *Ignorant Advice—Customer Advisory Service for Ethical Investment Funds*, 15 BUS. STRATEGY & ENV'T 200, 207–08 (2006) (reasoning that ESG products may prove unfamiliar to the advisers who supply their clients with information that is "usually incomplete, often vague and provided mostly after long consultation of their databases").

reform is to get providers to inquire about the client's sustainability preferences at the very time of providing advice services or portfolio management services to the client.[258] In addition, the suitability evaluation is expected to account for the client's sustainability preferences in a way that safeguards the client's best interest. This includes protection against abusive practices including greenwashing.[259]

This rationale has guided the reform of the MiFID II suitability assessment within the frame of EU sustainable finance policy.[260] Advisors and portfolio managers, when conducting the suitability assessment, shall meet "the investment objectives of the client in question, including the client's risk tolerance and any sustainability preferences".[261] Moreover, "[t]he information about the investment objectives of the client or potential client shall include, where relevant, information about the length of time for which the client wishes to hold the investment, his or her preferences regarding risk taking, his or her risk tolerance, the purpose of the investment and in addition his or her sustainability preferences."[262] Among other issues, the reform also stressed that the treatment of sustainability preferences shall be stated and explained to the retail client in the suitability report.[263]

Importantly, the Commission has also provided a formal definition of sustainability preferences in article 1(1) of the Draft DA MiFID II. As examined earlier in Section II.2.C of this Article, sustainability preferences have been defined as a client's or potential client's choice of financial instruments containing sustainability properties, and such financial instruments have been classified under the SFDR: the financial instrument meets the criteria set out in article 2(17) SFDR, or qualifies as sustainable under the EU Taxonomy Regulation, or considers principal adverse impact on sustainability factors.[264] Only such instruments can be utilized to satisfy the stated sustainability preferences of the client. Instruments falling outside

258. Draft DA MiFID II, *supra* note 148, recital 5 ("Investment firms that provide investment advice and portfolio management should be able to recommend suitable financial instruments to their clients and potential clients and should therefore be able to ask questions to identify a client's individual sustainability preferences.").

259. Section II.2.B *infra* elaborates on the conduct of greenwashing.

260. EU Action Plan, *supra* note 1, § 2.4, action 4.

261. Draft DA MiFID II, *supra* note 148, art. 1(6)(a) (replacing art. 54(2)(a) of MiFID II DR).

262. *Id.* art. 1(6)(b) (replacing art. 54(5) of MiFID II DR).

263. *Id.* art. 1(6)(e) (replacing art. 54(12) first paragraph of MiFID II DR).

264. *Id.* art. 1(1) (amending art. 2(7) MiFID II DR), recital 6. Section II.2.C *supra* has presented an overview of the definition of sustainability preferences as laid down in the SFDR.

such categorization are deemed to be uncapable of meeting sustainability preferences and therefore cannot be recommended by the advisor or the portfolio manager to those clients who stated having sustainability preferences.[265]

Since the sustainability preferences of clients can be, and will likely be, widely distributed, it is unlikely that providers may always find a suitable product for those clients.[266] In such a case, investment firms "shall not recommend or decide to trade where none of the services or instruments are suitable for the client."[267] This obligation to refrain from recommending, and from trading in, instruments that are inadequate to satisfy the client's sustainability preferences has the purpose, as explained by the Commission, of fighting greenwashing.[268] Under this obligation, the "investment firm shall explain to the client or potential client the reasons for not [recommending or deciding to trade] and keep record for those reasons."[269] A margin for flexibility has been introduced by allowing for the reformulation of stated preferences in the client-provider space, provided that the client's consent is duly accounted for.[270] In the situation where "no financial instrument meets the sustainability preferences of the client or potential client, and the client decides to adapt his or her sustainability preferences, the investment firm shall keep records of the decision of the client, including the reasons for that decision."[271]

3. Conflict of Interest Requirements

Although the regulation of conflict of interest under MiFID II is already abundant, a statement on sustainability preferences has been explicitly

265. *Id.* art. 1(6)(d) (amending art. 54(10) MiFID II DR), recital 6.

266. *See, e.g.*, Joakim Sandberg, *Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective*, 101 J. BUS. ETHICS 143–62 (2011) (analyzing the various purposes of social investment); UNEP FINANCE INITIATIVE, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT (Oct. 2005), http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf [hereinafter Freshfield Report].

267. Draft DA MiFID II, *supra* note 148, art. 1(6)(d) (replacing art. 54(10) MiFID II DR).

268. *Id.* recital 7 ("In order to prevent mis-selling and greenwashing, investment firms should not recommend or decide to trade financial instruments as meeting individual sustainability preferences where those financial instruments do not meet those preferences.").

269. *Id.* art. 1(6)(d) (replacing art. 54(10) MiFID II DR).

270. *Id.*

271. *Id.*

added. Under MiFID II, the investment firms are required to put in place internal measures to prevent or manage conflicts of interest (1) between the investment firm and its clients and (2) between one client and another.[272] As a general rule, the existence of a conflict of interest does not in itself attract a duty to disclose the conflict to the client. The requirement for disclosure is triggered whenever the firm is unable to sufficiently prevent or manage the conflict of interest and this situation poses a risk of harm to the client's interests.[273] A conflict of interest that carries a risk of harm to the client has been broadly identified in the directive, such as the situation whereby the investment firm is likely to make a financial gain, or avoid a financial loss, at the expense of the client or where the firm receives inducements, in the form of monetary or non-monetary benefits or services, from a third party.[274] To the extent that the risk of causing detriment to the interests of the client cannot be duly prevented by the firm, disclosure duties are attracted to protect the client's informed choice.[275] Working this way, the duty to disclose a conflict of interest has been conceived as a last resort measure.[276]

When required, the disclosure must provide a detailed description of the conflict of interest (nature and sources) that arises in the provision of investment and/or ancillary services as well as a description of the risks to the client that emerge from this conflict so that the client is able to make an informed investment decision.[277] The disclosure must also indicate the steps undertaken by the investment firm to mitigate these risks.[278] From the perspective of its internal operations, the firm is required to establish, implement and maintain an effective conflict of interest policy.[279] Such a policy shall be 'set out in writing and appropriate to the size and organisation of the firm and the nature, scale and complexity of its business'[280] It shall be disclosed to clients containing policy descriptions in summary form,[281] and

272. MiFID II, *supra* note 14, arts. 16(3), 23(1).

273. *Id.* art. 16(3), 23(2); MiFID II DR, *supra* note 14, arts. 33–43.

274. MiFID II DR, *supra* note 14, art. 33(a) and art. 33(e). For additional rules on inducements see, MiFID II, *supra* note 14, art. 24(9); MiFID II DD, *supra* note 52, ch IV, arts 11-13.

275. MiFID II, *supra* note 14, art. 16(3) and art. 23; MiFID II DR, *supra* note 14, art. 33 and art. 34(4). Information disclosure assists retail investors in making informed choices. *See* MiFID II, *supra* note 14, art. 24(5).

276. MiFID II DR, *supra* note 14, art 34(4).

277. *Id.*

278. *Id.*

279. MiFID II, *supra* note 14, arts. 16(3), 23; MiFID II DR, *supra* note 14, art. 34.

280. *Id.*; MiFID II DR, *supra* note 14, art. 34(1).

281. MiFID II DR, *supra* note 14, art. 46(1)(h) (complementing art. 24(4) of MiFID

the clients may access further details upon request.[282] Moreover, the investment firm must assess and periodically review, at least annually, their conflict of interest policy and take all appropriate measures to address any deficiencies. In this sense, "[o]ver-reliance on disclosure of conflict of interest shall be considered a deficiency in an investment firm's conflicts of interest policy."[283]

In the context of sustainability-related reforms, the Commission's objective has been to maintain a high standard of investor protection. To this effect, 'investment firms should, when identifying the types of conflicts of interest, the existence of which may damage the interests of a client or potential client, include those types of conflicts of interest that stem from the integration of a client's sustainability preferences.'[284] The text of the reform states that "[f]or the purposes of identifying the types of conflict of interest that arise in the course of providing investment and ancillary services or a combination thereof and whose existence may damage the interests of a client, including his or her sustainability preferences,(. . .)".[285] Drawing from the text quoted above, conflict of interest in a sustainability context has been thought of in terms of this conflict having the potential to harm the sustainability preferences of the client. The client's interest must be served first, and this interest, embodied in the client's sustainability preferences, shall be protected in the course of service provision.

This obligation is best construed by reference to the last resort principle spelled out earlier in this section. The investment firm is required to prevent or manage conflict of interest afflicting the service of sustainability preferences.[286] If unable to do so, and the risk of damage to the client's sustainability preferences is present, this conflict of interest will need to be dealt with through disclosure to the client.

4. Product Governance Requirements

Changes related to sustainability have also been made in the MiFID II rules setting out product governance requirements. These requirements have been created in view of investor protection goals.[287] They are laid down in

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II).

282. *Id.* art. 46(1)(i) (providing that art 3(2) of the same regulation is satisfied (complementing art. 24(4) of MiFID II).

283. *Id.* art. 34(5).

284. Draft DA MiFID II, *supra* note 148, recital 4.

285. *Id*. art. 1(4) (replacing art. 33 MiFID II DR).

286. MiFID II DR, *supra* note 14, at 7.

287. LEHMANN & KUMPAN, *supra* note 216, at 89 (stating that the requirement for

Articles 16(3) and 24(2) MiFID II supplemented by the Commission Delegated Directive (EU) 2017/593 (MiFID II DD)[288] and guidelines produced by ESMA.[289] According to product governance rules, "[a]n investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients."[290] The manufacturing of financial instruments encompasses "the creation, development, issuance and/or design of financial instruments."[291] The process of product approval involves the analysis of potential conflict of interest each time a financial instrument is manufactured. In this context, the investment firm "shall assess whether the financial instrument creates a situation where end clients may be adversely affected".[292] The firm should also consider whether the financial instrument "may represent a threat to the orderly functioning or to the stability of financial markets."[293] Importantly, the process of product approval involves the identification of the target market of end clients to make sure that "all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market."[294]

The target market must be identified "at a sufficiently granular level . . . for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible."[295] Moreover, the investment firm shall also identify a so-called negative target market, namely "any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible."[296] Based on its own analysis, the investment firm shall determine "whether a financial instrument meets the identified needs, characteristics and

product approval "is a qualification of the general requirements to make the client's interest paramount when pursuing investment services" and "the product approval process goes even beyond any client protection in that it must consider the orderly functioning of markets as such").

288. MiFID II DD, *supra* note 52 arts. 9–10.

289. *See* ESMA Product Governance Guidelines, *supra* note 52.

290. MiFID II, *supra* note 14, art. 16(3).

291. MiFID II DD, *supra* note 52 art. 9(1); ESMA Product Governance Guidelines, *supra* note 52, ¶ 6.

292. MiFID II DD, *supra* note 52, art. 16(3).

293. *Id.* art. 9(4).

294. MiFID II, *supra* note 14, art. 16(3).

295. MiFID II DD, *supra* note 52, art. 9(9).

296. *Id.*

objectives of the target market."[297] Among other factors, such evaluation will include whether the risk/reward profile of the instrument is consistent with the identified target market and whether "the financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable." [298] To this effect, the manufacturer "shall determine the needs and characteristics of clients for whom the product is compatible based on their theoretical knowledge of and past experience with the financial instrument or similar financial instruments, the financial markets and the needs, characteristics and objectives of potential end clients."[299] Moreover, it shall undertake "a scenario analysis of their financial instruments which shall assess the risks of poor outcomes for end clients posed by the product, and in which circumstances these outcomes may occur."[300]

Distributors of financial instruments are also subject to the obligation of identifying the financial instrument's target market. A distributor denotes an investment firm that offers, sells, or recommends investment products and services to a client.[301] In order to meet this obligation, distributors "shall use the information obtained from manufacturers and information on their own clients to identify the target market and distribution strategy. When an investment firm acts both as a manufacturer and a distributor, only one target market assessment shall be required."[302] Since the information drawn from the product approval process of a financial instrument is important to distributors, the manufacturer shall provide them with this information including "the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment."[303] The quality of such information must show "an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly."[304] In turn, the distributors shall put in place adequate arrangements to obtain and process the information about financial instruments and target markets received from the manufacturers.[305] The

297. *Id.* art. 9(11).
298. *Id.*
299. *Id.* art. 9(9).
300. *Id.* art. 9(10).
301. *Id.* recital 15, art. 10(1); ESMA Product Governance Guidelines, *supra* note 52, ¶ 6.
302. MiFID II DD, *supra* note 52, art. 10(2).
303. *Id.* art. 9(13); MiFID II, *supra* note 14, art. 16(3).
304. MiFID II DD, *supra* note 52.
305. MiFID II DD, *supra* note 52, art. 16(3).

distributors "shall determine the target market for the respective financial instrument, even if the target market was not defined by the manufacturer."[306]

In the views of the Commission, the formal integration of sustainability matters into the processes governing the manufacturing and distribution of financial instruments is a necessary response to the ever-increasing demand for sustainable products.[307] The Commission stated that the adequate implementation of the EU Action Plan will further encourage investors to demand sustainable investments and, therefore, it is "necessary to clarify that sustainability factors, and sustainability related objectives should be considered within the product governance requirements set out in Commission Delegated Directive (EU) 2017/593."[308] As a result, investment firms are now required to consider sustainability factors in the product approval process including the target market assessment.[309] Here, the amended text of the law directs investment firms to consider the sustainability objectives of clients in the process of determining the target market for the financial instrument:

> "Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client with whose needs, characteristics and objectives, including any sustainability related objectives, the financial instrument is compatible."[310]

To be sufficiently granular, the firm manufacturing and distributing financial instruments will need to "specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed."[311] In the product approval process, investment firms will need to evaluate the financial instrument against the needs, characteristics and objectives of the identified target market including, among others, whether "the financial instrument's sustainability factors, where relevant, are consistent with the target market."[312] Moreover, "[t]he sustainability factors of the financial instrument shall be presented in a transparent manner and provide distributors with the relevant information to duly consider any

306. *Id.* art. 10(1).
307. *See* discussion *supra* Section II.2.B.
308. Draft DD Product Governance (n 215) recital 4.
309. *Id.* recital 5.
310. *Id.* art. 1(2) (replacing art. 9(9) of MiFID II DD).
311. *Id.* recital 6.
312. *Id.* art. 1(2) (replacing art. 9(11) of MiFID II DD).

sustainability related objectives of the client or potential client."[313]

V. FIDUCIARY DUTY, PENSION FUNDS AND THE IORP II DIRECTIVE

This section briefly outlines sustainable finance policy in the context of pension funds. From a legal perspective, the question has been to what extent pension funds are legally permitted to pursue sustainable investment strategies. This question has been particularly relevant in the United States. Here, pension trustees are bound to fiduciary duties, and it has remained unclear to what extent such duties prevent pension trustees from engaging in sustainable investing.[314] The legal position is different in the European Union since statutory provisions under the IORP II Directive have promoted—albeit on a comply or explain basis—sustainable investments.[315]

Broadly defined, the fiduciary duty entails "a duty to act with the highest degree of honesty and loyalty toward another person and in the best interest of the other person (such as the duty that one partner owes to another)".[316] Fiduciary relationships are representative in character: a person (agent) acts on behalf of and for the benefit of another person (principal). This representative property creates the risk of opportunistic behaviour or abuse by the agent towards its principal.[317] With the aim of mitigating such a risk, the law imposes fiduciary obligations upon the agent—in its capacity of fiduciary—towards the principal. As explained by Gold and Miller, "[f]iduciary law governs relationships marked by asymmetries of power. Fiduciaries enjoy power over beneficiaries. And fiduciary law expresses an expectation that fiduciaries act in their beneficiaries' interests."[318]

A product of judge-made law in the fields of trusts and equity, the fiduciary duty has long been recognized in common law jurisdictions,[319] and

313. *Id.* art. 1(2) (adding this text to art. 9(13) MiFID II DD).

314. *See* John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 97–98; *see also* Schanzenbach & Sitkoff, *supra* note 53, at 392–99.

315. IORP II Directive, *supra* note 15, at 393.

316. *Fiduciary Duty*, Black's Law Dictionary, (11th ed. 2019).

317. Fiduciary law has been viewed as a mechanism to mitigate agency costs. *See* Robert H. Sitkoff, "An Economic Theory of Fiduciary Law," PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew S. Gold & Paul B. Miller eds., (Oxford University Press, 2014), 204-08; *see* Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

318. Introduction," PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW at 1 (Andrew S. Gold and Paul B. Miller eds., 2014).

319. The Law Commission, "Fiduciary Duties of Investment Intermediaries," LAW COM No 350 (20 June 2014, United Kingdom), ¶¶ 1.16-1.20, ch. 3 [hereinafter UK Law Commission].

operated in the context of fiduciary relationships including the relationship between the trustee and the beneficiary, the solicitor and its client, the company director and the company, among other categories.[320] In some countries, the duty has also been codified in statutory rules, such as the case of the United States in the area of securities law and of pension law.[321] The definition of the fiduciary duty has evolved over time, and its content is not uniform but has varied across jurisdictions. Advancing its interpretation of the fiduciary duty set forth in the US Investment Advisers Act of 1940, the Securities and Exchange Commission (SEC) has stressed that

> [a]n investment adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty. This fiduciary duty requires an adviser to adopt the principal's goals, objectives, or ends. This means the adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own.[322]

In the sector of pensions, the Employee Retirement Income Security Act of 1974 (ERISA) has codified a trustee's fiduciary duty in terms of duty of loyalty and duty of prudence.[323] According to ERISA, a trustee should "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries . . . ",[324] and do so "with the

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320. *Id*. ¶¶ 3.14–3.15 (citing a rich body of judge-made law). Outside the traditionally accepted categories of fiduciary relationships, other relationships may also be categorized as fiduciary provided that the particular facts so indicate as, for example, when a person undertake to act on behalf of or in the interest of another. *Id*. ¶¶ 3.16-3.24.

321. Statutory fiduciary duties have created in the United States at the levels of federal and state law. *See* Securities and Exchange Commission (SEC), "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," 17 CFR Part 276 (Release No. IA-5248; File No. S7-07-18), Jul. 12 2019, https://www.sec.gov/rules/interp/2019/ia-5248.pdf [hereinafter "SEC"] (producing an interpretation of the standard of conduct of investment advisers under the Investment Advisers Act of 1940 and citing *SEC v. Capital Gains Research Bureau, Inc.* (1963) in which the U.S. Supreme Court recognized the fiduciary nature of the investment advisory relationship); *see also* Marianne M. Jennings, *Investment Professionals and Fiduciary Duties*, 9 CFA Institute Research Foundation, at 7 (2014) (noting that different standards apply to investment advisers compared with broker/dealers). A trustee operating under the Employee Retirement Income Security Act of 1974 ("ERISA") is subject to fiduciary duties encompassing the duty of loyalty and the duty of prudence (care). Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1104(a)(1), 1104(a)(1)(B).

322. SEC, *supra* note 322, at 7–8 ("[T]he combination of care and loyalty obligations has been characterized as requiring the investment adviser to act in the 'best interest' of its client at all times.").

323. 29 U.S.C. § 1104(a).

324. *Id*. § 1104(a)(1).

care, skill, prudence, and diligence" of a prudent man.[325]

A narrower interpretation of the content of fiduciary duties is found at common law. According to the UK Law Commission, the duty of loyalty is the core, distinguishing feature of the fiduciary duty: "the principal is entitled to the single-minded loyalty of his fiduciary."[326] In turn, the fiduciary duty does not encompass a duty of care, which stems from the law of torts or law of trusts.[327] Following this construction, the duty of loyalty has various facets whereby the fiduciary

> "must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list . . . ."[328]

This approach to fiduciary duties has stressed the negative or "not to do" obligations of a fiduciary, in particular, the "non-conflict rule" and the "non-profit rule".[329] Separately, a trustee must also exercise reasonable care and skill when using its powers of investment. This duty of care entails that a trustee when investing "is to take such care as an ordinary prudent man would take if he were to make an investment for the benefit of other people for whom he felt morally bound to provide."[330]

Scholars and commentators have largely examined the frictions between the fiduciary duty and sustainable investment strategies in the area of investments decisions of US pension fund trustees.[331] The question has been posed as to whether the fiduciary duty—imposed upon the fiduciary as administrator of others' money—precludes the trustee from making socially responsible investments (SRIs). The most conservative view has argued that

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325. *Id*. § 1104(a)(1)(B).

326. *See* UK Law Commission, *supra* note 320 ¶ 3.27 (citing Bristol and West Building Society v. Mothew (1998)).

327. *Id*. ¶¶ 3.12, 3.68, 3.75 (referencing section 1 of the Trustee Act 2000, which codifies a trustee's duty of care in England and Wales).

328. *Id*. ¶ 3.27 (citing Bristol & West Building Society v. Mothew).

329. *Id.* ¶¶ 3.28, 3.30–3.36.

330. *Id.* ¶ 3.75.

331. Gary, *supra* note 53; Schanzenbach & Sitkoff,, 'Reconciling Fiduciary Duty' *supra* note 54; UK Law Commission *supra* note 322; Schanzenbach & Sitkoff, 'ESG Investing: Theory' *supra* note 53; Sanders, *supra* note 53; Joakim Sandberg, *(Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds?*, 21 (5) CORP. GOVERNANCE: AN INT'L REV. 436 (2013); Richardson, *supra* note 53; Alexandra Horváthová, Rasmus Kristian Feldthusen and Vibe Garf Ulfbeck, *Occupational Pension Funds (IORPs) & Sustainability: What does the Prudent Person Principle say?* 1 NORDIC J. OF COM. L. 28 (2017).

a trustee pursuing SRIs would breach its fiduciary duties and incur liability, although this view has been challenged.[332] A distinction has been made between the duty to act in the "sole interest" of beneficiaries and the duty to act in the 'best interest' of beneficiaries. In this sense, an ERISA trustee is required to act in the "sole (financial) interest" of the beneficiaries,[333] and this standard has been construed to restrict the trustee's investment strategy to look exclusively at the interest of beneficiaries and, by implication, the interest of any other person is excluded.[334] Purposes other than obtaining a 'financial interest' are also excluded.

Following this understanding, the ERISA fiduciary rule appears as incompatible with sustainable investment strategies to the extent that social or environmental investment objectives look also at the interests of third parties (e.g., societal interest) or involve purposes that may go beyond financial benefits (e.g., moral or ethical goals). It follows that such investment strategies, if unauthorized, would breach the ERISA fiduciary duty and generate liability on the trustee.[335] They would trigger "'an irrebuttable presumption of wrongdoing'".[336] A different stance has applied to the "best interest" rule. This rule—applicable, for instance, to the duty of loyalty in the context of US corporate law, securities regulation as well as trust law of private trusts and charities—has been construed to allow a fiduciary greater freedom of action in the area of sustainable investment, provided that its conduct align with the best interests of beneficiaries and the terms of the trust.[337]

Drawing from the above, the "best interest" rule need not preclude sustainable investment strategies. From the vantage point of financial benefits, for example, recent studies have shown that sustainable funds have performed equal or better compared with conventional funds.[338] This new

332. *See*, *e.g.*, Gary, *supra* note 53.

333. Schanzenbach & Sitkoff, *supra* note 53 at 399–403.

334. *Id*.

335. *Id.* at 403 ("Furthermore, in 'providing benefits' under ERISA, the Supreme Court has held that the relevant purpose to which ERISA's sole interest rule applies is 'financial benefits' for the plan beneficiaries" (quoting Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2468 (2014)).

336. *Id.* at 400–01.

337. *Id. at* 401–03 ("The best interest rule is typically implemented by way of an 'entire fairness' test. The entire fairness test is sometimes expressed in corporate law as requiring fair price and fair dealing. Likewise, a trustee must still 'act fairly, in good faith, and in the interest of the beneficiaries' even if the sole interest rule is waived. Whereas the sole interest rule allows no defense at all to an unauthorized conflict, the best interest rule permits a fiduciary to defend a conflicted action as entirely fair.").

338. Gary, *supra* note 53, at 748–53 (stating that sustainable investing "does not

scenario makes it more likely that mixed purpose investments (by which the investment contains financial and social/environmental motives) are likely to find a 'best interest' justification. If such justification was met, it would not matter whether the purpose of investment partially contained non-financial features, or whether the interest of society or of any other third-party group were also influenced by the investment. A different avenue enabling sustainable investment strategies occurs when pension trustees are provided legal authorization by their beneficiaries to so invest.[339]

In relation to the US prudent investor rule, it has been argued that this rule does not, per se, preclude sustainable investment strategies. Under US trust law, a fiduciary shall satisfy the "prudent investor rule".[340] In simple terms, this rule means that "a fiduciary must invest in only those securities or portfolios of securities that a reasonable person would buy."[341] The prudent investor rule has incorporated modern portfolio theory into the management of investment risk whereby the fiduciary shall diversify its investment portfolio (spreading the risk across the portfolio rather than analyzing risk on an asset-by-asset basis) and make investment decisions based on risk and return objectives reasonably suited to the trust.[342] A portfolio that adds financial value is a "a portfolio that improves returns for a given level of market risk, and it requires aligning the overall risk and return with the terms and purposes of the trust."[343] As Schanzenbach & Sitkoff noted, the prudent investor rule permits a trustee "to undertake any type or kind of investment so long as the resulting overall portfolio is diversified, and its overall risk and return align with the terms and purposes of the trust."[344]

In the absence of new reforms integrating sustainability considerations into the law, the adoption of sustainable investment strategies in the US context depends, ultimately, on the interpretation of existing statutory and

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necessarily require making a tradeoff in investment performance; on the contrary, sustainable investments often exhibit favorable return and risk characteristics compared to their traditional peers").

339. Sanders, *supra* note 53, at 537.

340. Gary, *supra* note 53, at 789; Schanzenbach and Sitkoff, 'Reconciling', *supra* note 53, at 426 (citing Unif. Prudent Inv'r Act § 2(b) (UNIF. LAW COMM'N 1994), and 3 RESTATEMENT (THIRD) OF TRUSTS §§ 90(a)-(b) (AM. LAW. INST. 2007)).

341. *Prudent Investor Rule*, BLACK'S LAW DICTIONARY (11th ed. 2019).

342. *See* Gary, *supra* note 53, at 789–90; *see also* Schanzenbach & Sitkoff, 'Reconciling . . .', *supra* note 53, at 426.

343. Schanzenbach & Sitkoff, 'Reconciling . . .', *supra* note 53, at 426.

344. *Id.* at 449 ("All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.").

judge-made rules. In Europe, however, the landscape looks quite different. The IORP II Directive has recently introduced provisions that promote sustainable investments and long-termism goals in investment.[345] The IORP II Directive requires that the Institutions for Occupational Retirement Provision (IORPs) make investment decisions in accordance with a "prudent person rule."[346] This rule contains a loyalty standard seeking managers to invest the pension assets in "the best long-term interest of members and beneficiaries as a whole".[347] Moreover, and specifically on the dimension of sustainability, Article 19 (1)(b) of IORP II Directive states that "Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors."[348]

The European Insurance and Occupational Pensions Authority (EIOPA) has construed this sustainability-related provisions in the IORP II Directive as an opportunity for IORPs to manage sustainability risk.[349] Commenting on article 19 (1)(b) of IORP II Directive, EIOPA pointed out that "[t]aking into account ESG factors to reduce the risk exposure of IORPs toward ESG risks is also likely to help IORPs in the pursuit of sustainability goals. Conversely, considering the long-term impact of investment decisions on ESG factors can contribute to mitigating IORPs' exposures to ESG risks."[350] The scope of Article 19(1)(b) of IORP II Directive is nevertheless broad enough to enable sustainable investment strategies undertaken in "the best long-term interest" of beneficiaries and promoting the "the potential long-term impact" of investment decisions on sustainability.[351] The permissiveness of sustainable investment strategies is compounded by the fact that the IORP II Directive's prudent person rule requires a long-term

345. IORP II Directive, *supra* note 15. The formal term "fiduciary duty" has not been adopted in the European Union, except for countries that count with common law. European Commission, DG Environment (2015), "Resource Efficiency and Fiduciary Duties of Investors", Final Report (ENV.F.1/ETU/2014/0002), 26–31, London: Ernst & Young.

346. IORP II Directive, *supra* note 15.

347. *Id.* art. 19(1)(a).

348. *Id.* art. 19(1)(b).

349. See EIOPA, SUSTAINABLE FINANCE ACTIVITIES 2022-24, https://www.eiopa.europa.eu/sites/default/files/publications/other_documents/eiopa-sustainable-finance-activities-2022-2024.pdf.

350. European Insurance and Occupational Pensions Authority, *Opinion on the Supervision of the Management of Environmental, Social and Governance Risks Faced by IORPs*, §2, Annex 2 EIOPA-BoS-19-248 (July 10, 2019), (Annex 1 to the Opinion provides illustration of this interaction).

351. IORP II Directive *supra* note 15, at art. 19(1)(a), 19(1)(b).

horizon in investments.

Given the above, the prudent person rule laid out in the IORP II Directive appears as consistent with portfolios constructed around sustainable investment strategies that rely on long-term value creation as opposed to short-term financial returns.[352] This rule is also consistent with mounting evidence showing that there is a business case for sustainable investment strategies as "[c]ompanies that perform well on material ESG issues, also show a superior financial performance . . . [and] [t]his is consistent with the idea that strong management of material ESG issues brings a real competitive advantage."[353] Successful sustainable investing at the corporate level has been found to require "a lot of strategic planning because it directly relates to decisions with a long-term impact, including production technology, the use natural resources, and the social dimension, which refers to both the relation with the employees and the community. Improper management of the environmental and social dimension may have a serious and negative impact on the ability of the firm to conduct its business."[354]

Moreover, the IORP II Directive's prudent person rule requires that the pension fund's assets "shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole".[355] Within this frame, the lower portfolio risk diversification that results from the inclusion of sustainable investment strategies in the portfolio should not represent a constraint to sustainable investing either. It has been noted that portfolios relying on sustainable investment strategies, such as screening or best in class strategies, can be at odds with principles of portfolio theory due to lower risk diversification: "it is impossible for an ESG-screened universe to be more diversified than a conventional universe, since the former is a subset of the latter. And this raises the possibility that ESG screening could entail an increase in risk through a loss of diversification."[356] However, such

352. Dirk Schoenmaker & Willem Schramade, *Investing for Long-Term Value Creation*, 9 J. SUSTAINABLE FIN. & INV. 356 (2019) (proposing a definition of long-term value creation in terms of a company aiming to "optimise its financial, social and environmental value in the long term, making it prepared for the transition to a more sustainable economic model").

353. *Id.* at 357 (citing several academic sources).

354. *See id.* at 531–32; *see also* Susan N. Gary, *supra* note 53, 779–84 (quoting J Hawley & J Lukomnik, *The Long and Short of It: Are We Asking the Right Questions*?, 41 Seattle U. L. REV. 449 (2018)) (pointing out that long-term investing may even allow for portfolio designs that confront or mitigate systemic risks, and examining the financial rationale long-term investments including the limits of modern portfolio theory to promote long-term investments).

355. IORP II Directive, *supra* note 15, art. 19(1)(c).

356. Tim Verheyden et al., *ESG for All? The Impact of ESG Screening on Return,*

a problem need not curtail financial performance.

Recent studies have shown that sustainable (or socially responsible) investments do not necessarily lead to a loss in risk-adjusted financial returns due to less diversified portfolios. In this sense, even when screening strategies may restrict the number of stocks for selection and increase the correlation between portfolio stocks, evidence has shown that the additional returns compensate for such losses. Relative to unscreened portfolios, sustainability-screened portfolios bring about very small losses from diversification, whereas any such losses are more than offset by a sufficient amount of returns (alpha).[357] To the extent that sustainability screening in portfolios has improved risk-adjusted returns, it has been suggested that restricting the universe of stocks by way of sustainability (ESG) screening is an adequate investment strategy even for those investment managers that are not interested in sustainability.[358]

In overall, this means that within the scope of Article 19(1)(b) of IORP II Directive, the prudent person rule need not preclude a fiduciary to invest in mixed strategies—combining financial and sustainability objectives—provided that such strategies duly reflect the best long-term interest of beneficiaries as a whole.[359] It is worth noting, however, that Article 19(1)(b) of IOPR II Directive does not mandate the consideration of sustainability risks and investments. Rather, it works on a comply or explain basis, although EIOPA, the sector regulator, is weighing the possibility of new reforms in this area in line with recent changes of law and policy in EU sustainable finance.[360]

VI. FINAL CONSIDERATIONS

This Article outlined and examined key legal and regulatory reforms in the area of EU sustainable finance. Relying on the distinction between sustainability risk on the one side, and sustainable investments on the other side, this Article has focused on reforms aimed at managing sustainability risk, largely climate risk, and at promoting instruments and markets in

Risk, and Diversification, 28 J. APPLIED CORP. FIN., 47, 51–52 (2016) (citing Markowitz, H., *Portfolio Selection*, 7 J. FIN. 77–91 (1952)).

357. *See id.* at 53–54.

358. *See id.*

359. *See* Schanzenbach & Sitkoff, *supra* note 53, at 400–02.

360. *See* Susanna Rust, *EIOPA Floats IORP II Change to Require Impact on ESG Consideration*, NEWS IPE (July 17, 2020), https://www.ipe.com/news/eiopa-floats-iorp-ii-change-to-require-impact-on-esg-consideration/10046920.article (evaluating the possibility of making art. 19(1)(b) IORP II Directive requirement mandatory).

sustainable investments. Although these reforms are well-intended and meritorious, it is important to also touch on the basic shortcomings that these reforms will likely face as they enter their implementation phase.

The implementation of the EU Taxonomy Regulation has posed challenges, including how to evaluate and report on the "Do Not Significantly Harm" (DNSH) requirement,[361] and on the Key Performance Indicators (Turnover, CapEX and OpEX).[362] Although the design of the taxonomy has been praised for its science-based standards, the recent proposal sponsored by the Commission has included gas and nuclear power projects in the list of climate-friendly energy sources.[363] The fact that such energies may play a role as bridge technologies to support the transition to a low-carbon economy, and meet the EU's target of net zero emissions by 2050, has not abated the controversy created around this proposal.[364] Further

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361. *See* EU Taxonomy Regulation, *supra* note 12, 17; DA Taxonomy Regulation, *supra* note 137, at 5, 7.

362. *See* Supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation, at 2, COM (2022) 4987 final (July 6, 2021).

363. *See* Amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities, at 2, COM (2022) 631 final (03 September, 2022); *see also* Fin. Stability, Fin. Servs. & Cap. Mkt. Union, *EU taxonomy: Complementary Climate Delegated Act to accelerate decarbonization*, EUR. COMM'N. (Feb. 2, 2022) https://ec.europa.eu/info/publications/220202-sustainable-finance-taxonomy-complementary-climate-delegated-act_en (pointing that this new draft delegated act has included in the EU taxonomy classification gas and nuclear energy projects as transitional activities, covered by art. 10(2) of the Taxonomy Regulation); *see also* Questions and Answers on the EU Taxonomy Complementary Climate Delegated Act covering certain nuclear and gas activities, EUR. COMM'N. (Feb. 2, 2022) https://ec.europa.eu/commission/presscorner/detail/en/QANDA_22_712 ("These are activities that cannot yet be replaced by technologically and economically feasible low-carbon alternatives, but do contribute to climate change mitigation and with the potential to play a major role in the transition to a climate-neutral economy, in line with EU climate goals and commitments, and subject to strict conditions, without crowding out investment in renewables.").

364. *See* Kevin O'Sullivan, *Inclusion of Gas and Nuclear in EU Taxonomy Not Necessary – Eamon Ryan*, IRISH TIMES (Feb. 5, 2022) https://www.irishtimes.com/business/energy-and-resources/inclusion-of-gas-and-nuclear-in-eu-taxonomy-not-necessary-eamon-ryan-1.4794040 (reporting that "the EU Financial Services Commissioner with responsibility for the taxonomy file, Mairead McGuinness, repeated this week that the proposal was based on best scientific advice. Four member states have accused the Commission of departing from scientific evidence, and Austria and Luxembourg have threatened to sue, with the possible backing of Denmark."); *see also* Jennifer Rankin, *EU Includes Gas and Nuclear in Guidebook for "Green" Investments,* GUARDIAN (Feb. 22,

complexities will inexorably arise in the near future from the advent of the EU social taxonomy,[365] because conceptualizing and measuring social impact poses difficult questions whose answers are unsettled and often elusive.[366] This means that the classification of an economic activity as environmentally or socially sustainable is not, and will not be, a one-off exercise. Instead, the classification effort will evolve over time accompanying the policy process and transitions and requiring significant flexibility and possibly re-definitions.

It is submitted that the new rules mandating sustainability information disclosures, namely the CSRD, the SFDR and the EU Taxonomy Regulation, will improve the availability and quality of non-financial information. Despite the advantages of more and better sustainability disclosure, the implementation of these rules is expected to be a complex process that must be monitored closely. On the side of corporate sustainability reporting, the double-materiality principle entails that financially immaterial information may nevertheless prove to be socially or environmentally material, a fact that will pose harsh challenges to corporate teams.[367] In order to meet these challenges, companies are expected to put in place due diligence and other management processes to make sure that they make the right judgments. The determination of materiality of social or environmental information can give rise to ambiguity caused by diverging interpretations.[368] Moreover, as suggested by empirical studies, stakeholder groups may show different perceptions of the materiality level of an item (e.g., employees, suppliers and investors may attribute a different level of materiality to the same sustainability item).[369] Due to the nature of non-financial information (such

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2022), https://www.theguardian.com/environment/2022/feb/02/eu-guidebook-taxonomy-green-investments-gas-nuclear-included.

365. *See* Subgroup 4, Platform on Sustainable Finance, EUR. COMM'N, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en#subgroups (accessed on 31 October 2021).

366. *See generally* Luigi Corvo et al., *Mapping Social Impact Assessment Models: A Literature Overview for a Future Research Agenda*, 13 SUSTAINABILITY (2021); Irene Eleonora Lisi, *Determinants and Performance Effects of Social Performance Measurement Systems*, J. BUS. ETHICS (2018); J Reisman, V Olazabal & S Hoffman, *Putting the "Impact" in Impact Investing: The Rising Demand for Data and Evidence of Social Outcomes*, 39 AM. J. EVALUATION (2018); Alno Ebrahimi & Kasturi Rangan, *A Framework for Measuring the Scale and Scope of Social Performance*, 56 UNIV. CAL., BERKELEY (2014).

367. Mathide Bossut et al., *supra* note 181, at 8–9.

368. *See id.* at 9.

369. *See id.*

as biodiversity data), the risk of material omissions and misrepresentations, as well the risk of information overloading, is likely to be higher compared with the case of financial information.[370]

Reporting on principal adverse impact (PAI) of a firm or product on sustainability factors, is likely to be costly and burdensome to FMPs. The SFDR requires that FMPs and IAs fill out mandatory reporting templates on PAI composed of multiple quantitative and qualitative indicators.[371] Restrictions in the availability of data on environmental and social impact, as well as poor quality of available measurements and metrics will certainly remain a concern as the new rules start to be implemented.[372] It is an inescapable reality that the capacity of FMPs and IAs to meet the new reporting obligations imposed by the SFDR, and by the EU Taxonomy Regulation, heavily depends on a full and adequate information disclosure by investee companies. Without investee companies satisfying this role, FMPs and IAs will find irredeemable obstacles in their quest to determine the sustainability characteristics and impact of their portfolios, including the extent to which their portfolios are taxonomy-aligned.[373] Since the corporate sustainability reporting system is the vital source that originates sustainability data and spills these data over market participants and stakeholders, the role that the investee company plays in the process of data origination, processing and measurement is paramount.[374]

This means that the quality and quantity of corporate sustainability reporting is a fundamental factor without which the EU sustainable finance policy will most likely fail. Against this backdrop, the fact that corporate sustainability disclosure will abide to standards that are EU-wide, mandatory and externally audited is of critical importance.[375] Tackling greenwashing

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370. *See* Baumuller, *supra* note 37, at 101–03.

371. Final Report on draft Regulatory Technical Standards, JC 2021 50 (Oct. 22, 2021).

372. *See Principal Adverse Impacts Reporting: Practical insights for the next stage of SFDR implementation*, IRISH FUNDS 1, 12 (Aug. 2021) (having an evaluation of the current conditions for compliance with the Principal Adverse Impact Reported under the SFDR by the investment fund industry in Ireland has been produced by the Irish Funds Industry Association).

373. *See Testing the Taxonomy. Insights from the PRI Taxonomy Practitioners Group*, PRINCIPLE RESPONSIBLE INV. (Sep. 9, 2020), https://www.unpri.org/eu-taxonomy-alignment-case-studies/testing-the-taxonomy-insights-from-the-pri-taxonomy-practitioners-group/6409.article (identifying data and logistic problems detected by market participants when reporting the alignment of selected investment portfolios with the EU Taxonomy rules).

374. *See* ERM, *supra* note 34, at 18.

375. *See* discussion *supra* Section III.

problems at the corporate level is equally crucial. It is submitted that, among other objectives, the new rules on corporate sustainability reporting have been certainly designed with an eye to mitigating greenwashing practices. It is noted, however, that the typical incentives identified in voluntary information disclosure models towards misstating sustainability performance will not abruptly vanish. Market pressure arising from competition forces,[376] and social pressure requiring companies to demonstrate 'legitimacy' towards society or towards stakeholders[377] will remain, if not intensify, in the coming years. Bowing to these pressures, companies may choose to greenwash (or "socialwash") with the purpose of maintaining or augmenting their competitive performance (false signalling) or their legitimacy towards society and stakeholders (false legitimacy).[378]

Substantial reforms by companies in their operations, due diligence, and management systems are expected in order to ensure compliance with the new rules imposing mandatory and audited reporting on sustainability performance.[379] Member States and designated NCAs in their supervisory and investigative role will take on the challenges of securing the transparency and integrity of the sustainability reporting regime.[380] Similarly, the importance of due compliance with the SFDR is apparent at the level of financial intermediaries, and although designated NCAs are expected to supervise and investigate compliance deficits, this control system has yet to be set up and effectively implemented.[381] In this same light,

376. Signalling theory posits that a company discloses information to the public in sustainability reports because it wants to communicate to the market that they are good performers and, this way, the company aims at differentiating from other competitors (e.g., poor performers) and gain a competitive edge or advantage. *See* Ali Uyar et al., *Is Corporate Social Responsibility Reporting A Tool Of Signaling Or Greenwashing? Evidence From The Worldwide Logistics Sector*, 253 J. CLEANER PROD. (2020). *See generally* Brian L. Connelly et al., *Signaling Theory: A Review And Assessment*, 37 J. MGMT. (2011).

377. *See generally* Craig Deegan, *Introduction: The Legitimising Effect Of Social And Environmental Disclosures–A Theoretical Foundation*, 15 ACCOUNTING, AUDITING, AND ACCOUNTABILITY J. (2002). Legitimacy theory claims that a company discloses information to the public in sustainability reports because it wants to increase or maintain its social legitimacy or stakeholder legitimacy. *See id.*

378. *Id.*

379. *See* discussion *supra* Section III

380. *See, e.g.,* Council Directive 2021/0104, art. 1(12), 2021 O.J. (L 189) 54 (EC). (replacing art. 51 of the Accounting Directive 2013/34/EU) ("[Member States] shall provide for penalties applicable to infringements of the national provisions adopted in accordance with this Directive and shall take all the measures necessary to ensure that those penalties are enforced. The penalties provided for shall be effective, proportionate and dissuasive.").

381. Commission Regulation 2020/852, art. 13, 2020 O.J. (L 198) 38 (EU) ("Member

other mechanisms set up for the protection of investors in the context of MiFID II, more specifically suitability and product governance requirements, will need close supervision and vigorous enforcement as well.

Challenges may emerge from the internal operation and practicalities of the assessment of suitability. The Commission has recently published its findings from a common supervisory action (CSA) with NCAs on the application of MiFID II suitability rules across the European Union.[382] Conducted throughout 2020, this CSA looked at the application of suitability requirements covering a total of 206 firms located in 26 countries of the EU and European Economic Area.[383] The CSA found adequate compliance in relation to items of the suitability requirement already regulated under MiFID I "such as firms" understanding of products and clients and the processes and procedures to ensure the suitability of investments.'[384] Shortcomings were also detected, however, especially in relation to requirements newly imposed by MiFID II, "notably the requirement to consider the cost and complexity of equivalent products, the costs and benefits of switching investments and suitability reports."[385] This CSA report did not investigate the integration of sustainability considerations into the suitability assessment. However, it is reasonable to expect that implementation problems will emerge in relation this new sustainability dimension of the suitability requirements.

The Commission has decided to adopt a so-called "two-step" suitability assessment.[386] Under this mechanism, the service provider shall first make sure that the products selected satisfy the client's financial objectives. Only after that first step is concluded will the provider consider the client's stated sustainability preferences. Although the underlying logic of this two-step mechanism makes good sense, a degree of caution is required until evidence

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States shall ensure that the competent authorities designated in accordance with sectoral legislation . . . The competent authorities shall have all the supervisory and investigatory powers that are necessary for the exercise of their functions under this Regulation."); *see also* EU Taxonomy Regulation, *supra* note 12, art. 21–22.

382. European Securities and Markets Authority, *ESMA Presents The Results Of The 2020 Common Supervisory Action (CSA) on Mifid II Suitability Requirements*, Public Statement, (July 21, 2021) [hereinafter *CSA Report on* Sustainability].

383. *Id.* at 2 ("A total of 206 firms where included in the CSA sample, 104 of which credit institutions (CIs), and 83 investment firms (IFs); a few branches of investment firms passported in other Member States and fund management companies were also included in the CSA sample.")

384. *Id.*

385. *Id.*

386. European Securities and Market Authority, *Consultation Paper on Integrating Sustainability Risks and Factors in MiFID II*, Consultation Paper (Dec. 19, 2018).

demonstrates how adequately the second step of the evaluation has been undertaken. The risk is that, as a matter of industry practice, the evaluation of suitability may end up focussing largely in the first step at the expense of the second step of the assessment.[387] From the perspective of enforcement, MiFID II firms shall ensure that they duly account for and treat the client's sustainability preferences. According to Article 25(2) MiFID II, a failure to satisfy the client's sustainability preferences will constitute a breach of the client's investment objectives (provided that a client's sustainability preferences be defined as part of a client's overall investment objectives) and, consequently, a breach of the suitability obligation. This logic would provide a neat and concrete legal basis for supervision and liability.[388]

To the extent that MiFID II product governance rules have also been created to protect investors from mis-selling practices,[389] the rules should also be capable of mitigating greenwashing practices relating to financial instruments. Notwithstanding this potential, it remains to be seen how manufacturers and distributors of financial instruments manage to integrate sustainability risk and preferences in the product approval process.[390] Evidence to this effect is currently lacking. It has been argued that under EU product governance rules manufacturers and distributors of financial instruments are likely to struggle to provide target market descriptions and to collect/share feedback information about clients and markets, the result of which is a restricted product offer.[391] There is a danger of exacerbating this problem as a result of incorporating sustainability-related requirements into

387. Mezzanotte, *supra* note 248.

388. Although this approach has prevailed in the legal formulation of the draft DA MIFID II, further interpretations may be needed as the rule is implemented. *See* European Securities and Market Authority, *Draft implementing technical standards under MiFID* II, Final Report (Dec. 11, 2015) (amending art. 54(2) and art. 54(5) of MiFID II DR); *see also* Mezzanotte, *supra* note 251; Veerle Colaert, *Integrating sustainable finance into the MiFID II and IDD investor protection* frameworks, Jan Ronse Institute, Ku Leuven (Nov. 2020) at 7–11; MiFID II Art. 25 Assessment of Suitability and Appropriateness and Reporting to Clients, European Securities and Markets Authority (Last Visited: June 25, 2022).

389. Veerle Colaert, *Product Governance: Paternalism Outsource to Financial* Institutions, Jan Ronse Institute, Ku Leuven (Nov. 2019) at 2.

390. A survey identifying shortcomings in the implementation of product governance rules has been conducted by CFA Institute without, however, including sustainability issues. *See generally The Brave New World of Product Governance in the EU Asset Management* Industry, CFA Institute (May 2020).

391. Colaert, *supra* note 390 (arguing that the introduction of MiFID II product governance obligation will affect distributors by rendering the identification of product markets and the transmission of information to manufacturers more complicated, thereby creating disincentives to product offer).

the product approval processes. Following ESMA's CSA on suitability requirements, a CSA on product governance requirements has recently been launched.[392] Findings on this latter CSA have yet to be published. Although such findings are expected to yield valuable insights into compliance problems afflicting product governance processes, the goals set for this CSA have not included sustainability considerations.[393]

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392. European Securities and Markets Authority, *ESMA Launches a Common Supervisory Action with NCAs on MIFID II Product Governance Rules* (Feb. 1, 2021) https://www.esma.europa.eu/press-news/esma-news/esma-launches-common-supervisory-action-ncas-mifid-ii-product-governance-rules.

393. *See id.*