Deloitte.

ESG preferences and MiFID suitability

The challenges posed by the EU's new requirements and how these might be tackled

December 2020

CENTRE *for* REGULATORY STRATEGY EMEA

Contents

Overview

This paper outlines the challenges firms will face in capturing clients' ESG preferences in their suitability assessments as envisaged in the EU's proposed changes to the MiFID II suitability rules. As the EU requirements do not prescribe a specific format for suitability assessments, firms will have significant practical flexibility and scope in how they assess their clients' ESG preferences.

In that context, the paper explores the complications and risks created by the low levels of ESG related data presently available, and the lack of standardised approaches to considering the separate E, S and G considerations and preferences clients may have. It also explores the need for firms to revisit their product governance frameworks and oversight, particularly in relation to the risks posed to suitability, and hence to firms' reputations, by "greenwashed investments".

Target audience

Those firms providing MIFID II investment advice and portfolio management, i.e. advisory investment management firms, including independent financial advisers, wealth managers and asset managers more generally and in particular, heads of proposition/product, compliance officers, COOs, CROs and heads of regulatory change. The paper will also be of interest to board members looking to scrutinise their firms' approach to ESG issues.

At a glance

As part of the drive towards sustainable investing on the part of politicians, regulators and investors, the EU has proposed changes to the MiFID II suitability rules to ensure that investors' environmental, social and governance (ESG) preferences are taken into consideration during the investment advice and portfolio management processes.

The European Commission draft delegated regulation was published on 08 June 2020 with a feedback deadline of 06 July 2020. At the time of writing, it is expected that the relevant delegated act will be adopted by December 2020. The earliest application date is expected to be late Q1 2022/early Q2 2022. This timeline is subject to change depending on the European parliamentary scrutiny process and delays to adoption, as the industry is currently debating certain provisions/definitions in the act and providing feedback to the Commission.

Firms will benefit from having a clear in-house ESG strategy, which will not only provide them with a potential competitive advantage over their rivals, but will also reduce the complexity of implementing the new suitability rules and reduce the risk of clients' preferences not being adequately reflected.

Firms will face a number of challenges in obtaining and reflecting clients' ESG preferences:

- Explaining E, S and G and the scope of the suitability exercise to clients in plain language.
- Identifying ESG issues that are material to their businesses/ products.
- Obtaining clients' preferences at a suitably granular level, differentiating between the respective E, S and G factors, highlighting any tensions or contradictions between these, and explaining the consequences on risk and return of favouring one or more over others.
- Providing a credible range of performance scenarios for clients' ESG investments; this will include recognising, and explaining to clients, the complexity and associated uncertainties of modelling future environmental/ social events.
- Ensuring that investments and advice are suitable overall, such that ESG preferences are appropriately combined with clients' existing requirements in areas such as liquidity, expected expenditure and risk profile.
- Following up explicitly with clients to clarify their preferences if their ESG responses contradict their existing profiles; for example, if they are open to materially higher risk or lower returns when it comes to sustainability investments, as compared to their existing investment requirements.
- This will entail obtaining clients' preferences at a suitably granular level, differentiating between the respective E, S and G factors, and explaining the consequences on risk and return of favouring one or more over others.
- Obtaining a full understanding of clients' preferred ESG strategy e.g.
  - Whether they prefer only divestment from non ESG compliant stocks or if they would like to invest actively in certain ESG compliant stocks; or
  - Whether they prefer investing in stocks that are currently non-compliant but are investing in sustainable operations etc.
- Disclosing to clients the limitations of current ESG related data, and what these may imply as to the accuracy of ESG related categorisations and performance scenarios.
- Ensuring robust consistency between internal categorisation and external marketing of ESG products and firms' suitability assessments.
- Changing internal portfolio construction tools and ensuring consistency of approaches by different portfolio managers/ teams.
- Reducing regulatory risk, including any mis-perception of greenwashing, by having well recorded and documented:
  - Processes and research for determining ESG classifications, including how this is incorporated into risk management policies;
  - Governance challenge and oversight; and
  - ESG client conversations and suitability assessments.

Introduction: ESG is rapidly rising up the regulatory agenda

In recent years, climate change, sustainability and good governance have all risen rapidly up the regulatory agenda. Whereas only a few years ago climate change was considered to fall primarily within firms' corporate social responsibility agenda, it is now at the heart of much recent financial services policy making and regulation. Amongst many other initiatives, the Task Force on Climate Related Financial Disclosures (TCFD) has developed a series of voluntary climate related disclosures that many regulators are now looking to make mandatory. In the UK the Bank of England has set out plans for climate related stress tests. At an EU level, the European Commission has developed a wide ranging Sustainable Finance Action Plan, which includes initiatives to put new sustainability related disclosure requirements on certain firms, and to develop a Taxonomy setting out a list of sustainable activities.

Whilst the Taxonomy will assist firms and consumers in determining whether activities carried out by issuer companies can be deemed sustainable, the EU's Sustainable Disclosures Regulation (hereafter referred to as the Disclosures Regulation), will require certain firms to disclose the principal adverse impacts that investment decisions have on sustainability indicators including the climate, human rights and social matters, and anti-corruption/bribery matters. Furthermore UCITS and AIFMD are being amended to include requirements for relevant firms to integrate sustainability risks and factors into investment decision making.

This rising focus on environmental issues has occurred against a backdrop in which good governance, culture and strong accountability are now central to many post-financial crisis conduct frameworks. Accountability has been sharpened through a number of jurisdictions adopting formal accountability regimes such as the UK's SM&CR. Many of these seek not only to improve firms' governance but also to enhance executives' accountability for any unethical behaviour.

Furthermore, there have been significant changes in political and social attitudes to investing and to capitalism more generally. In particular, the wider social responsibilities firms have to their employees and communities are increasingly being emphasised as a challenge to the previously dominant view that a firm's primary function is to maximise shareholder returns.[1]

These changes have led to increasing investor interest in Environmental, Social or Governance (ESG) investments. These are investments which not only seek to provide a financial return, but intend to do so in a way that promotes, or is at least consistent with, wider ESG goals such as protecting the environment and tackling climate change, bringing about a more socially responsible world, or promoting good and ethical governance.

It is against this background that, as part of the EU's aforementioned Sustainable Finance Action Plan, the EU has proposed making changes to MiFID II in order to ensure that any ESG preferences (for the purposes of this paper, 'ESG preferences' is interchangeable with 'sustainability preferences', whiich is the terminology used in the new rules - definitions on pg 9) that investors may have are taken into account as part of firms' suitability assessments; the mandatory assessments that firms providing financial advice and portfolio management services have to carry out, in order to understand their customers' investment preferences and tolerance to risk.

Suitability is an area that already attracts significant supervisory and regulatory scrutiny, both from ESMA and from national regulators such as the FCA. Once in force, the requirements for firms to consider clients' ESG preferences are likely to attract similar high levels of attention.

1 Governor of the Bank of England and former FCA CEO, Andrew Bailey talked about this change in attitudes to corporate responsibility in a speech on Trust and Ethics, 16.10.2018

The new suitability rules and key issues they raise for advisory wealth managers

A brief review of existing suitability requirements – what was missing?

The existing MiFID II rules require those **providing investment advice and portfolio management** (hereafter cumulatively referred to as **'wealth managers'**) to obtain information on clients' financial objectives, risk profiles (including capacity and willingness to bear loss) and knowledge and experience in investment and finance. This is to allow them to recommend or invest in financial instruments that are suitable for individual clients given their overall circumstances and preferences. Whilst wealth managers collect non-financial data such as clients' age, marital status or education, this is mainly to assess the impact of these factors on the latter's financial objectives and risk profiles; to date clients' personal non-financial objectives and preferences in sustainability have not featured prominently and have not been explicitly provided for in the regulations.

However, the European Commission is in the process of amending MIFID II to ensure that in future, wealth managers will be required to take into account clients' 'sustainability preferences' as part of the overall suitability process.

At the time of writing it is unclear whether, and to what extent, these new suitability rules will be adopted in the UK following the end of the transition period. City Minister, John Glen, has said that the UK is committed to "at least match the ambition of the objectives of the EU Sustainable Finance Action Plan"[2] suggesting that broadly equivalent rules will be adopted in the UK, even if they do not exactly match the EU's. Accordingly, UK wealth managers would also benefit from familiarising themselves with these rules and any operational changes these may involve.

2 City Minister, John Glen, letter to the House of Common's European Scrutiny Committee, 28.05.2020

The new rules and key definitions

At present, the draft new rules stipulate the following:

- Whilst describing the type and range of financial instruments considered in the **advice process**, wealth managers will be required to explain how **sustainability factors** were taken into account.
- Whilst obtaining information from the client to allow their investment objectives to be met in the context of specific transactions that are recommended or entered into, wealth managers will need to consider **sustainability preferences**.
- Whilst complying with the existing requirement to obtain information about clients' investment objectives, wealth managers will need to enquire about **sustainability preferences**.
- Wealth managers will be required to include, and demonstrate that they have included **sustainability factors** in the policies and procedures used to ensure they understand the nature of financial instruments selected for clients.
- Suitability Reports, which include information on how the investment advice/recommendation provided is suitable for the client, will be required to outline how the services provided meet any **sustainability preferences** expressed by clients.

A separate recital states that firms should have in place appropriate arrangements to ensure that the inclusion of sustainability factors in the advisory process and portfolio management does not lead to mis-selling practises or to the misrepresentation of instruments or strategies as fulfilling sustainability preferences when they do not. If sustainability preferences take precedent over a client's conventional investment objectives, this may result in mis-selling. **Therefore sustainability preferences should be addressed within the suitability process only once the client's conventional investment objectives, time horizon and individual circumstances have been identified.**

Given that the investment industry is still implementing several sustainable finance related rules, and preparing for the ones above, **understanding and correctly applying certain new definitions is fundamental to ensuring compliance.**

The draft EC text defines **'sustainability preferences'** as a client's or a potential client's choice as to whether either of the following should be integrated into their investment strategy:

- Financial instruments that have **sustainable investments** as their objectives
- Financial instruments that **promote environmental or social characteristics as referred to** in **Article 8 of the Sustainable Finance Disclosures Regulation (hereafter referred to as the Disclosures Regulation) and that either:**
  - Pursue, among others, sustainable investments as defined in Article 2 of the Disclosures Regulation; or
  - As of 30 December 2022, consider principle adverse impacts on sustainability factors, as referred to in Article 7 of the Disclosures Regulation

With regards to the definitions of **'sustainable investments'**, **'environmental and social characteristics' and 'sustainability factors'** the draft text references the anticipated Disclosures Regulation which entered into force in December 2019 is expected to apply from 10 March 2021 (level 1 measures will apply from 10 March 2021, but level 2 measures, i.e. RTS are due to apply at some point in 2022) at the time of writing this paper. The Disclosures Regulation provides the following definitions:

Sustainable investment : *an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or 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*

Financial instrument that promotes environmental or social characteristics: *where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed is:*

(a) information on how those characteristics are met;

(b) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.

Sustainability factors: *environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.*

ESMA Suitability Guidelines

The ESMA 2018 Suitability Guidelines were published to assist wealth managers in implementing the existing MiFID II suitability rules. ESMA had stated that adoption of the guidelines would be the most effective way of implementing the rules, ensuring investor protection and effective compliance. When incorporating the new sustainability related rules into their suitability assessments, wealth managers may thus want to consider these guidelines as a starting point.

A number of the ESMA guidelines will be key in implementing the new suitability rules, and will help firms to think through some of the specific issues that may arise whilst adopting these new rules. The ESMA guidelines do not currently address the new suitability rules but we have analysed the key guidelines in this context as follows.

Begin by knowing your sustainability strategy

Many firms are still in the process of determining their overall sustainability strategy. This includes the amount of resources they are willing or able to dedicate to ESG investing; whether they need to expand or modify their existing offering; and whether they need to invest in dedicated ESG related teams. Firms would benefit from deciding upon their overall sustainability strategy (although this may continue to evolve) prior to amending their suitability assessments, as the firm's overall strategy is likely to have a significant impact on the nature of sustainability related questions in the assessments.

If firms do not have a strategy in place prior to updating their suitability assessment, they risk misaligning their offering and their client questionnaires. As an example, a suitability assessment with very detailed questions about clients' sustainability preferences, sent by a firm that has a very simple and limited offering, may lead clients to believe that all their preferences will be taken into account in the investment process, which may not be the case. On the other hand, a very limited questionnaire sent out by a firm that has an extensive offering may prevent the firm suitably matching its products to clients due to lack of information. The extensiveness of the suitability assessments should thus be tailored to the nature and scale of the individual firm's business.

Explaining the sustainability context to clients

The ESMA guidelines state that firms should give their clients a clear and simple explanation of the purpose of the assessment and highlight to them the importance of gathering complete and accurate information in order to be able to recommend suitable products. Given that sustainable investing has hitherto tended to be a specialist activity, many investors, particularly ones with limited financial knowledge, may not be fully conversant with the concept of ESG/ sustainable investing and what it means in practice for their investments.

Wealth managers therefore need to provide an explanation of what sustainable investing means and further definitions of the individual environment, social and governance (ESG) components within it. The EU Taxonomy[3], which will provide a common EU framework for defining the types of activities that are environmentally sustainable, can be used to inform the explanations. However the taxonomy is a detailed technical document and so it will be important that any explanations provided to clients use plain and easily understood language throughout.

This information should precede questions about sustainability preferences to help clients provide accurate responses.

Alongside this, firms should also explain how these preferences will be used to inform investments and examples of the types of circumstances in which clients should update the information they have provided at times other than during the annual suitability update.

If the firm has created an internal rating system for investee companies, or has house views on sustainability, it would be beneficial to explain these before inviting client responses to the questions.

3 European Council Press Release, "Sustainable finance: Council adopts a unified EU classifications system", 15 April 2020,

ESG Risk and Performance

An intrinsic part of suitability assessments is obtaining clients' risk profiles. ESMA guidelines suggest that instead of assuming that clients understand the risk-return trade off, it is prudent to provide examples of practical risk and return scenarios, both positive and negative. In the context of obtaining sustainability preferences, this is vital.

One of the main challenges is the plausibility of these scenarios: whilst certain ESG funds have been around for some time, mainstream ESG investing is still in its relative infancy, which complicates the task of making well-reasoned plausible future scenarios. This is due to lack of historical data on how ESG compliant investments perform, how certain types of risk affect their performance, and how their levels of return may differ from conventional portfolios.

Modelling scenarios is further complicated by the fact that they may need to reflect external events, such as climate shocks or difficult to quantify changes in political and social consensus outlooks (and potential resultant regulatory changes), rather than conventional economic cycles. As an example, a portfolio that is invested in a significant proportion of investee companies that are adopting sustainable policies and operations may be in a better position than one that is invested in companies that are not, in events whereby negative effects of climate change make it difficult for investee companies that are producers to procure raw materials.

For instance, companies that have sustainable processes for obtaining fish, or rely on sustainable sources of fish, may be less affected where certain types of fish have declined in stock or have changed migration or reproduction patterns due to climate change. That said, these things are difficult to predict.
It is also essential to explain to clients how taking their sustainability preferences into account would affect the returns that they have been experiencing on their conventional portfolios, and provide quantified examples or ranges of how different levels of incorporating sustainability preferences may affect return. Firms should consider how they can best provide clients with the relevant information and assumptions that have been used to model the scenarios, in order to maintain transparency and allow investors to see how firms have reached their conclusions.

Another challenge is lack of reliable data on investee companies; Historically, companies have not been required to measure or disclose data regarding the consequences of their activities on environmental and social issues. More recently, rising regulatory and investor pressure has led companies to produce more extensive data.

In particular the EU Taxonomy, which is a tool to assist investors, companies and issuers in navigating the transition to a low-carbon and resource efficient economy[4], sets performance thresholds for whether certain activities contribute towards specific environmental objectives.

This, alongside the Disclosure regulation, which will require wealth and fund managers to disclose the sustainability impact of investment decisions, is intended to encourage investee companies to measure and release more data on their ESG characteristics and hence increase capital flows towards those firms with more advanced sustainability practises. Furthermore, the Non-Financial Reporting Directive, which requires larger public interest companies to disclose information in relation to environmental protection, social responsibility, diversity and corruption is currently being reviewed as part of the EU's strategy to strengthen sustainable investment.

The data disclosed by investee companies will need to be filtered and analysed by data providers. However it will take a number of years before companies are providing the type and quantity of data envisaged in the regulatory requirements and the market for data provider companies is still relatively young. Data companies are still seeking to improve both the range and reliability of ESG related data they offer.

Consequently, although the Taxonomy provides definitions on which types of activities contribute towards certain sustainability objectives, lack of data on investee companies means that it can be hard to determine whether these companies' equities and bonds can be said to possess E, S or G characteristics.

4 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf

Although the range and quality of data is limited at present, over time the aforementioned regulatory changes are likely to drive the creation of a growing ESG data market. In the meantime, data limitations need to be made clear to clients so that they are aware of the limitations in risk-return calculations; although firms can of course also set out the efforts they have made to source accurate data.

It may also be helpful to investors to provide graphs and examples of how different proportions of E, S and G focused stocks affect risk and return, and how they affect a set of conventional portfolio holdings. Firms should consider having a range of varied questions related to risk and return to obtain a full picture of the client's willingness to bear loss due to incorporating sustainability preferences. For example, some questions could be phrased purely in terms of potential lower investment returns, some purely in terms of adverse impacts to the E, S or G factors, and some as a combination of both. Firms will also want to add questions that help to satisfy themselves that clients have understood the risk-return trade-offs of sustainable investing.

Example Questions

- The tables/scenarios above provide indications of how incorporation of ESG preferences in different percentages into different portfolios may affect return. Based on this, what percentage of your portfolio would you like to constitute of ESG compliant stocks? (provide answers to choose from)
- What level of investment return would you be prepared to potentially risk missing out on, in order to incorporate ESG compliant stocks, or by omitting ESG compliant stocks? (provide answers to choose from)

Extent of information to be collected

The guidelines suggest all the 'necessary information' must be collected before providing investment services. What constitutes of 'necessary information' may vary depending on the type of service provided and the needs and circumstances of the client. Bearing these factors in mind, wealth managers may benefit from obtaining sufficient information about the client's preferences in the following areas:

(a) Client's ESG strategy

Clients may have different preferences and ideas about how they wish to pursue sustainable investing. Firms may thus want to consider developing a framework which demonstrates to clients how recommended products can meet their needs, so helping to match clients with the products that are most suitable for them. Some key questions would be how much of their wealth they wished to dedicate to this type of investing and whether they wished to modify existing portfolios or dedicate separate sums. Information could also be sought on whether clients wished to invest in companies that are highly rated as E, S or G compliant or whether they wished simply to remove certain types of stocks from their portfolios that are not compliant. Some clients may wish to invest in companies that, whilst currently having a negative impact on the environment, are nonetheless investing in sustainable operations.

Others may want to shift investments towards those that do not currently have a severe negative impact, but may not necessarily be investing as heavily in sustainable operations.

(b) Preference between E,S and G
Clients may also want to invest in only one or two of the three constituent parts of ESG or may want to prioritise certain factors over others. Firms should therefore seek to understand which of the different parts of ESG are most important to the client. As an example, if a client wants to prioritise investing in companies that have a good governance record, they might be asked whether they are content that certain companies with a good governance record might have a low rating in terms of environmental contribution. Requiring clients to rate their interest in the different parts of E, S or G, and obtaining information on what possible trade-offs they would tolerate, would undoubtedly help with providing a fuller picture on their preferences.

(c) Interpretation of 'sustainability preferences'
It is important to note that firms' endeavours in relation to points (a) and (b) above may be constrained by the definition of 'sustainability preferences'. This definition, as set out in the 'new rules and key definitions' section earlier in this paper, is currently being debated within the investment management industry. Some stakeholders consider the current definition to be too restrictive and are concerned that it suggests that if a client expresses sustainable preferences that they can only be offered investments (whether collective investment schemes or direct investments) that fall within the definition of Article 8 or Article 9 of the Disclosures Regulation. Particularly for direct investments, firms would need to ensure that they possess enough data from investee companies to determine whether they fall within the Disclosures Regulation Article 8 and 9 definitions, as well as where they fall within the Taxonomy criteria. This definition is yet to be finalised by the Commission and so firms may want to follow developments here closely. Firms may also want to consider which of the existing products they often recommend to clients or invest in on their behalf (whether in their in-house range or whole of market), fall within Articles 8 and 9 of the Disclosures Regulation.

Example Questions

- Is it more important for you to incorporate ESG compliant investments or to maintain returns on your portfolio?
- Which do you think is more important, divestment from companies that are non-ESG compliant or investment in companies that are ESG-compliant or both?
- Would you be open to investing in a company that currently has very adverse impacts on the environment but is investing heavily in sustainable operations?
- Would you prefer to invest in companies that have a larger carbon footprint at the moment but are investing heavily in sustainability or companies that already have a smaller carbon footprint, but don't intend on increasing investing in sustainable operations?
- If you had to choose would you prefer to invest in a company that paid special attention to governance and human rights or one which invested heavily in reducing their carbon footprint?
- How would you feel about investing in a company that invested heavily in reducing their carbon footprint but had a weaker human rights records?
- Which one of the E, S and G factors are you willing to trade off on, if you could only invest in one or two of these?

Ensuring overall suitability to match clients with products

Wealth managers should ensure that clients' sustainability preferences are considered alongside all of clients' existing preferences and circumstances, in particular liquidity, capacity and willingness to bear loss, time horizon, and financial objectives (e.g. income, growth or balanced).

Importantly, if a client's responses to the suitability assessment suggest contradictions between their existing preferences and sustainability preferences e.g. willingness to take much higher risk than usual or willingness to invest in heavily illiquid assets in relation to sustainable investing, wealth managers will need to ensure that their processes trigger further discussions to clarify the client's position. Similarly, they will need to stay alert to any indications in clients' responses that they have not understood the scope or impact of sustainable investing on their overall portfolio or objectives and follow up on any of these points with the client in a timely manner.

It may be prudent to provide some examples of 'illustrative portfolios,' as part of the suitability assessments, so that clients can see how combinations of their existing preferences and certain sustainability preferences may affect the expected return and riskiness of their investments.

Suitability reports need to make clear how sustainability preferences have been considered alongside the clients' existing preferences to arrive at decisions on specific transactions or advice.

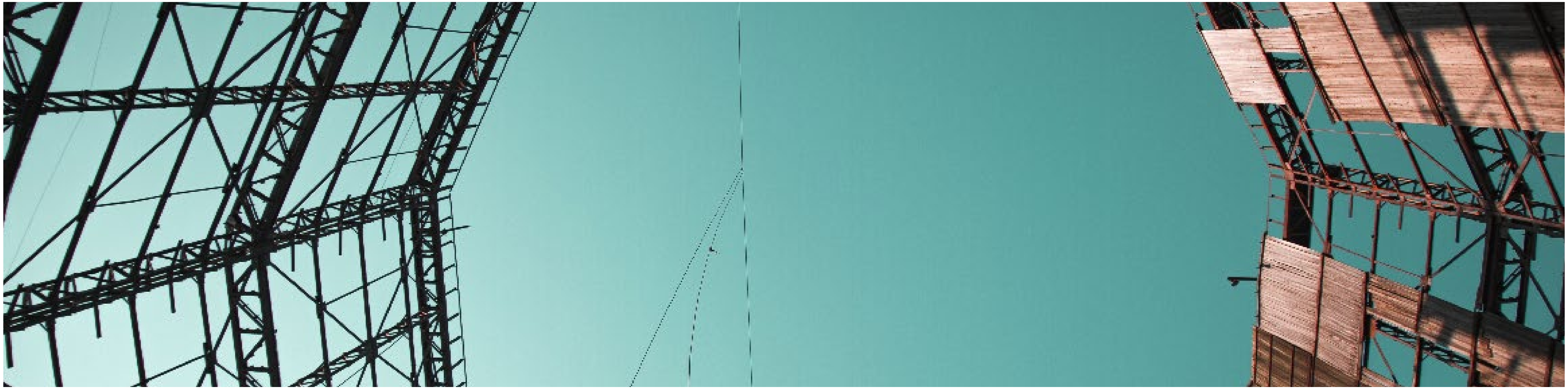
Wealth managers may wish to consider whether the existing format of their suitability assessments would still be practical given the new requirements e.g. given the amount of new information required, an online assessment may be more practical than a paper assessment. However, whilst making any such changes, access for vulnerable consumers and data protection need to be borne in mind. Furthermore, wealth managers will need to ensure that their staff have sufficient training in sustainable investing to be able to assess overall suitability for clients and match the right products.

Costs of equivalent products and of switching products

ESMA guidelines suggest that firms must have suitability policies in place that ensure that, before investment advice is given, or an investment is made on behalf of a client, an assessment of possible alternatives is taken. Whilst switching investments, the benefits of switching, taking into account all relevant factors such as expected return and changes in market circumstances, must outweigh the costs.

In the context of sustainable preferences, it would be prudent to design firms' suitability questionnaires to include questions about the costs clients are willing to bear to modify their portfolios towards investments compliant in E, S or G factors. Furthermore, clear and accurate records will need to be kept of all suitability assessments and portfolio switches. This will assist with demonstrating that products have not been mis-sold and that new rules are not being used to disadvantage clients via unnecessary switching.

Other key challenges



Product governance

As part of the drive to integrate 'sustainability risks' into MiFID II, the European Commission has published a draft delegated act in June 2020[5] on amending the directive's product governance rules. The new rules, which are likely to come into force in H1 2021, are set out below.

Product manufacturers are required to (where relevant):

- **Consider the sustainability preferences** (alongside needs, characteristics and objectives), of the specified target market
- Determine whether the product **meets the needs of the target market, including sustainability factors and risk/reward profile**
- Regularly review whether the **product remains consistent with the needs of the target market, including sustainability preferences**

Product distributers are required to (where relevant):

- Ensure that they have in place adequate product governance arrangements to ensure that services and products they intend to offer or recommend are **compatible with the needs of the target market, including sustainability preferences**
- Put arrangements in place to review the products they offer or recommend and the services they provide to assess whether these remains consistent with **the needs of the target market, including sustainability preferences.**

5 European Commission, Draft Delegated Directive – Sustainable Finance – obligation on investment funds to advise clients on social & environmental aspects, 08 Jun 2020

'Sustainability risk' is defined by the Disclosures Regulation[6] 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 [an] investment.

The objective of these rules is harmonisation between investor preferences and investment products and hence a reduction in the likelihood of missselling and greenwashing. Under the rules, wealth managers, whether in the role of product manufacturers or distributors, will be required to categorise products as having certain E, S and G characteristics. If the product offering is likely to remain constant, suitability assessments are best harmonised with these internal categorisations so that clients are aware of the different categories of products available and the different E, S and G characteristics they fulfil. Suitability reports would also benefit from having a clear link between clients' stated sustainability preferences and how the characteristics of any recommended products are likely to meet these preferences. These practices will help demonstrate that the firm is actively aware of and managing the risks of mis-sselling and greenwashing.

6 European Parliament draft Regulation (not yet published in the Official Journal), Regulation of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector, 23 Oct 2019

Greenwashing

The FCA defines greenwashing as "marketing that portrays an organisation's products, activities or policies as producing positive environmental outcomes when this is not the case"[7].

Greenwashing can pose significant reputational risks to wealth managers. If firms recommend or invest in an investment that subsequently turns out to be greenwashed or non ESG compliant this has the potential to attract adverse publicity. Consequently firms will want to look at ensuring they have the processes/activities in place to identify potentially greenwashed investments

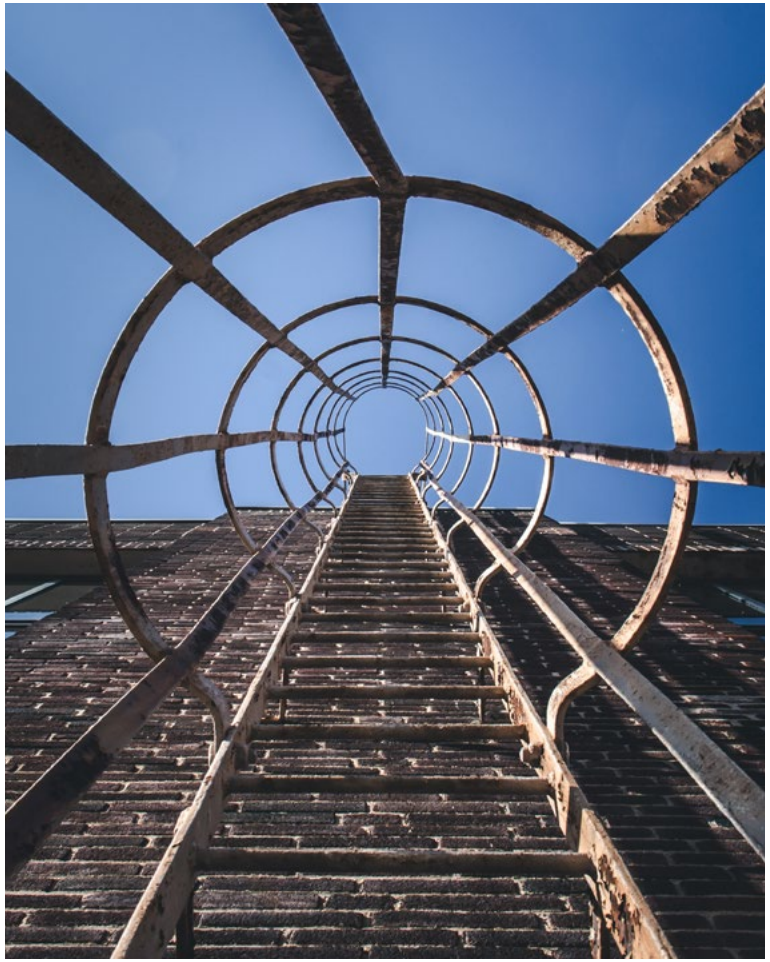
Firms will also need to ensure they undertake suitable due diligence on any companies they invest in on behalf of clients, to ensure any environmental claims that these firms are making are well founded. This will mean going beyond any labelling provided by companies through scrutinising documentation, data and supply chains in order to build an accurate picture of the companies' environmental stance and credibility.

For example, when analysing firms' carbon emissions it will be important to look at the firm's entire supply chain and at their outsourcing arrangements in order to form an accurate picture of the firm's carbon footprint. Failing to do so may give a misleading impression, in which firms who outsource carbon intensive activity to other companies look superficially attractive from a green perspective.

7 The FCA, Climate Change and Green Finance Discussion Paper, DP 18/8, p10

For example, if a company outsources their data storage and parts of their IT infrastructure to a cloud computing firm, then the energy intensive nature of this part of their business would not show up in the firm's own carbon emissions as these emissions would belong to the cloud computing firm. Only by looking at the company's outsourced activities and their relationships with the cloud computing firm could a comprehensive view of the firm's carbon emissions be arrived at.

Conclusion: Key Questions



Wealth managers face a number of important challenges in incorporating clients' ESG preferences into their suitability assessments.

Firms should consider the following key questions in thinking through their implementation of these important new rules:

- What is our in-house strategy on sustainability, and how can we ensure our advice and product offerings are joined up with the ESG questions we ask of clients in our suitability assessments?
- What are the E, S and G issues which are material to our product offering?
- Do we need to expand or modify our product offering?
- Do we want to include the modifications into our existing suitability questionnaires or would a different form of assessment be more practical?
- How extensive does the questionnaire need to be? Do any aspects of the process risk the perception of greenwashing?
- What type of performance scenarios will we utilise to explain ESG related risk/return trade-offs to clients? How will we satisfy ourselves of the accuracy of the data used for these? Is there a need to disclose data limitations to clients?
- Which types of responses on the questionnaire match which products? And if there are indications of contradictions within what time frame do we want to follow up with clients?
- Under what circumstances and how often must clients update us on their preferences (outside of the annual update)?
- Do we have enough information about the costs of switching products and has this been made clear to clients?

As always, clear and detailed records of the annual process will not only help in demonstrating compliance to the regulator but will also provide an audit trail that can be referred back to in case clients wish to discuss or amend strategies in due course.

Contacts

Andrew Bulley
Partner
EMEA Centre for Regulatory Strategy
abulley@deloitte.co.uk

Felix Bungay
Senior Manager
EMEA Centre for Regulatory Strategy
fbungay@deloitte.co.uk

Isha Gupta
Assistant Manager
EMEA Centre for Regulatory Strategy
iggupta@deloitte.co.uk

Deloitte.

Designed and prepared by Core Creative Services, Poland. RITM0542758