CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

# SFDR: A new regulatory landscape for sustainable investment in Europe

## Part 3: Integration of SFDR 2 into MiFID II

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Marketing communication

# Learning through practice.

Welcome to the 3rd episode of our series "Be an expert on SFDR". After listing the "*Five things to know about the SFDR in June 2022*", we discussed in the 2nd paper the regulatory technical standards of *level 2 of the SFDR* and in particular the pre-contractual reporting templates.

In this episode, we focus on the integration of SFDR into MiFID II.

## MiFID II has been enriched to take into account client preferences

Introduced in 2007, MiFID regulations were aimed at strengthening investor protection from financial institutions, as well as market and transaction transparency. These regulations require institutions to know their clients' investor profile to ensure that they understand the financial products offered to them, and that these products best meet their expectations. This information is obtained through a suitability questionnaire also called a *suitability assessment*, which covers:

- financial objectives,

- the risk profile (including ability and willingness to bear losses),

- financial knowledge,

- investment experience.

As part of its action plan for a greener and cleaner economy, the European Commission wanted to make changes to MiFID II in order to **ensure that clients' ESG preferences are properly taken into account**. Thus **since August 2,**, financial advisers must, before offering a financial investment to clients, **take into account their sustainability preferences.** The *suitability assessment* must now include questions relating to these sustainability preferences.

## What are sustainability preferences?

"Considering the sustainability of a financial investment means paying attention to its environmental, social, human rights and anti-corruption consequences" (AMF[1]) - these non-financial analysis criteria are also referred to as ESG criteria.

1 - Your sustainable development preferences: what changes for your investments | AMF (amf-france.org), https://www.amf-france.org/fr/espace-epargnants/actualites-mises-en-garde/vos-preferences-en-matiere-de-developpement-durable-ce-qui-change-pour-vos-placements

Preferences are determined according to 3 axes:

• the proportion of investments that the client wishes to be invested in activities considered environmentally sustainable by the European classification ("Taxonomy"),

• the proportion of investments that the client wishes to be invested in "sustainable investments" within the meaning of the SFDR,

• consideration of "main negative impacts" (PAI or *Principal Adverse Impacts*), for example greenhouse gas emissions, hazardous waste, human rights violations, etc.

These preferences can be assessed at the level of a financial investment or for the entire portfolio.

## In practice, how can the adviser help investors define their preferences?

They may ask the client, for example, if they wish to:

- support a specific environmental objective such as the fight against climate change

- invest part of their portfolio in a particular sector such as renewable energy,

- exclude certain sectors of activity such as fossil fuels,

- ensure that their investment does not have a negative impact on biodiversity or the climate.

Each financial adviser may have their own question grid. Once they have been informed of their client's "ESG preferences", they will be able to offer solutions that best match their expectations.

## A lack of precision that leaves room for interpretation

In the absence of clarification from the European authorities, the application of these sustainability preferences is a headache for all players in the sector. Indeed, it poses problems of interpretation.

- **Do the 3 questions need to be interpreted individually or cumulatively?** that is, should preferences take into account both the proportion of the portfolio invested in sustainable activities according to the taxonomy and the proportion invested in sustainable investments within the meaning of the SFDR, and also take into account the main negative impacts? (cumulative approach or "*and/and*")? Or *at least one* of these three elements? (" *or/or* " approach)

- Based on the answers to these three questions, **is it necessary to build an overall score** (low/medium/high -> what combination for the 3?), **or interpret each question separately**?

- In terms of the proportion of investments in sustainable investments, should we take into account a minimum proportion, or a range?

In order to comply with the implementation date of 2 August, prior to the publication of ESMA's guidelines, each player had to develop its own approach, making its own methodological choices, in order to draw up its questionnaire and train all of its advisers.

**Our approach at Candriam has been to give clients as much freedom as possible by asking them to specify whether they want the three responses to be taken into account cumulatively ("and/and") or not ("or/or").**

It seems difficult to aim to be precise enough to capture particular sensitive points such as the exclusion of certain companies or business sectors, while ESG data is still severely lacking. Beyond the lack of standardisation of data and methodologies for calculating the percentage of sustainable investments, we note that non-financial companies will not publish the share of their investments in line with the taxonomy until 2023 (2024 for financial companies). How can we offer clients products that meet their expectations in this area when no specific regulations or data are available?

## A tight schedule that places the cart before the horse

The rapid implementation of the guidelines is a problem for the financial industry as a whole. The date of application of MiFID II is independent of the timing of the implementation of the SFDR and the European Taxonomy. As previously explained, the *suitability assessment* must be ready even before the application of the SFDR Level 2 technical standards and the obligation to publish disclosures on percentages of sustainable investments, plus alignment with the taxonomy and consideration of the main negative impacts.

Until players begin to publish their PAI indicators and the share of their investments in line with the Taxonomy, in 2023, financial institutions will have to continue to find proxies to recommend sustainable financial products to their clients.

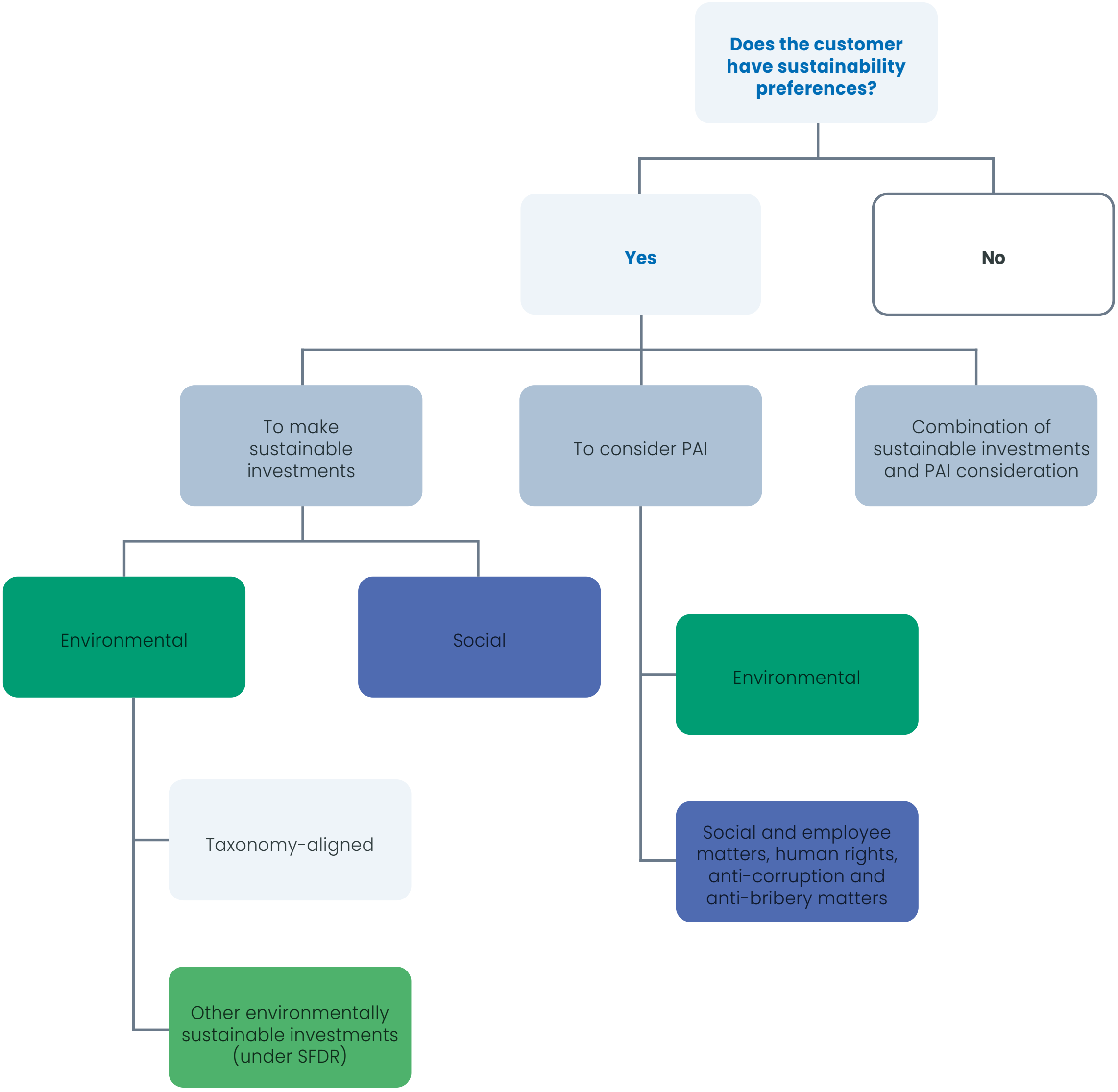
## Clarifications are gradually being provided

Clarifications were provided by the**EIOPA** in its Guidelines published in July[2]: the preferred approach seems to be that of "*minimum proportion*" for investments aligned with the Taxonomy and "sustainable" according to SFDR.

In addition, the EIOPA favours a non-cumulative interpretation of the three responses, as shown in the following diagram:

2 - Guidance on the integration of the client's sustainability preferences in the suitability assessment under IDD | Eiopa (europa.eu), https://www.eiopa.europa.eu/document-library/report/guidance-integration-of-customers-sustainability-preferences-suitability

**Figure 1:**
Collecting information from the customer - Step 1




**Source: EIOPA**

The sector was also eagerly awaiting the publication by **ESMA** of a guide to support financial institutions. These guidelines, published at the end of September[3], provided additional insight and recommendations on how to apply the directives.

The AFG[4] offers a clear and useful reading:

• "Clients whose sustainability preferences have not yet been updated are considered "sustainability preference neutral"[5]

3 - ESMA publishes final guidelines on MiFID II suitability requirements (europa.eu), https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-mifid-ii-suitability-requirements-0
4 - Publication des orientations de l'ESMA sur les préférences de durabilité dans les exigences d'adéquation MIF – AFG – Association Française de la gestion financière, https://www.afg.asso.fr/afg-news/publication-des-orientations-de-lesma-sur-les-preferences-de-durabilite-dans-les-exigences-dadequation-mif/
5 - ESMA final guidelines on MiFID II suitability requirements, supporting guideline 57, page 54.

• "The guideline to combine sustainability preferences is removed. The client must be asked if they have sustainability preferences for the different ESG categories of MiFID (a, b, c). It is also specified in Appendix III of the final report that these categories (a, b, c) are alternative unless expressly requested by the client." [6]

• "In terms of minimum proportions, the ESMA proposes the basis of "standardised minimum proportions" (e.g. 20% minimum, 25% minimum etc.)[7]. This strategy is in line with the EIOPA guidance published during the summer."

As such, the framework is gradually becoming clearer. It is regrettable, however, that the tight schedule of SFDR and the lack of synchronisation in the implementation of the various directives are forcing the industry to proceed by instinct and make interpretation-based choices that may be challenged by the later publication of clarifications on the application of these regulations.

The European Commission has heard the issues raised by national authorities and associations in the sector, but maintains its schedule under the principle of "*learning by doing*" ("*learning through practice*").

It is commendable that the climate emergency has pushed the EU to act quickly to bring retail investors on board and direct savings as quickly as possible towards products that contribute to a more sustainable economy. Now that savers are at the heart of the ecological transition, they need to have the keys to play their part. There is still a huge lack of knowledge of responsible investment among savers.

The implementation of SFDR 2 requires a joint effort to educate investors as well as their investment advisers. This challenge and the energy required to meet it are probably equal to the climate challenge we must face.

The new MiFID regulation aims to promote sustainable financial products, avoiding "green" marketing and combating greenwashing. Mistakes in interpreting vague directives can be the cause of many disagreements, especially as the various stakeholders in climate and planet defence consider the facts and the actions of stakeholders at all levels. Caution requires fund promoters to remain as faithful as possible, in their marketing documentation, to the regulatory prospectuses approved by the competent authorities.

*Candriam remercie l'AFG pour son éclairage.*

6 - ESMA final guidelines on MiFID II suitability requirements, paragraph 35, page 25.
7 - ESMA final guidelines on MiFID II suitability requirements, supporting guideline 27, page 46.

**€143 B**

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