

# ESG changes to MiFID II product governance regime

## Speed read

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The European Commission has finalised its proposed ESG-related changes to MiFID II. These are intended to fit together with SFDR, and are part of a suite of ESG related changes being made via amends to AIFMD, the UCITS directive etc. However, the ESG changes to MiFID II apply more broadly than SFDR – with implications for MiFID investment firms and banks that manufacture and distribute MiFID products.

Overall, the changes are intended to put “sustainability considerations” at the heart of the EU financial system. They are also intended to “turbo charge” the European Commission’s efforts to redirect private capital into efforts to “green” the EU, plus avoid greenwashing. One strand of the changes being made is a requirement for relevant firms to incorporate certain ESG considerations into their product governance arrangements. **This briefing gives further detail on this new requirement and draft ESMA guidance.**

## How did we get here?

- **December 2016** – The EU Commission established a High-Level Expert Group (HLEG) to develop an EU strategy on sustainable finance.
  - **January 2018** – The HLEG published its final report with various recommendations, including the need to improve the contribution of finance to sustainable and inclusive growth, and strengthen financial stability by incorporating ESG factors into investment decision making. Another recommendation was that, as a routine component of financial advice, advisers should ask about/respond to investor preferences on sustainability.
  - In **June 2020**, the European Commission published draft changes to MiFID II to reflect ESG considerations, together with similar changes to AIFMD, the UCITS Directive, the IDD and Solvency II.
  - **10 March 2021** – A key plank of the EU’s reforms began to apply – the Sustainable Finance Disclosure Regulation (SFDR). This imposes new transparency and disclosure requirements on certain firms, to increase the focus on ESG risks and address the risk of “greenwashing”.
- But importantly, SFDR only applies to a very limited set of firms and products, eg:
- in scope – portfolio managers and investment advisers, fund managers, insurance advisers, and insurers (for certain products only).
  - not in scope – structured products, derivatives, securitisation vehicles, bonds, etc.
- On **21 April 2021**, the European Commission adopted the delegated regulation and directive. No significant changes were made to the drafts, despite industry push back.
  - On **2 August 2021**, the new law was published in final form in the Official Journal. For a copy, see [here](#).
  - On **8 July 2022**, ESMA issued a [consultation](#) with proposed updates to its existing product governance guidelines, including changes to deal with the new law referred to above. This consultation ends on 7 October 2022, and final guidelines are due in Q1 2023.

## What you need to know about the changes to the MiFID II product governance regime<sup>1</sup>

### What

<b>LEGISLATION</b>	Commission Delegated Directive (EU) 2021/1269 as regards the integration of sustainability factors into the product governance obligations
<b>AMENDMENTS</b>	Amended MiFID II – in particular, Delegated Directive (EU) 2017/593
<b>SOURCE</b>	For the new law, see <a href="#">here</a> . For a copy of the original law, marked up to show the changes made, see the Annex. Make sure you view this alongside the recitals to the new Delegated Directive, also set out in the Annex.

### When

22 November 2022 – ESG changes to MiFID II product governance regime come into force.<sup>2</sup>

### What market segments and scope

- **Professional vs retail** – The new rules apply to MiFID II firms generally, whether they manufacture/distribute for professional or retail.
  - **EU vs UK** – It is worth noting that there is currently no indication that the FCA will amend the UK version of MiFID II or PROD (its Product Intervention and Product Governance Sourcebook) to reflect the ESG requirements discussed in this bulletin.
- **Scope** – The ESG product governance related changes to MiFID II will have a broader scope than SFDR – eg:
    - **in scope** – all MiFID II firms in relation to all MiFID II product and services.
    - SFDR – **in scope** – portfolio managers and investment advisers, fund managers, insurance advisers, and insurers (for certain insurance products only); **not in scope** – structured products, derivatives, securitisation vehicles, bonds, etc.

<sup>1</sup> This bulletin focuses only on the product governance related changes to MiFID II – if you would like a copy of our bulletin on all the changes being made to MiFID II, let us know. In this bulletin, “firm” means a MiFID II investment firm or a bank that conducts relevant activities in scope of MiFID II.

<sup>2</sup> EU Member States will need to amend their national rules to implement these changes – the deadline for this is 21 August 2022, and the new rules are intended to apply from 22 November 2022.

## Product Governance – New requirements for manufacturers and distributors

### Summary:

There are a number of strands to the overall suite of ESG changes made to MiFID II, one being the consideration by MiFID II product manufacturers or distributors of sustainability factors and preferences in product governance arrangements.

The work required to implement these changes will likely build upon industry approaches adopted ahead of MiFID II implementation, e.g. the International Capital Market Association approaches for use in the syndicated/flow bond markets. Discussions are already progressing within a number of working group forums, particularly in the wholesale context, and proposals for a proportionate approach may be developed in line with requirements and expectations.

### Detailed overview

<b>Timing and impact</b>	<p>Affected firms will have to ensure they have updated their internal systems and controls and documents by 22 November 2022, when the relevant changes to MiFID II come into force. For manufacturers, it is not clear on the face of the new law whether existing products must be considered against the requirements of the new law, or whether these can be considered “grandfathered” in some way. Based on draft ESMA guidelines, the approach we would propose is as follows:</p> <ul style="list-style-type: none"><li>– products manufactured for the first time after 22 November 2022 – must be put through a process compliant with the new law;</li><li>– products manufactured on an ongoing basis before and after 22 November 2022 –the manufacturer should make any required updates to the target market analysis (if any), at minimum as part of its next product review cycle (if not before).</li><li>– products manufactured prior to 22 November 2022 and no longer available to new clients/end-clients – out of scope of the new requirements.</li></ul>
<b>Purpose of new law</b>	<p><b>We see two key goals here:</b></p> <ul style="list-style-type: none"><li>– <b>First, to support the European Commission’s efforts to reorient private capital flows into investments to help “green” the EU. Eg:</b> <i>“Proper implementation of the [EU’s climate change action] plan encourages investors’ demand for sustainable investments. It is therefore 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” (recital 4).</i></li><li>– <b>Secondly, to mitigate the risk of greenwashing. Eg:</b> <i>“It is necessary to address concerns about ‘greenwashing’, that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial instrument as environmentally friendly or sustainable, when in fact that financial instrument does not meet basic environmental or other sustainability-related standards” (recital 7 Commission Delegated Regulation (EU) 2021/1253).</i></li></ul>

<p><b>Key Concepts</b></p>	<p>The new law uses the term “sustainability factors”. This is defined by a cross reference to SFDR, where it is defined as follows: “sustainability factors’ mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters”<sup>3</sup></p> <p>In shorthand, we may think of this as essentially “ESG” – E (environment), S (social), G (governance). Beyond this, the new law uses various phrases to refer to clients with ESG requirements or preferences – eg “clients seeking financial instruments with a sustainability-related profile” and “clients with sustainability related objectives”. These should be understood as generic concepts referring to clients with some form of preference for ESG or ESG friendly products. It is therefore distinct from ESG classifications that are emerging under various EU legislation – eg:</p> <ul style="list-style-type: none"> <li>– an Article 8 or Article 9 product under SFDR;</li> <li>– in particular, a product with a sustainable investment objective under SFDR;</li> <li>– a product with an objective to make environmentally sustainable investments under the Taxonomy Regulation;</li> <li>– the concept of a “sustainability preference” under the new MiFID II regime.</li> </ul>
<p><b>What manufacturers have to do<sup>4</sup></b></p>	<p><b>Product approval, governance and oversight</b></p> <p>You must consider sustainability factors as follows:</p> <p><i>“Investment firms manufacturing ... financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile” (recital 5).</i></p> <p>In other words, if you are targeting clients or end-clients with any form of ESG preference (however positioned or framed), you must specifically cover ESG in:</p> <ul style="list-style-type: none"> <li>– your product approval process;</li> <li>– your product governance and oversight arrangements. This is presumably intended to address greenwashing risk.</li> </ul>
	<p><b>Target market</b> – When you identify the potential target market for a product and specify the types of client for whose needs, characteristics and objectives the product is compatible, you must include “any sustainability related objectives”.</p> <p>This must be done in a granular way. As per the recitals:</p> <p><i>“Considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed” (recital 6).</i></p> <p>Also, under the existing law, you need to determine whether a product meets the identified needs, characteristics and objectives of the target market, including by examining certain prescribed elements such as whether the product’s risk/reward profile is consistent with the target market. The new law requires you to now expressly consider an additional element, namely “[whether] the financial instrument’s sustainability factors, where relevant, are consistent with the target market”.</p>
	<p><b>No negative target market analysis</b> – Under the existing law, you need to identify any negative target market a product may have- ie any group of clients for whom the product is not compatible. The new law explicitly states that this need not be done where the product “considers sustainability factors”.</p> <p>The recitals also clarify as follows:</p> <p><i>“To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible” (recital 7).</i></p>

<sup>4</sup> Amendment to Article 9 of the MiFID Delegated Directive (2017/593) (product governance obligations for investment firms manufacturing financial instruments) and recitals 4-8 of Delegated Directive 2021/1269.



	<p><b>Information given to distributors</b> – You must present the sustainability factors of the product in a transparent manner and provide distributors with “<i>the relevant information to duly consider any sustainability related objectives of the client or potential client</i>”. The recitals also add as follows:</p> <p><i>“The sustainability factors of a financial instrument should be presented in a transparent manner to enable the distributor to provide the relevant information to its clients or potential clients” (recital 8).</i></p>
	<p><b>Periodic review</b> – When you periodically review the products you manufacture, you must consider if they remain consistent with the needs, characteristics and objectives, “<i>including any sustainability related objectives</i>”, of the target market.</p>
<p><b>What distributors have to do<sup>5</sup></b></p>	<p><b>Due diligence, governance and oversight arrangements</b></p> <p>As with manufacturers, you must consider sustainability factors as follows:</p> <p><i>“Investment firms ... distributing financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile” (recital 5).</i></p> <p>In other words, if you are offering or recommending products to clients with any form of ESG preference (however positioned or framed), you must specifically cover ESG in:</p> <ul style="list-style-type: none"> <li>– your due diligence and product approval process;</li> <li>– your product governance and oversight arrangements.</li> </ul> <p>As above, this is presumably intended to address greenwashing risk.</p>
	<p><b>Due diligence and mis-selling risk</b> – You must ensure you only offer or recommend products that do what they “say on the tin” from an ESG perspective. In particular:</p> <p><i>“investment firms [must] have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, <b>including any sustainability related objectives</b>, of an identified target market and that the intended distribution strategy is consistent with the identified target market” (emphasis added).</i></p>
	<p><b>Target market</b> – As with manufacturers, this must be set in a granular way. As per the recitals:</p> <p><i>“Considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed” (recital 6).</i></p>
	<p><b>No negative target market analysis</b> – Under the existing law, you need to identify any negative target market a product may have – ie any group of clients for whom the product is not compatible. The new law explicitly states that this need not be done where the product “<i>considers sustainability factors</i>”.</p> <p>The recitals also clarify as follows:</p> <p><i>“To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible” (recital 7).</i></p> <p>In our view, despite the wording of recital 7, appropriateness and the client’s best interest rules will still apply. A distributor will not be entitled to distribute a product with sustainability factors to any client regardless of risk.</p>
	<p><b>Periodic review</b> – When you periodically review the products you offer or recommend, you must consider if they remain consistent with the needs, characteristics and objectives, “<i>including any sustainability related objectives</i>”, of the target market.</p>

<sup>5</sup> Amendment to Article 10 of the MIFID Delegated Directive (2017/593) (product governance obligations for investment firms manufacturing financial instruments).

## Implementation steps

- Establish a working group to conduct relevant implementation work.
- For manufacturers
  - Form a view as regards the scope of the project and existing vs new products as discussed above; and
  - If existing products are considered out of scope:
    - Ensure your approach gives rise to no overarching TCF issues; and
    - Ensure your approach is clear/documented, with a documented supporting analysis and rationale.
  - If existing products are considered in scope:
    - Determine how you will define sustainability objectives and sustainability-related profiles;
    - Conduct an inventory of your MiFID II products to identify which of those products (if any) target clients or end-clients with sustainability objectives or a sustainability-related profile; and
    - Prepare a project plan to consider these against your updated policies and procedures (as below).
- For both manufacturers and distributors
  - Conduct a gap analysis of your existing product approval, due diligence, product governance and oversight policies, procedures, internal documents etc against the new requirements;
  - For any gaps, prepare a project plan to conduct any necessary work; and
  - In particular, update your policies and procedures:
    - to expressly require a consideration of sustainability factors;
    - to expressly require the new target market elements to be considered for relevant products;
    - to ensure these are developed in a way that would be considered sufficiently granular by regulators;
    - (for manufacturers that use third party distributors) to expressly require a consideration as to the information needs of distributors and end-clients and to include steps to ensure these are met;
    - (for distributors) to require appropriate due diligence is undertaken to gain comfort that the product will deliver “what it says on the tin” from an ESG perspective, as verified by the product documents provided;
    - add practical guidance on relevant issues to help staff;
    - to ensure the periodic review process expressly picks up ESG and ESG related target market considerations;
  - Consider any data needs, and if changes are required, what additional third party data may be required and how this may be sourced;
  - Consider if a regulator would be comfortable that key personnel have the right skill set, experience etc. If additional training, new hires etc are required, consider how this may be done and on what timeline;
  - Consider if existing wording in any distribution agreements/disclosure documents is sufficient or requires updating
  - Check if existing verification and record keeping processes are “fit for purpose” – if not, considering tightening these or adding new relevant requirements; and
  - Consider if additional awareness building or training is required, and if so, roll this out on an initial and ongoing basis. *Note: In relation to greenwashing risk in particular, this is recommended.*



## Relevant work by ESMA

### Consultation – new draft guidelines

On 8 July 2022, ESMA published a **consultation**<sup>6</sup> on proposed changes to its draft product governance guidelines.

This underlines the importance placed on product governance:

*“The product governance requirements introduced by MiFID II **have proved to be one of the most important elements of the MiFID II investor protection framework**, aiming at ensuring that financial instruments and structured deposits (“products”) are only manufactured and/or distributed when this is in the interest of clients”* (emphasis added).

As regards the ESG related changes to the framework, ESMA noted that: *“They are part of a broader Commission’s initiative on sustainable development and lay the foundation for an*

*EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe’s economy into a greener, more resilient and circular system in line with the European Green Deal objectives.”*

This consultation runs until October 2022, and is proving slightly controversial in that the industry will only see final guidelines in Q1 2023 – ie after the implementation deadline for the ESG changes to MiFID II. That said, however, the consultation focuses mainly on topics beyond ESG and offers less than a handful of paragraphs on point, including the following:

Proposed new guideline	A&O commentary
<p>[3.3.2 Guidelines for manufacturers ...]</p> <p>“20. Within the broad category of clients’ objectives and needs, the firm should also specify any sustainability-related objectives the product is compatible with. To ensure a sufficient level of granularity of the target market, when identifying sustainability-related objectives, firms may specify, where relevant, the following aspects (in line with the definition of “sustainability preferences” according to Article 2(7) of the MiFID II Delegated Regulation and as further detailed in the ESMA Guidelines on certain aspects of the MiFID II suitability requirements):</p> <ul style="list-style-type: none"> <li>– The minimum proportion of the product that is invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852; [ie the Taxonomy Regulation]</li> <li>– The minimum proportion of the product that is invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088; [ie SFDR]</li> <li>– Whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them;</li> <li>– Which principal adverse impacts (PAI) on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration. Firms could use the categories presented in the SFDR RTS (instead of an approach based on each PAI indicator) such as “emissions”, “energy performance”, “water &amp; waste”, etc.”</li> </ul>	<p>This draft guideline relates to the new requirement for MiFID II regulated manufacturers and distributors to specify, as part of their target market assessment, any sustainability related objectives the product is compatible with.</p> <p>There are three points to note here.</p> <p>(1) First, this paragraph suggests relevant firms may use the three limbs of the definition of “sustainability preferences” as a starting point, with a “catch all” fourth category being <i>“Whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them”</i>. It is likely that only this “catch all” category will be relevant to most MiFID II manufacturers on “day 1”, as:</p> <ul style="list-style-type: none"> <li>(a) the three limbs of the definition of “sustainability preferences” are relevant at present more to the funds industry; and</li> <li>(b) manufacturers of funds (ie AIFMs and UCITS managers) are outside the scope of the MiFID product governance regime.</li> </ul> <p>The most useful category is therefore the “catch all”, which is anything but granular.</p> <p>(2) In its commentary, ESMA states that: <i>“Even though the term ‘minimum proportion’ is derived from the SFDR and the Taxonomy Regulation ..., ESMA notes that in the MiFID context, it should be read in a broad sense (ie possibly also applying to products with sustainability factors that are not in scope of the SFDR and/or the Taxonomy Regulation).”</i></p> <p>This is probably a self-evident point, but in any case, has not found its way into the draft guidelines themselves.</p> <p>(3) ESMA notes that, <i>“when determining the potential target market, a manufacturer may specify sustainability-related objectives a product is compatible with by referring to the sustainability data ... of either i) the issuer of the product, or ii) the product itself (ie its underlying assets).”</i></p> <p>It asks for input on this, which should be useful – ie whether/when ESG related objectives can be satisfied at an entity level vs a product level.</p>

<sup>6</sup> See also **ESMA MiFID II product governance guidelines**

<p>Application of product governance requirements to the distribution of products that were manufactured before the date of application of MIFID II.</p> <p>“78. Products which were manufactured before 3 January 2018 and continue to be distributed to investors should fall within the scope of product governance requirements applicable to distributors, in particular, the requirement to identify a target market for any product. In this situation, the distributor should act as if the manufacturer was an entity not subject to MiFID II product governance requirements. When the target market has been identified by the manufacturer (on a voluntary basis/on the basis of commercial agreements with distributors) in line with these guidelines, the distributor, after reviewing it with a critical look, could rely on this target market identification.”</p> <p>NB: For completeness, the existing text of the guidelines: “79. However, a target market should be assigned by the manufacturer to such products, at the latest, following the next product review process cycle conducted according to Article 16(3) of MiFID II after 3 January 2018. The distributor should then consider this target market in its own review process.”</p>	<p>This guideline is not specific to ESG, but will assist firms in determining what they need to do in relation to legacy products.</p> <p>This supports our views on this subject as set out above, although should be kept under review as the guidelines are finalised.</p> <p>Our views on legacy products are also supported by the original guidelines, which relevantly read as follows:</p> <p>“64. Products manufactured and distributed before 3 January 2018 should not fall within the scope of the product governance requirements as defined by MiFID II.”<sup>7</sup></p>
<p>“3.3.4 Guidelines on issues applicable to both manufacturers and distributors</p> <p>Identification of the ‘negative’ target market and sales outside the positive target market ...”</p> <p>“81. For products which consider sustainability factors, firms are not required to identify a negative target market with respect to their sustainability-related objectives. This means that the sustainability-related objectives of such products only contribute to identifying a “positive” target market in terms of clients (groups of clients) with compatible sustainability preferences. The same products could still be distributed to clients falling outside that “positive” sustainability-related target market, provided that they are compatible with the features of the other target markets categories defined by these Guidelines [FN]. Hence, for products which consider sustainability factors, the firm should always perform a negative target market assessment with respect to the five target market categories (client type, knowledge and experience, financial situation, risk tolerance and objectives and needs), but should not consider the sustainability-related objectives of the products. This is to assess whether these other target market aspects might be incompatible with certain target market clients, for example, if the product that considers sustainability factors concerns a risky product intended for clients with a long-term investment horizon and willing and able to lose their investment amount (in which case the product would not be compatible with clients that would have a low risk tolerance).”</p>	<p>This guideline underlines the carve out for ESG related products from the usual requirements relating to negative target market.</p> <p>Put simply, the European Commission did not wish to put any dampener on the flow of private capital into such products.</p>

7 ESMA MiFID II product governance requirements

8 “41 Recital 7 of Delegated Directive (EU) 2021/1269 explains that “To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible.”



## Comments on current industry practice

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Also on 8 July 2022, ESMA **published** the results of its “2021 Common Supervisory Action (CSA) on MiFID II product governance requirements” This had considered a sample of relevant firms, comprising 214 firms across 26 jurisdictions. Firms may wish to have regard to the observations made, and areas for improvement identified, when implementing the new ESG requirements discussed above.

ESMA’s observations included the following:

- *“in some cases the definition of a target market appears to be approached as a formalistic exercise as it is done at an insufficiently granular level and with the use of unclearly defined terms”*; and
- *“the definition of a target market does not always translate into a compatible distribution strategy that enables the product to reach the identified target market”*.

It has **separately** stated that *“this exercise revealed that there was room for improvement in firms’ compliance with several aspects of the product governance requirements.”*

Areas identified by ESMA for improvement included the following:

- scenario analysis – with the suggestion that firms may not be properly using them to help identify a product’s target market;
- charging structure analysis (*“For example, it emerged that manufacturers’ procedures insufficiently describe how a product’s cost structure is evaluated to ensure compatibility with the product’s target market”*);
- product review (*“For example, it emerged that such reviews are not always performed frequently enough and with an adequate scope to verify if the financial instrument remains consistent with the needs, characteristics and objectives of the target market”*);
- exchange of information between manufacturers and distributors (*“For example, a significant number of firms provide reports to the product manufacturers only at the latter’s request and not on a proactive basis”*).

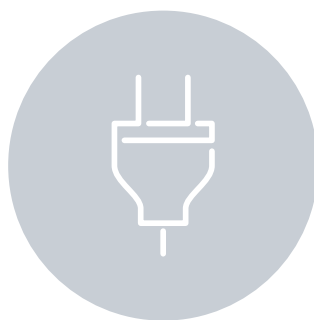
## Recommendations

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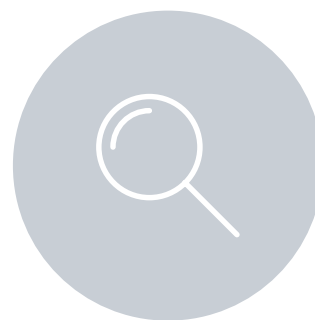
In terms of what firms should be doing now:



Get up to speed on the new requirements and establish an internal team to run your implementation project



Ensure you are “plugged in” to industry work on the new law



Undertake a preliminary gap analysis



In light of the outcome of the gap analysis, identify actions required to put in place the necessary internal systems

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.

## Annex

### **Key recitals to Commission Delegated Directive (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations**

- (3) In March 2018, the Commission published its Action Plan ‘Financing Sustainable Growth’ ..., setting up an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in the Action Plan is to reorient capital flows towards sustainable investments to achieve sustainable and inclusive growth.
- (4) Proper implementation of the Action plan encourages investors’ demand for sustainable investments. It is therefore 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
- (5) Investment firms manufacturing and distributing financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile.
- (6) Considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed.
- (7) To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible.
- (8) The sustainability factors of a financial instrument should be presented in a transparent manner to enable the distributor to provide the relevant information to its clients or potential clients.
- (9) Delegated Directive (EU) 2017/593 should therefore be amended accordingly.



# Blackline to show amendments to MiFID Delegated Directive (EU) 2017/593

## Article 1

Scope and definitions.

5. "sustainability factors" means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088 of the European Parliament and of the Council (\*1).<sup>9</sup>

(\*1) 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 (OJ L 317, 9.12.2019, p. 1)

## Article 9

Product governance obligations for investment firms manufacturing financial instruments

9. 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 for with whose needs, characteristics and objectives, including any sustainability preferences, the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for with whose needs, characteristics and objectives the financial instrument is not compatible, except where financial instruments consider sustainability factors.

11. Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:

(a) the financial instrument's risk/reward profile is consistent with the target market; ~~and~~

(b) the financial instrument's sustainability factors, where relevant, are consistent with the target market;

~~(b)~~ (c) 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.

13. Member States shall require investment firms to ensure that the provision of information about a financial instrument to distributors includes information about the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment and is of an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly.

The sustainability factors of the financial instrument shall be presented in a transparent manner and provide distributors with the relevant information to duly consider any sustainability related objectives of the client or potential client.

14. Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if whether the financial instrument remains consistent with the needs, characteristics and objectives, including any sustainability related objectives, of the target market and if it is ~~being~~ distributed to the target market, or is ~~reaching~~ reaches clients for with whose needs, characteristics and objectives the financial instrument is not compatible.

## Article 10

Product governance obligations for distributors

2. Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives including any sustainability related objectives, of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, investment firms shall identify any groups of clients with for whose needs, characteristics and objectives the product or service is not compatible except where financial instruments consider sustainability factors.

5. Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives, including any sustainability related objectives, of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.

<sup>9</sup> Clip from SFDR – Article 2 "(24) 'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters."



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