

XIV CONVEGNO ANNUALE
DELL' ASSOCIAZIONE ITALIANA DEI PROFESSORI UNIVERSITARI
DI DIRITTO COMMERCIALE "ORIZZONTI DEL DIRITTO COMMERCIALE"

***"IMPRESE, MERCATI E SOSTENIBILITÀ: NUOVE SFIDE PER IL DIRITTO
COMMERCIALE"***

Roma, 26-27 maggio 2023

ANDREA PERRONE
PROFESSORE ORDINARIO DI DIRITTO COMMERCIALE

ANDREA CARDANI
DOTTORANDO IN DIRITTO COMMERCIALE

Investment Services and the Risks of Sustainable Finance

SOMMARIO: 1. Investment Services Regulation after MiFID II. – 2. The Rise of Sustainability and the Role of Finance. – 3. Investment Services and ESG Regulatory Framework. – 4. Possible Consequences of the New Framework. – 5. The Risks of Sustainable Financial Instruments. – 5.1 The Risks of ESG-Output Investments. – 5.2 The Risks of ESG-Input Investments. – 6. The Problem of Investor Protection. – 7. Conclusion.

1. Investment Services Regulation after MiFID II

After the revolution ushered in by the adoption of Directive (EU) 2014/65 (hereinafter, 'MiFID II')¹, the relevant Level 2 legislation, and ESMA soft law², the rise of sustainable finance and crypto assets has

¹ Jean-Pierre Casey and Karel Lannoo, *The MiFID Revolution* (CUP 2009), 6 ff.

² With respect to the Level 2 legislation of MiFID II, see European Commission, 'Implementing and Delegated Acts – MiFID II', <https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/markets-financial-instruments-directive-ii_en>. For ESMA soft law, see ESMA, 'Guidelines, Recommendations and Technical Standards', <<https://www.esma.europa.eu/publications-and-data/guidelines-recommendations->

brought new challenges to investment services and their regulation. Investments that pursue environmental, social, and governance (hereinafter, 'ESG') goals or embody distributed ledger technologies and cryptography have introduced products, strategies, and risks that present investment services providers (hereinafter, 'ISPs') with innovative business models and organizational arrangements³. As a response, the European Union (hereinafter, 'EU') has adopted detailed action plans⁴ followed by a set of legislative measures, usually known as the Sustainable Finance Package⁵ and the Digital Finance Package⁶.

The Digital Finance Package, however, has only a minor impact on the investment services regime. The proposal of the European Commission (hereinafter, 'EC') for a regulation of market in crypto assets (hereinafter, 'MiCAR Proposal')⁷ is crystal-clear in stating that 'crypto assets that qualify as "financial instruments" as defined in Article 4(1), point (15), of MiFID II should remain regulated under the general existing Union legislation'⁸. Therefore, by regulating only investments in crypto assets that are not financial instruments (*i.e.*, in the EC terms, utility tokens, asset-referenced tokens, and electronic money tokens)⁹, the MiCAR Proposal falls outside the scope of investment services regulation. The chapters of the MiCAR Proposal that govern the provision of services mirror the MiFID II regime

and-technical-standards>. For an in-depth discussion, Niamh Moloney, *EU Securities and Financial Markets Regulation* (4rd ed, OUP 2023), 362 ff (forthcoming).

³ On the evolution of ESG investing, Iain McNeil and Irene-marié Esser, 'From a Financial to an Entity Model of ESG' (2022), 23 EBOR, 9 ff.; for an insight on crypto assets, Philipp Hacker and Chris Thomale, 'Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law' (2018), 15 ECFR, 645 ff.

⁴ European Commission, 'Action Plan: Financing Sustainable Growth' COM(2018) 97 final, and European Commission, 'FinTech Action plan: For a More Competitive and Innovative European Financial Sector' COM(2018) 109 final.

⁵ European Commission, 'Sustainable Finance', <https://finance.ec.europa.eu/sustainable-finance_en>.

⁶ European Commission, 'Communication on Digital Finance Package' (2020), <https://ec.europa.eu/info/publications/200924-digital-finance-proposals_en>, 1.

⁷ European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on Market in Crypto assets, and amending Directive (EU) 2019/1937' COM(2020) 593 final. For an early comment: Dirk A. Zetzsche, Filippo Annunziata, Douglas W. Arner, Ross P. Buckley, 'The Markets in Crypto-Assets Regulation (MICA) and the EU Digital Finance Strategy' (2020), EBI Working Paper Series 77/2020, 5 ff <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3725395#>.

⁸ Recital no. 6 MiCAR Proposal; see Article 2(2) MiCAR Proposal.

⁹ Recital no. 9 MiCAR Proposal.

on conduct-of-business rules¹⁰. Under this approach, however, the MiCAR Proposal does not pose a question about innovations in the investment services regime; rather, it raises only potential issues for investor protection to the extent the correspondence between the MiFID II and MiCAR rules is incomplete.

The Sustainable Finance Package affects the investment service regime to a much higher degree. Indeed, following the current hype over sustainable investments, the new provisions pervade crucial aspects of the MiFID II investor protection framework. At the same time, they appear problematic. While patently aimed at fostering sustainable finance, the new rules do not consider the risks that inherently affect sustainable financial instruments and, thus, raise the issue of whether investors are adequately protected from those risks.

This chapter addresses these issues and proceeds as follows. Section 2 describes the increasing emphasis on sustainability and the rationale for involving capital markets in the transition toward a sustainable economy. With a specific focus on the investment services regime, section 3 outlines the regulatory framework for sustainable finance and its fundamental goals. Section 4 highlights the political economy of the new investment services regime, while section 5 details the specific risks of ESG investments. Considering these risks, section 6 assesses the suitability of the current regime, suggesting further steps to improve investor protection. Section 7 concludes.

2. The Rise of Sustainability and the Role of Finance

The category of sustainability has become crucial in response to the negative externalities massively produced by the profit-oriented governance of corporations¹¹ and the financial expectations of institutional

¹⁰ This represents a regulatory strategy already adopted for the Directive (EU) 2016/97 on insurance distribution. On this point, Verlee Colaert, 'European Banking, Securities and Insurance Law: Cutting through Sectoral Lines?' (2015), 52 CML Rev, 1602 (noting that 'the EU legislature planned to mirror the MiFID conduct of business rules in a fully revised IMD II').

¹¹ John Armour, Luca Enriques and Thom Wetzer, 'Corporate Carbon Reduction Pledges: Beyond Greenwashing' (*Oxford Business Law Blog*, 2 July 2021), <www.law.ox.ac.uk/business-law-blog/blog/2021/07/corporate-carbon-reduction-pledges-beyond-greenwashing> (highlighting how 'business models that depend on the extraction and sale of fossil fuels involve profiting from the social costs that their activities generate'). In general terms, Dirk Schoenmaker and Willem Schramade, *Principles of*

shareholders¹². The United Nations (hereinafter, 'UN'), for its part, has made it a priority to enhance global sustainable development. The UN 2030 Agenda has encouraged firms 'to decouple economic growth from environmental degradation'¹³, 'upgrade infrastructure and retrofit industries to make them sustainable'¹⁴, and 'adopt sustainable practices'¹⁵. Furthermore, through the Paris Agreement¹⁶, the UN have required corporate governance to prioritise the transition towards a 'net-zero emission economy', *i.e.* an economy where greenhouse gas emissions by human activity are radically reduced.

Two basic strategies can be adopted to address the sustainability issue: a market mechanism and public intervention. While being a low-cost solution, a market-based approach features, however, unpredictable investment decisions, which may potentially not result in an adequate or timely capital allocation benefiting sustainable companies. Accordingly, it has become imperative for regulators to limit the adverse impact of economic activities by using appropriate legislative measures.

Internalizing social costs through direct regulation (e.g., emission standards) and carbon-pricing mechanisms (e.g., carbon tax, cap-and-trade schemes, and the elimination of fossil fuel subsidies)¹⁷ would affect corporate governance most effectively since firms would pay for their own activity. At the same time, multiple reasons may prevent the adoption of these measures¹⁸. Direct regulation and taxes result in clear distributional

Sustainable Finance (OUP 2019), 117 (stating that 'Business models and practices are important for sustainability, because social and environmental externalities are generated primarily in the corporate sector').

¹² In this regard, see Recital no. 2, Directive (EU) 2017/828: 'the current level of 'monitoring' of investee companies and engagement by institutional investors and asset managers is often inadequate and focuses too much on short-term returns, which may lead to suboptimal corporate governance and performance'. Among legal scholars, John C. Coffee Jr, 'The European Commission Considers 'Short-Termism' (And 'What Do You Mean By That?')' (*Oxford Business Law Blog*, 17 November 2020), <www.law.ox.ac.uk/business-law-blog/blog/2020/11/ec-corporate-governance-initiative-series-european-commission>.

¹³ UN, 'Transforming Our World: the 2030 Agenda for Sustainable Development' (2015), Goal 8.4, <www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E>.

¹⁴ UN (n 13), Goal 9.4.

¹⁵ UN (n 13), Goal 12.6.

¹⁶ UN, 'Paris Agreement' (2015), <<https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>>.

¹⁷ See Nicholas Stern, 'The Economics of Climate Change' (2008) 98(2) *American Economic Review*, 24-26 (showing different ways to price externalities).

¹⁸ Eswaran Somanathan and others, 'National and Sub-national Policies and Institutions', in Ottmar Edenhofer and others (eds.), *Climate Change 2014: Mitigation of Climate Change*.

consequences that could affect the actual viability of the relevant policy options¹⁹. Indeed, it is common for large corporations to exercise political influence ‘to undermine the efficacy of regulatory internalization’²⁰ and thus avoid the relevant effects on their profits. From a different perspective, ‘green’ policies may have the unintended effect of causing a reduction of firms’ competitiveness and, thus, increasing the risk of ‘carbon leakage’, *i.e.* the probability of economic production being relocated to other countries²¹.

The risk of a political failure for strategies based on regulation and taxes justifies the choice of the EU to emphasize ‘the contribution of finance to sustainable and inclusive growth’²². Indeed, a legal framework that nudges investments towards ESG-compliant activities creates an incentive for corporations to adopt sustainable policies, indirectly affecting their governance²³. In the words of the EC, policies should ‘reorient capital flows towards sustainable investment’, while ‘mainstreaming sustainability in risk management’ and ‘fostering transparency and long-termism’²⁴. By doing so, the EC has openly stated its goal to become the ‘global leader’²⁵ in the transition towards a net-zero economy.

Contribution of Working Group III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change (CUP 2014), 1159 ff.

¹⁹ Somanathan and others (n 18), 1159 (affirming that ‘policy may be driven by ... the distribution of costs rather than on considerations of pure efficiency’, thus hampering the adoption of carbon taxes). Implicitly, Sebastian Steuer and Tobias H. Tröger, ‘The Role of Disclosure in Green Finance’ (2021), ECGI Working Paper Series 604/2021, 2 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3908617> (noting that ‘a politically and fiscally quasi-neutral activation of market forces arguably avoids conflicts that arise from the distributional consequences of direct regulation and taxes’).

²⁰ Armour and Jeffrey N. Gordon, ‘Systemic Harms and Shareholder Value’ (2014) 6 J. Legal Anal., 38; see also Schoenmaker and Schramade (n 11), 78 (emphasizing that ‘there are strong forces to maintain the status quo, such as lobbying by incumbent companies against change in order to preserve the current value of their assets’). For corporate spending in political contributions, John C. Coates IV, ‘Corporate Politics, Governance, and Value Before and After *Citizens United*’ (2012), 9 Journal of Empirical Legal Studies, 657 ff.

²¹ European Commission, Delegated Decision (EU) 2019/708, Explanatory Memorandum, 1, n 1.

²² European Commission (n 4), Action Plan, 1. See Celine Tan, ‘Private Investments, Public Goods: Regulating Markets for Sustainable Development’ (2022), 23 EBOR, 246 (stating that ‘financial markets are viewed as critical intermediaries between capital and SDG financing needs’).

²³ With a specific focus on the nudging approach, Colaert, ‘The Changing Nature of Financial Regulation. Sustainable Finance as a New Policy Objective’ (2022), 27 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4087166>.

²⁴ European Commission, ‘Action Plan: Financing Sustainable Growth’ (n 4), 2.

²⁵ European Commission, ‘The European Green Deal’ COM(2019) 640 final, 20.

3. Investment Services and the ESG Regulatory Framework

The regulatory framework applicable to sustainable finance aims at balancing the need for allocating capital to sustainable activities with a high level of investor confidence.

3.1. As for the first goal, the amendments to the MiFID II investment services regime reorient investor choices towards sustainability objectives²⁶. To enhance investors' awareness²⁷ and empower those who 'would not raise [sustainable] preferences themselves'²⁸, Delegated Regulation (EU) 2021/1253 supplements the suitability assessments. In particular, ISPs are required to: (1) obtain from clients specific information to assess any sustainability preferences they may have as part of their investment objectives²⁹; (2) provide a description of the sustainability factors taken into account in the process of selecting financial instruments, where relevant³⁰; (3) abstain from recommending financial instruments that do not meet the clients' sustainability preferences, unless 'the client decides to adapt his or her sustainability preferences'³¹; (4) have in place adequate policies to ensure that they understand the nature, features, and risks of sustainable financial instruments³²; and (5) identify and mitigate any potential conflict of interest arising from the inclusion of a client's sustainability preferences³³.

Similarly, Delegated Directive (EU) 2021/1269 integrates sustainability factors into the product governance regime. Both manufacturers and distributors must consider sustainability factors when defining the relevant target market for their financial instruments, periodically reviewing whether the latter is consistent with the formers³⁴.

²⁶ European Commission, 'EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal' COM(2021) 188 final, 11.

²⁷ Delegated Regulation (EU) 2021/1253, Explanatory Memorandum, 4.

²⁸ Delegated Regulation (EU) 2021/1253, Explanatory Memorandum, 1.

²⁹ Article 54(2) Delegated Regulation (EU) 2017/565, as amended by the Delegated Regulation (EU) 2021/1253 (hereinafter, the 'MiFID II Delegated Regulation').

³⁰ Article 52(3) MiFID II Delegated Regulation.

³¹ Article 52(10) MiFID II Delegated Regulation.

³² Article 52(9) MiFID II Delegated Regulation.

³³ Article 33 MiFID II Delegated Regulation.

³⁴ Articles 9 and 10 Delegated Directive (EU) 2017/593, as amended by the Delegated Directive (EU) 2021/1269 (hereinafter, the 'MiFID II Delegated Directive').

In the case of sustainable financial instruments, manufacturers and distributors are exempted from identifying the ‘negative target market’, *i.e.* the group of clients for whom the financial instruments are incompatible³⁵. With a major departure from the ordinary product governance regime explicitly pursued by the EU lawmaker³⁶, sustainable financial instruments may, therefore, also be distributed to investors who do not have sustainability-related objectives.

3.2. The further goal of ensuring a high level of investor confidence in sustainable financial instruments is pursued through more general provisions aimed at (1) eliminating ‘greenwashing’, *i.e.* ‘the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met’³⁷; and (2) integrating sustainability risks into collective asset management to monitor their impact on financial performance³⁸.

In particular, Regulation (EU) 2020/852 (Taxonomy Regulation: hereinafter, ‘TR’)³⁹ provides a unified classification system for sustainable activities to help investors allocate capital towards economic activities that ‘contribut[e] substantially to one or more of the environmental objectives’, while not significantly harming other objectives⁴⁰. Furthermore, Regulation (EU) 2019/2088 (Sustainable Finance Disclosure Regulation: hereinafter,

³⁵ Articles 9(9) and 10(2), MiFID II Delegated Directive.

³⁶ See recital no. 7 Delegated Directive (EU) 2021/1269: ‘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.’

³⁷ Recital no. 11 Regulation (EU) 2020/852. In literature, Geneviève Helleringer, ‘EU vs Greenwashing: The Birth Pangs of Transparency, Comparability, Cooperation and Leadership’ (*Oxford Business Law Blog*, 5 July 2021), <www.law.ox.ac.uk/business-law-blog/blog/2021/07/eu-vs-greenwashing-birth-pangs-transparency-comparability-cooperation> (noting that ‘greenwashing could undermine low-carbon transition’).

³⁸ European Commission, ‘Action Plan: Financing Sustainable Growth’ (n 4), 8. In this perspective, see Delegated Directive (EU) 2021/1270 and Delegated Regulation (EU) 2021/1255 that, respectively, require asset managers of Undertakings for Collective Investments in Transferable Securities funds and asset managers of Alternative Investment Funds to adopt appropriate organisational structures in order to integrate sustainability risks and sustainability factors within their management.

³⁹ Taxonomy Regulation is further detailed in Delegated Regulation (EU) 2021/2139 and Delegated Regulation (EU) 2021/1278, in turn amended by Delegated Regulation (EU) 2022/1214.

⁴⁰ Article 3 TR. With respect to environmental objectives, see Article 9 TR.

‘SFDR’)⁴¹ classifies sustainable financial instruments according to their fitness to pursue ESG goals and requires asset managers and ISPs to disclose in pre-contractual information how they integrate sustainability risks and adverse impact on sustainability factors into their investment policies. Finally, Regulation (EU) 2019/2089 provides two benchmarks – EU Climate Transition Benchmarks and EU Paris-Aligned Benchmarks – that foster sustainable investment in the market for passive funds.

4. Possible Consequences of the New Framework

The new MiFID II rules reduce the traditional neutrality of the investment services regime and openly favor ESG investments.

Asking clients for sustainability preferences fosters considering sustainable financial instruments⁴². Although sustainable financial instruments are not regulated as a default option⁴³, and sustainability preferences are only one of the multiple elements relevant to identifying investment objectives⁴⁴, asking customers for sustainability preferences is bound to increase the demand for sustainable financial instruments⁴⁵.

By the same token, allowing clients to adapt their sustainability preferences when the relevant financial instrument does not meet their initial sustainability preferences⁴⁶ might justify ISPs modifying the client’s profile to pass the suitability test. In turn, this dramatic innovation to the ordinary regime could pave the road for indiscriminate dissemination, if not misselling, of sustainable financial instruments, especially when the supply of ESG financial instruments is limited in number and variety⁴⁷. ESMA soft law further strengthens this conclusion. Indeed, the most recent ESMA guidelines on MiFID II suitability requirements (hereinafter, “ESMA

⁴¹ SFDR is further elaborated by Delegated Regulation (EU) 2022/1288 (‘SFDR Delegated Regulation’).

⁴² See Veerle Colaert, ‘Integrating Sustainable Finance into the MiFID II and IDD Investor Protection Frameworks’, in Danny Busch, Guido Ferrarini and Seraina Grünwald (eds.), *Sustainable Finance in Europe* (Palgrave MacMillan 2021), 473.

⁴³ Colaert, (n 42), 461.

⁴⁴ Article 54(5) MiFID II Delegated Regulation.

⁴⁵ See European Commission (n 26), 11.

⁴⁶ Article 54(10) MiFID II Delegated Regulation.

⁴⁷ Securities and Market Stakeholder Group, ‘MSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements’ (May 2022), ESMA22-106-4032, 9 (noting ‘an inverse correlation between the incidence of amended sustainability preferences ... and the number and variety of sustainable investment products on offer in the market’).

Guidelines on Suitability Requirements”)⁴⁸ allow ISPs to ‘recommend products both with and without sustainability-related features’ when ‘a client does not answer the question whether it has sustainability preferences or answers “no”⁴⁹.’

Similar arguments apply to product governance rules. By asking intermediaries to include sustainability factors in their product approval process, the new regime forces ISPs and asset managers to take a stand on sustainable investments. In a cultural and market context that strongly promotes green investments, manufacturing and distributing financial instruments whose target market is adverse or even neutral to ESG may come with high reputational costs. Avoiding such reputational costs is, thus, a further incentive for intermediaries to manufacture and distribute sustainable financial instruments. The most apparent evidence of the regulatory favor for the distribution of ESG investments is, however, the provision that exempts manufacturers and distributors from identifying the negative target market in the product governance process of sustainable financial instruments. Indeed, removing the negative target market makes it possible to disseminate sustainable financial instruments to all investors, thus promoting and enlarging the distribution market.

5. The Risks of Sustainable Financial Instruments

The EU open favor for ESG investments is problematic. Indeed, sustainable financial instruments present specific risks, which by fostering sustainable investments the EU regulatory strategies both overlook and increase. Analyzing these risks helps in understanding some implications of the new regime and assessing its overall impact.

To this end, the risks related to sustainable financial instruments can be distinguished by considering whether ESG factors are integrated into investments as an output (hereinafter, “ESG-Output Investments”) or an input (hereinafter, “ESG-Input Investments”). ESG-Output Investments allocate resources for an environmental, social, or governance objective (e.g., shares, bonds, or units of a mutual fund aimed at financing companies operating in the geothermal energy sector). Under the SFDR framework, ESG-Output Investments correspond to financial instruments that either

⁴⁸ ESMA, ‘Guidelines on certain aspects of the MiFID II suitability requirements’ (September 2022), Final Report, ESMA35-43-3172.

⁴⁹ ESMA, (n 48), n. 85.

have sustainable investment objectives⁵⁰ or promote, ‘among other characteristics, environmental or social characteristics’⁵¹.

ESG-Input Investments consider the risks associated with sustainability. The risks associated with sustainability are physical risk and transition risk⁵². Physical risk comprises natural events (e.g., climate change) that may have ‘financial implications for organizations, such as direct damage to assets and indirect impacts from supply chain disruption’⁵³. Transition risk includes significant policy, legal, technology, and market adjustments addressing climate change, which may pose financial and reputational risks for companies in proportion to the nature and speed of this transition. ESG-Input Investments consider physical and transition risk to mitigate them and thus improve their risk-adjusted return⁵⁴ (e.g., units of a mutual fund that excludes from its asset allocation fossil fuel-related activities expecting a decrease of the relevant return

⁵⁰ Article 9 SFDR.

⁵¹ Article 8 SFDR. According to EC, ‘Question-related to 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 (Sustainable Finance Disclosure Regulation 2019/2088)’, (July 2021), Ref. Ares(2021)4556843, 7: ‘Article 8 of Regulation (EU) 2019/2088 lays down transparency rules for financial products that have a sustainability-related ambition lower than the ambition of financial products subject to Article 9’.

⁵² Task Force on Climate-related Financial Disclosure, ‘Recommendations of the Task Force on Climate-related Financial Disclosure’ (2017), Final Report, 5 f <www.fsb-tcfd.org/publications/>; see also European Central Bank, ‘Guide on climate-related and environmental risks’ (2020), 10 <www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr201127~5642b6e68d.en.html>. In literature, Seraina Grünewald, ‘Climate Change as a Systemic Risk in Finance: Are Macroprudential Authorities Up to the Task?’, in D. Busch, G. Ferrarini, S. Grünewald (eds.), *Sustainable Finance in Europe*, (Palgrave Macmillan 2021), 229; Stefano Battiston and Irene Monasterolo, ‘The Climate Spread of Corporate and Sovereign Bonds’ (2020), 4 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3376218.

⁵³ Task Force on Climate-related Financial Disclosure (n 52), 6.

⁵⁴ See Mats Andersson, Patrick Bolton, and Frederic Samama, ‘Hedging Climate Risk’ (2016), 72(3) *Financial Analysts Journal*, 15 (noting that sustainable investments, such as decarbonized indexes, are bound to outperform the benchmark ‘from the day CO2 emissions are priced meaningfully and consistently and limits on CO2 emissions are introduced’). With respect to institutional investors’ engagement as a strategy for mitigating ESG risks at a portfolio level, Jeffrey N. Gordon, ‘Systematic Stewardship’ (2021), ECGI Working Paper Series 566/2021, 3 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814>; Condon, ‘Externalities and the Common Owner’ (2020), 95 *Wash. L. Review*, 17 ff. In general terms, see Cyrus Taraporevala, ‘CEO’s Letter on our 2020 Proxy Voting Agenda’ (2020), <www.ssga.com/us/en/institutional/ic/insights/informing-better-decisions-with-esg> (stating that ESG is ‘a matter of value, not values’).

determined by the transition toward a net-zero economy). Therefore, in ESG-Input Investments, sustainability is not the necessary goal of the investment; rather, ESG factors only matter as a possible driver of risks to mitigate in order to achieve higher financial profits. Under the SFDR framework, ESG-Output Investments correspond to financial instruments where ‘sustainability risks are integrated’ into the relevant investment decision⁵⁵.

5.1 *The Risks of ESG-Output Investments*

ESG-Output Investments come with the risk of being fundamentally unfit to meet investors’ preferences. This risk of radical unfitness depends on two reasons.

First, ESG-Output Investments suffer from a severe measurement problem, thus preventing an effective assessment of whether the investment reached the sustainability objective it aimed at pursuing⁵⁶. As foreshadowed by the same EU lawmaker⁵⁷, ‘it is difficult to measure the ESG orientation of a mutual fund’⁵⁸. Operationally, the ‘fluidity of the ESG rubric means that assessment and application of ESG factors will be highly subjective’⁵⁹, entangling to establish strong causal links⁶⁰. Methodologically, ‘the metrics for sustainable outcome evaluation remains

⁵⁵ Article 6 SFDR.

⁵⁶ Along the same lines, Paul Brest, Ronald J. Gilson, and Mark A. Wolfson, ‘How Investors Can (and Can’t) Create Social Value’ (2018), ECGI Working Paper Series 394/2018, 5 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3150347> (noting that the market in socially-motivated investments reflects ‘marketing strategies rather than measurable results’).

⁵⁷ See Article 19(1)(b), SFDR (providing that in evaluating the application of the SFDR the Commission shall consider ‘whether the functioning of this regulation is inhibited by the lack of data of their suboptimal quality’).

⁵⁸ Quinn Curtis, Jill E. Fisch, and Adriana Z. Robertson, ‘Do ESG Mutual Funds Deliver on Their Promises?’ (2021), ECGI Working Paper Series 586/2021, 16.

⁵⁹ Max M. Schanzenbach and Robert H. Sitkoff, ‘Reconciling Fiduciary Duties and Social Conscience: The Law and Economics of ESG Investing by a Trustee’ (2020), 72 Stanford Law Review, 433. Similarly, Paul Brest, Ronald J. Gilson, and Mark A. Wolfson (n 56), 24 (emphasizing the ‘breadth and vagueness of the factors as a whole’).

⁶⁰ Kai Hockerts and others, ‘Defining and Conceptualizing Impact Investing: Attractive Nuisance or Catalyst?’ (2022), 179 Journal of Business Ethics, 945 (noting the ‘difficulties to prove strong causal outcome relationships’). See also Dirk A. Zetzsche and Linn Anker-Sørensen, ‘Regulating Sustainable Finance in the Dark’ (2022), 23 EBOR, 66 [in terms of ‘lack of broadly acknowledged theoretical insights (typically laid down in standard models) into the co-relation and causation of sustainability factors with financial data’].

an open field'⁶¹: on the one hand, private sector agents have weak incentives to develop metrics that deviate from models considering only financial features⁶²; on the other hand, the proliferation of reporting standards and sustainability ratings hinders the creation of a common and homogeneous ESG assessment framework⁶³.

Second, the 'doing well by doing good' hypothesis underlying ESG-Output Investments⁶⁴ may fail the reality check, thus thwarting the investor's expectation of associating sustainability and financial return. Consider, for example, economic activities that generate carbon emissions ('brown activities') 'for which there is no technologically and economically feasible low-carbon alternative'⁶⁵ ('green activities'). In this case, a stable core of brown activities might persist and remain dominant despite the transition to low-carbon activities. Thus, a product aimed at financing green activities (1) might be opposed to the market trend and, therefore, less profitable or (2) could become profitable only with stable public funding⁶⁶,

⁶¹ Iris H-Y Chiu, 'The EU Sustainable Finance Agenda: Developing Governance for Double Materiality in Sustainability Metrics' (2022), 23 EBOR, 96.

⁶² Chiu (n 61), 102.

⁶³ Florian Berg, Julian F. Koelbel, and Roberto Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings' (2020), 31 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533, (noting that 'measurement divergence is problematic ... if one accepts the view that ESG ratings should ultimately be based on objective observations that can be ascertained'); Colin Myers and Jason J. Czarnezki, 'Sustainable Business Law? The Key Role of Corporate Governance and Finance' (2022), 51 Environmental Law, 1022, n 226 (noting that 'because organizations target different audiences and use different standards and frameworks, it is difficult for investors to compare information provided by different companies').

⁶⁴ With respect to the 'doing well by doing good' hypothesis, see Larry Fink, 'Purpose and Profit' (*Harv. L. School Forum on Corporate Governance*, 23 January 2019), <<https://corpgov.law.harvard.edu/2019/01/23/purpose-profit/>> (stating that 'purpose is not the sole pursuit of profits but the animating force for achieving them'); Schoenmaker and Schramade (n 11), 189 (stating that it is possible to develop an investment approach that 'realize companies' social and environmental value in tandem with their financial value'); Robert G. Eccles and Svetlana Klimenko, 'The Investor Revolution' (*Harvard Business Review*, 2019), <<https://hbr.org/2019/05/the-investor-revolution>>.

⁶⁵ Article 10(2) Taxonomy Regulation. See also International Energy Agency, 'Coal 2021. Analysis and Forecast to 2024' (2021), <www.iea.org/reports/coal-2021> (stating that 'For most industrial purposes where coal is used, such as iron and steel production, there are not many technologies that can replace it in the short term').

⁶⁶ Christian Gollier, 'Fighting Climate Change and the Social Cost of Carbon', in Arezki and others (eds.), *Coping with Climate Crisis* (Columbia UP 2018), 62 (noting that 'western countries have made some attempts at reducing GHG emissions, notably through direct subsidization of green technologies: generous feed-in electricity tariffs for solar and wind energy, bonus-malus systems favoring low-emission cars, subsidies to the biofuel

which is, however, also subject to risks arising from the political and economic context. The limited success of mutual funds that directly pursue sustainable objectives⁶⁷ as well as short selling by hedge funds with respect to wind energy stocks⁶⁸ might confirm this conclusion. Moreover, ESG-Output Investments might feature a paradoxical financial effect. ESG investments allow ESG-compliant companies to reduce their cost of capital⁶⁹. However, lower cost of capital entails higher stock prices for green activities and, simultaneously, lower stocks prices for brown activities, thus giving sustainability-neutral investors an attractive market opportunity: on the one hand, selling green assets to achieve higher returns; on the other hand, buying brown assets to benefit from the discounted price⁷⁰. Because this arbitrage process would continue until the prices of the two assets were identical, any price impact based on the green-motivated trading would be eliminated, thus neutralizing any green value added⁷¹. More radically, the discounted price of brown assets could be a benefit *per se*. Indeed, hedge funds have achieved significant returns by exploiting a market situation oriented towards disinvesting from brown companies⁷². Shifting to an empirical perspective does not alter this conclusion. The difficulties to demonstrate causal links and extremely polarised evidence⁷³ question the reliability of empirical studies demonstrating the ‘doing well by doing good’ hypothesis.

industry’); Somanathan and others (n 18), 1155 (stating that ‘subsidies to low GHG products or technologies have been applied to by a number of countries but ... they demand public funds’).

⁶⁷ Morningstar, ‘SFDR Article 8 and 9 Funds: Q4 2022 in Review’ (2022), 5 <www.morningstar.com/en-uk/lp/sfdr-article8-article9>.

⁶⁸ Fletcher, ‘Hedge Fund Short Sellers Take Aim at Green Energy Stocks’ *Financial Times* (26 January 2022), <www.ft.com/content/05d218ea-982b-4e95-add1-26550316b2f0>.

⁶⁹ Brest, Gilson, and Wolfson (n 56), 11.

⁷⁰ Brest, Gilson, and Wolfson (n 56), 14.

⁷¹ Brest, Gilson, and Wolfson (n 56), 14.

⁷² Laurence Fletcher and Derek Brower, ‘Hedge Funds Cash in as Green Investors Dump Energy Stocks’ *Financial Times* (7 October 2021), <www.ft.com/content/ed11c971-be02-47dc-875b-90762b35080e>.

⁷³ George Serafeim, ‘ESG Hyperboles and Reality’ (2021), Harvard Business School Working Paper Series no. 22-031, 2 <www.hbs.edu/faculty/Pages/item.aspx?num=61452> (noting that ‘extreme polarized views can be found about the performance implications from ESG and about the usefulness of ESG evaluations and assessments’); see also Alex Edmans, ‘Is Sustainable Investing Really a Dangerous Placebo?’ (*Oxford Business Law Review*, 3 November 2021), <www.law.ox.ac.uk/business-law-blog/blog/2021/11/sustainable-investing-really-dangerous-placebo>.

The risk that ESG-Output Investments be unfit to meet investment expectations significantly impacts the new EU legal framework on sustainable finance. Financial instruments that allow ESG-Output Investments and thus meet the investor's sustainability preferences⁷⁴ might either be unclear whether they reached their sustainability objective or determine a lower financial return for investors. Adding sustainability preferences to the suitability assessment and thus favoring ESG-Output Investments⁷⁵ or exempting from identifying the negative target market and thus increasing the manufacturing and distribution of ESG-Output Investments⁷⁶, concentrate and increase these risks.

5.2 The Risks of ESG-Input Investments

While different in their details, similar arguments also apply to ESG-Input Investments.

Measuring physical risk in ESG-Input Investments is as difficult as determining the ESG orientation of ESG-Output Investments. Consider, for example, climate risk. Lack of data⁷⁷, obsolete risk assessment methodologies, and inadequate time horizon frameworks⁷⁸ result in a huge divergence of findings, thus frustrating precise pricing of climate risk. As a consequence, it might be difficult to determine the effective degree to which

⁷⁴ Article 2(7) MiFID II Delegated Regulation distinguishing: (a) 'financial instruments that pursue a minimum proportion of sustainable investments in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation'; (b) 'financial instruments that pursue a minimum proportion of sustainable investments, as defined in Article 2, point (17), of the SFDR, where the minimum proportion is determined by the client or potential client'; and (c) 'financial instruments that consider principal adverse impacts on sustainability factors, where elements demonstrating that consideration are determined by the client or potential client'. See also Delegated Regulation (EU) 2021/1253, Explanatory Memorandum, 2.

⁷⁵ Article 54(2) MiFID II Delegated Regulation; see above n. 4.

⁷⁶ Articles 9(9) and 10(2), MiFID II Delegated Directive; see above n. 4.

⁷⁷ Madison Condon, 'Market Myopia's Climate Bubble' (2022), 2022(1) Utah Law Review, 66 (noting that 'Shareholders and analysts currently lack the fine-grained asset-level data they need in order to make climate-risk assessments').

⁷⁸ European Banking Authority, 'Report on Management and Supervision of ESG Risks for Credit Institutions and Investment Firms' (2021), EBA/REP/2021/18, 51 (in terms of 'time-horizon mismatch between traditional management tools and the timeframe for the materialisation of ESG risks'). In general terms, see Mark Carney, 'Breaking the Tragedy of the Horizon - Climate Change and Financial Stability' (Lloyd's of London, London, September 2015), 3 <www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability> (stressing that 'the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors').

sustainability risk is priced in financial instruments⁷⁹: it may be overpriced, thus generating a ‘market bubble’, or it could be underpriced, making the relevant investment very attractive.

A deeper and fundamental uncertainty results from transition risk. It is unanimously agreed that markets must still address ‘a highly uncertain environment regarding the speed and timing of the transition to a low-carbon economy’⁸⁰. Indeed, two main obstacles may hinder the evolution from brown to green activities. First, climate change raises ‘a collective action problem requiring a coordinated, global governmental response’⁸¹. Many hurdles, however, undermine this response. In general, governmental choices about public funding may counteract or significantly delay the transition process, especially in the case of geopolitical tensions and war scenarios. More specifically, carbon-intensive sector shutdowns may deter oil-rich countries from effective cooperation⁸². In turn, interest groups can alter the agreed pathway for transition, as demonstrated by nuclear energy recently being considered sustainable by the EU⁸³. Second,

⁷⁹ Network for Greening the Financial System, ‘A Call for Action: Climate Change as a Source of Financial Risk’ (2019), 2 <www.greenfinanceplatform.org/research/call-action-climate-change-source-financial-risk> (noting that ‘there is a strong risk that climate-related financial risks are not fully reflected in asset valuations’). For empirical evidence of mispricing, Harrison Hong, Frank W. Li, and Jiangmin Xu, ‘Climate Risks and Market Efficiency’ (2019), 208 *Journal of Econometrics*, 265 ff.

⁸⁰ Advisory Scientific Committee of the European Systemic Risk Board, ‘Too Late, Too Sudden: Transition to a Low-Carbon Economy and Systemic Risk’ (2016) Report 6/2016, 4 <www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf?ea575bbcd2dd43eceb4545ea146f9710>. See also Thierry Déau and Julien Touati, ‘Financing Sustainable Infrastructure’, in Arezki and others (eds.), *Coping with Climate Crisis* (Columbia UP 2018), 171 (stressing that ‘we are entering an era of political uncertainty, marked by radical changes in political orientations, including with respect to the environment’).

⁸¹ Paul G. Mahoney and Julia D. Mahoney, ‘The New Separation of Ownership and Control: Institutional Investors and ESG’ (2022), 2021(2) *Colum. B. L. Rev.* 855; see also Joint Committee of the European Supervisory Authorities, ‘Subject: Public Consultation on a Renewed Sustainable Finance Strategy’ (2020), <www.esma.europa.eu/sites/default/files/library/2020_07_15_esas_letter_to_evp_dombrovskis_re_sustainable_finance_consultation.pdf> (noting that ‘both financial markets and sustainability challenges are by their nature global, and global approaches must therefore be sought’).

⁸² Gollier (n 66), 60 (noting that these shutdowns may ‘shed some light on the difficulties of reaching an international agreement involving oil-rich countries’).

⁸³ See Delegated Regulation (EU) 2022/1214 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities.

any action against climate change comes with additional risks⁸⁴. Policies aimed at limiting fossil fuel may dramatically increase carbon-intensive stranded assets, thus altering relevant market values and ultimately harming financial stability⁸⁵. Similarly, until the supply of renewable energy can meet consumer demand, ‘a rapid transition could result in constrained energy supply’⁸⁶ and the higher costs of production will be reflected in increased and more volatile energy prices, as was recognized by the European Commission’s EURepower Plan⁸⁷. Consequently, long-term benefits and short-term costs⁸⁸ may induce people to stop supporting transition policies and undermine the overall transition. In this context, ESG-Input Investments may seriously underperform ‘as long as climate mitigation policies are postponed and market expectations about their introduction are low’⁸⁹. Nor is it surprising that in 2021 the financial instruments of brown companies achieved higher returns than those issued by green companies⁹⁰.

⁸⁴ Advisory Scientific Committee of the European Systemic Risk Board (n 80), 4 ff.

⁸⁵ European Commission, ‘Strategy for Financing the Transition to a Sustainable Economy’ COM(2021) 390 final, 1 (noting that ‘Investment in unsustainable activities and assets are increasingly likely to become stranded, as climate and environmental challenges become ever more material’ and, thus, ‘the insufficient integration of these risks hampers reallocation of resources and risks leading to disruptive readjustments in the future, with implications for financial stability’); Stefano Battiston and others, ‘A Climate Stress-Test of the Financial System’ (2017), 7 *Natural Climate Change*, 287 (finding that ‘given the large direct and indirect exposures of financial actors to climate-policy-relevant sectors, [climate policies] might entail a systemic risk because price adjustments are abrupt and portfolio losses from the fossil-fuel sector and fossil-based utilities do not have the time to be compensated by the increase in value of renewable-based utilities’); Nathan De Arriba-Sellier, ‘Turning Gold into Green: Green Finance in the mandate of European Financial Supervision’ (2021), 58 *CML Rev*, 1135 (stating that ‘the current economic and climate trends orientate the world towards a late and sudden transition or a hothouse planet’, thus placing ‘financial stability significantly at risk’). In the regulation, see Recital no. 8, Regulation (EU) 2019/2175 (stating, in particular, that ‘The ESAs should play an important role in identifying and reporting risks that environmental, social and governance related factors pose to financial stability’).

⁸⁶ Advisory Scientific Committee of the European Systemic Risk Board (n 80), 10.

⁸⁷ European Commission, ‘REPowerEU Plan’, COM(2022) 230 final, 12 (stating that ‘the fast decoupling from Russian energy imports can lead to higher and more volatile energy prices’).

⁸⁸ Gollier (n 66), 60 (observing that ‘climate mitigation is a long-term investment’).

⁸⁹ Andersson, Bolton, and Samama, (n 54), 14.

⁹⁰ Patrick Temple-West and Kristen Talman, ‘ESG Shares Underperform Oil and Gas in 2021’ *Financial Times* (London, 30 December 2021), <www.ft.com/content/70984a9e-ab65-4905-a2fa-83202e3db68b>.

In light of the above, the MiFID II Delegated Directive product governance rules that exempt from identifying the negative target market and thus increases the manufacturing and distribution of ESG-Input Investments⁹¹ amplifies the impact of the relevant risks.

6. *The Problem of Investor Protection*

Investment services regulation provides several normative strategies to manage investment risks and ensure investor protection. Under the MiFID II framework, the suitability assessment is the most far-reaching safeguard governing the relationship between ISPs and clients, applying both at the point of sale and during the entire life cycle of the relevant financial instrument through the product governance regime. However, the suitability test might be reduced when the client expresses sustainability preferences. Indeed, sustainability objectives may be opposed to monetary goals, thus granting broad discretion in deciding which investment objectives are more suitable to the client's preferences.

To limit this discretion, the EU regulator has established a two-step process where ISPs can identify the financial instrument that fulfills the client's sustainability preferences only within a range of financial instruments identified as suitable under monetary objectives. According to Delegated Regulation (EU) 2021/1253 recitals, ISPs should 'first assess a client's or potential client's other investment objectives, time horizon and individual circumstances, before asking for his or her potential sustainability preferences'⁹². Following this approach, the guidelines issued by ESMA confirm that the 'sustainability preferences should only be addressed once the suitability has been assessed in accordance with the criteria of knowledge and experience, financial situation and investments objectives'⁹³. A similar provision applies to product governance. Indeed, the exemption from establishing a negative target market for sustainable financial instruments⁹⁴ cannot prevent intermediaries from performing 'a negative target market assessment with respect to the five target market

⁹¹ Articles 9(9) and 10(2) MiFID II Delegated Directive; *see above* n. 4.

⁹² Recital no. 5 Delegated Regulation (EU) 2021/1253.

⁹³ ESMA (n 48), n. 81.

⁹⁴ *See above* n. 3.1.

categories (client type, knowledge and experience, financial situation, risk tolerance and objectives and needs)’⁹⁵.

While helpful in clarifying the priority of financial objectives, the protection offered by ESMA guidelines might be lower than expected. As we have shown⁹⁶, sustainability could be decoupled from financial profit, therefore determining a lower financial return for investors. For this reason, the priority of financial goals can be assured only when the risks of sustainable financial instruments are well identified and measured, thus allowing an assessment of their impact on the investor’s financial objectives. Instead, when this assessment is lacking and sustainable investments are considered financially neutral, the two-step process provided by the ESMA guidelines misses its goal. Suitable financial instruments according to the investor’s financial objectives (e.g., bonds or units of a balanced mutual fund) might become unsuitable when their sustainable ‘companion’ (e.g., sustainable bonds or units of a sustainable balanced mutual fund) involve specific risks that impact their financial return.

In light of the above, effective investor protection requires considering the specific risks of sustainable investments. To this end, some help may come from the general provision on suitability assessment that requires ISPs to ‘have in place adequate policies and procedures to ensure that they understand’ the nature, features, and risks of the financial instruments ‘selected for their clients, including any sustainability factors’⁹⁷. In considering the risk factors of each investment product, these policies and procedures could focus on the specific risks of sustainable investments, in particular by taking into account the adverse market conditions and regulatory developments related to sustainable investments⁹⁸. For example, ISPs policies and procedures could consider the market trends determined by the persistence of brown activities despite the transition to low-carbon activities or risks connected with the public funding of green activities⁹⁹. Similarly, both physical and transition risk¹⁰⁰

⁹⁵ ESMA, ‘Guidelines on MiFID II product governance requirements’ (March 2023), Final Report, ESMA35-43-3448, n. 81.

⁹⁶ See above n. 5.1.

⁹⁷ Article 54(9) MiFID II Delegated Regulation.

⁹⁸ ‘Adverse market conditions’ and ‘regulatory developments’ are criteria to be adopted by manufacturers and distributors when reviewing the consistency of products with target market. See ESMA (n 95), n. 68.

⁹⁹ See above n. 5.1.

¹⁰⁰ See above n. 5.2.

could be taken into account. Moreover, to assess the impact of these risks on clients' portfolios and their risk tolerance, ISPs policies and procedures could also consider how the relevant financial instrument integrates sustainability factors (e.g., which proportion of sustainable financial instruments are included in a mutual fund) and how the client's portfolio is diversified. Indeed, the more sustainability factors are incorporated in the financial instruments and the lower the portfolio diversifies sustainable investments, the higher the risk associated with sustainable investment decisions.

A similar approach could be taken by both manufacturers and distributors in identifying the target market of sustainable financial instruments. Because the risks related to sustainable investments impact the risk and reward profile, both manufacturers and distributors could consider these risks in determining whether a sustainable financial instrument is consistent with the relevant target market. This strategy is critical when financial instruments are distributed without investment advice (e.g., through platforms) and, thus, without assessing suitability. In this case, investors' protection against the risks of sustainable investments fundamentally relies on disclosure, which, in turn, is a weak safeguard, considering the cost of processing information and investors' cognitive limitations¹⁰¹. Moreover, no additional protection stems from the disclosure obligations outlined in the SFDR. Rather than warning about the risks of sustainable financial instruments, the SFDR's provisions seem more oriented toward preventing greenwashing. Take, for example, the provision about exclusion strategies (*i.e.*, the strategies adopted by asset managers excluding investments that do not comply with environmental or social criteria). Under the relevant delegated act, financial participants are required to 'confirm any commitment in terms of excluded investments'¹⁰²; instead, no disclosure is provided for the lower diversification resulting from the exclusion of investments not complying with sustainability

¹⁰¹ Omri Ben-Shahar and Carl E. Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton UP 2014), 55 ff.; Ben-Shahar and Schneider, 'The Failure of Mandated Disclosure' (2011) 159 U. Pa. L. Rev., 647 ff.; Homer Kripke, 'The myth of the informed layman' (1973) 28 The Business Lawyer, 631 ff.

¹⁰² Recital no. 16 SFDR Delegated Regulation.

requirements.¹⁰³ Under this scenario, the product governance provisions play a crucial role. Considering the risks arising from sustainable investments and their impact on financial return might mitigate the problems related to the strategy of removing the negative target market and thus make it possible to distribute sustainable financial instruments also to those who do not have any sustainability-related objectives.¹⁰⁴ While removing the negative target market results in an indiscriminate enlargement of the distribution market, integrating the risks of sustainable investments in the risks and reward analysis of the relevant financial instruments determines a more balanced outcome and reduces the risk of misselling. Considering the risks of sustainable investments might also influence the type of service to be provided in relation to the nature of the product and the level of protection needed by the relevant investors.¹⁰⁵ In particular, this approach could channel the distribution of sustainable financial instruments into investment advice and portfolio management services, where investment objectives and risk tolerance are taken into consideration, and discourage the recourse to other investment services, where these elements do not play any role.

7. Conclusion

While clearly aimed at promoting sustainable investments, the EU strategy to integrate sustainability into investment services regulation does not consider the relevant risks and results in their possible increase. Sustainable investments may be unable to reach sustainability objectives and thwart the investor's expectations of associating sustainability and financial return. The relevant provisions of MiFID II Delegated Regulation and MiFID II Delegated Directive amplify the impact of these risks by adding sustainability preferences to the suitability assessment and exempting ISPs from identifying the negative target market. Against these risks, the two-step process requiring ISPs to assess the investor's objectives and then ask for the relevant sustainability references, as provided by the delegated acts and ESMA guidelines, might prove insufficient. Integrating the risks of sustainable investments into financial instruments' suitability

¹⁰³ Abraham Lioui and Andrea Tarelli, 'Chasing the ESG factor' (2021) 139 *Journal of Banking and Finance*, 2. See also Steuer and Tröger (n 19), 26 (in terms of 'trade-off between climate risk mitigation and diversification efforts').

¹⁰⁴ See above nn. 3.1. and 4.

¹⁰⁵ ESMA (n 96), n. 53.

assessment and product governance arrangements might offer a better option, thus avoiding a transition toward a net-zero economy coming at the cost of lower investor protection.

From this perspective, high-quality financial advice might be the critical element to solving the trade-off between financing the European Green Deal promoted by the EC and investor protection. With the European market accounting for 2,078 USD billion and thus 83% of global assets allocated in sustainable funds¹⁰⁶, a special focus of supervisors on financial advisors becomes imperative to ensure proper distribution of financial instruments and prevent misselling.

¹⁰⁶ Morningstar, 'Global Sustainable Fund Flows: Q4 2022 in Review' (2022), 2 <<https://www.morningstar.com/lp/global-esg-flows>>.