Iris H-Y Chiu

Building a Single Market for Sustainable Finance in the EU-Mixed Implications and the Missing Link of Digitalisation

Abstract: This article critically analyses the EU's sustainable finance reforms and argues that the interaction between its regulative and enabling aspects creates mixed messages for governance and market-building. The Regulations adopt an incentive-based approach towards market-building for quality sustainable finance, but lower-level products are not shut out. However, if the market responds to quality signals facilitated by regulatory reforms, the article predicts that market-building may be concentrated in passively-managed indexed products which appeal to retail investors. This market may be dominated by large investment intermediaries who may gain an advantage precisely because of more stringent governance imposed on them. The article further argues that retail investors can be helped by policy bridging between sustainable and digital finance, such as adjustments to the legal duty of suitability to cater for investment advice incorporating sustainability preferences, including robo-advisory channels. The connection between digital and sustainable finance can be highly synergistic in attracting both institutional and retail demand.

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1 Introduction

Since the European Commission adopted an action plan for promoting sustainable finance in 2018,[1] legislative reform has been introduced for market building in sustainable finance products as well as to harmonise the regulative standards for them.[2] Regulation is intended to mobilise the mainstream investment fund sector to develop and provide choice in their offers of sustainable financial products, hence it can be regarded as enabling in nature. Harmonised European regulation also provides for sufficiently high-quality regulative and protective standards so that market development is carried out in a manner that inspires market confidence. This is consistent with the ordoliberal underpinnings[3] of single market regulatory measures in the financial sector. This article examines the Regulation on sustainability disclosures required of the financial services sector[4] and the Taxonomy Regulation[5] in their roles to make sustainable finance products widely marketised by the mainstream investment funds sector. It also queries how digitalisation in the EU, which is keenly promoted under the Digital Single Market strategy,[6] can further the marketization agenda that is promoted by the Regulations. Indeed the article argues that policy thinking on promoting and marketising sustainable finance has not plugged into the potential offered by digitalising finance.

Section 2 discusses the EU reforms to mobilise and regulate mainstream sustainable finance particularly in collective investments and portfolio management. This Section examines the finely balanced nature of the EU's governance of sustainable finance as its enabling and regulative elements interact. It is argued that the net result may send mixed messages to the market, which may

1 *EU High Level Expert Group in Sustainable Finance*, Financing a Sustainable European Economy, 2018, https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

2 sect 2.

3 See *Josef Hien/Christian Joerges*, Ordoliberalism, Law and the Rule of Economics, 2017.

4 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 (Sustainability Disclosures Regulation 2019).

5 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Taxonomy Regulation 2020).

6 *European Commission*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-Term Review on the implementation of the Digital Single Market Strategy: A Connected Digital Single Market for All, 2017, SWD(2017) 155 final.

not lead to significant development in product choice. The Section further contends that the marketization of sustainable finance should connect with digitalisation of finance in order to appeal more broadly to retail investors. Section 3 discusses reforms to the duty of suitability in investment advice that may be key to how digitalisation can be woven into the sustainable finance governance framework. Section 4 concludes.

2 Mainstreaming Sustainable Finance in the EU

The Sustainability Disclosures Regulation 2019,[7] supported by the Taxonomy Regulation 2020,[8] introduces a governance regime that elevates the standards of responsibility in the investment sector across many types of fund management, while at the same time facilitating the marketization of sustainable finance products. This type of governance is highly characteristic of EU regulation where enabling harmonised legislation intended for market building[9] is framed in relatively high regulative standards to support the building of credible and responsible markets. One perspective on this is the 'law and finance' thesis that laws with sufficiently high standards that provide for investor protection and confidence are needed to build out strong and developed capital markets.[10] The other perspective is that economic development is not pursued as a singular and disembodied goal independent from wider notions of solidarity and responsibility, especially after the global financial crisis 2007–09.[11] Policy makers in the EU are developing market-building measures in more holistic ways, such as taking into account financial stability and consumer protection risks.[12] The impetus for sustainable finance has only grown in the wake of the Covid-19 pan-

7 Sustainability Disclosures Regulation 2019.

8 Fn. 5.

9 For eg *Eilis Ferran*, Building an EU Securities Market, 2003 on critically discussing the role of regulatory harmonisation in market-building. The EU has always viewed the role of law as key to capital markets building, see *Nicolas Véron/Guntram B. Wolff*, "Capital Markets Union: A Vision for the Long Term" Journal of Financial Regulation, 2016, 2, 130.

10 *Rafael La Porta/Florencio Lopez-De-Silanes/Andrei Shleifer*, "What Works in Securities Law?" Journal of Finance, 2006, 61, 1.

11 *Niamh Moloney*, "EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or more Risks?" Common Market Law Review, 2010, 47, 1317.

12 *Jacques de Larosière*, Report of the High Level Group on Financial Supervision in the EU, 2009, https://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf.

demic.[13] The governance of sustainable finance in this round of regulatory reforms reflects a careful balancing of market-building goals with regulative goals to improve financial intermediaries' conduct at the marketing front, their gatekeeping roles in supporting the credibility of sustainable finance, and ultimately, the social and public interest outcomes that sustainable finance is supposed to fund.[14]

2.1 Policy Context for Mobilising Investment Intermediaries in Relation to Sustainable Risks

Although financial intermediaries are not often directly responsible for harms to sustainability or bringing about sustainable outcomes, such as those embodied in the 30 UN Sustainable Development Goals,[15] their channelling of funds makes projects and activities possible, turning financial intermediaries into facilitating or 'complicit' actors who incentivise or disincentivise projects and activities. At this level of gatekeeping, debt intermediaries such as banks in project finance have become keenly aware of their proximity[16] to the creation of environmental and social harms, and many of them have implemented the voluntary Equator principles to minimise their legal risk and ameliorate social irresponsibility.[17] However, even the proximity of creditor-borrower relationships may not bring about optimal management of sustainability risks at the level of the borrower.[18]

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13 'ESG passes the Covid Challenge' (Financial Times, 1 June 2020), https://www.ft.com/content/50eb893d-98ae-4a8f-8fec-75aa1bb98a48.

14 This 'co-habitation' regulatory model involving the public and private sectors is discussed in *Nicholas Dorn*, "Capital Cohabitation: EU Capital Markets Union as Public and Private Co-regulation" Capital Markets Law Journal, 2016, 11, 84.

15 https://sustainabledevelopment.un.org/?menu=1300; *Jesse Griffiths*, "Financing the Sustainable Development Goals (SDGs)" Development, 2018, 61, 62; Alma Pekmezovic, The New Framework for Financing the 2030 Agenda for Sustainable Development and the SDGs in: *Julia Walker/ Alma Pekmezovic/Gordon Walker* (eds), Sustainable Development Goals: Harnessing Business to Achieve the SDGs through Finance, Technology, and Law Reform, 2019, 87.

16 *Kirk Herbertson/ David Hunter*, "Emerging Standards for Sustainable Finance of the Energy Sector" Sustainable Dev. L. & Pol'y, 2007, 7, 4.

17 Many leading multinational and national banks are signatories of the Equator principles, see https://equator-principles.com/members-reporting/.

18 *Douglas Sarro*, "Do Lenders Make Effective Regulators? An Assessment of the Equator Principles on Project Finance" German Law Journal, 2012, 13, 1500 relating to lack of monitoring and governance, therefore making lender governance a procedural and superficial phenomenon that lenders can brand themselves by, also *Patrick Haack/Dennis Schoenborn/Christopher Wickert*, "Exploring the Constitutive Conditions for a Self-Energizing Effect of CSR Standards: The Case

Investment intermediaries who channel funds to enterprises, projects and activities are arguably 'in less control' of their gatekeeping capacities, as they are often diversified and minority shareholders. Further, there is not always congruence between (a) investment intermediaries' legal duties to manage portfolios in a financially optimal manner and (b) their goals relating to sustainable behaviour or outcomes on the parts of their investee companies.[19]

As the investment sector wields significant influence, with global assets under management growing year over year and estimated to amount to USD $145 trillion by 2025,[20] policy makers have started looking to the gatekeeping capacities of the investment sector, so that these intermediaries in capital markets can play a useful part in the governance landscape that aligns economic behaviour with sustainable goals.[21] There is also increased appetite on the part of both institutional[22] and retail beneficiaries[23] in the EU for investing in pension and other collective investment funds that would meet sustainable objectives as well as provide a financial return, although different investors may prefer different mixes of the two objectives if there is a trade-off.[24]

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of the "Equator Principles"", 2010, University of Zurich Institute of Organization and Administrative Science IOU Working Paper No 115 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1706267.

19 In the UK see *Cowan v Scargill* [1985] Ch 270. But *UNEPFI*, Fiduciary Duty in the 21st Century, 2019, revised from 2009, has since clarified that ESG issues can be material to investment performance and it is not beyond the scope of fiduciary duties to take them into account, also *Sarah Barker/Mark Baker-Jones/Emilie Barton/Emma Fagan*, "Climate Change and the Fiduciary Duties of Pension Fund Trustees – Lessons from the Australian Law" Journal of Sustainable Finance & Investment, 2016, 6, 211 where fiduciary interpretation in common law traditions are less of a hindrance to integrating ESG considerations.

20 *PwC*, Asset & Wealth Management Revolution: Embracing Exponential Change, 2017, https://www.pwc.com/ng/en/press-room/global-assets-under-management-set-to-rise.html.

21 Fn. 14.

22 *Lei Delsen/Alex Lehr*, "Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investments" Journal of Sustainable Finance & Investment, 2019, 9, 240; *George Apostolakis/Frido Kraanen/Gert van Dijk*, "Pension Beneficiaries' and Fund Managers' Perceptions of Responsible Investment: A Focus Group Study" Corporate Governance, 2016, 16, 1.

23 *Charlotte Christiansen/Thomas Jansson/Malene Kallestrup-Lamb/Vicke Noren*, "Who are the Socially Responsible Mutual Fund Investors?", 2019, http://ssrn.com/abstract=3128432 points out that prosocial investors are still the minority. *Bernhard Zwergel/Anett Wins/Christian Klein*, "On the Heterogeneity of Sustainable and Responsible Investors" Journal of Sustainable Finance & Investment, 2019, 9, 282.

24 *Apostolakis et al*, 2016; *Riikka Sievänen/Hannu Rita/Bert Scholtens*, "European Pension Funds and Sustainable Development: Trade-Offs between Finance and Responsibility" Business Strategy and the Environment, 2017, 26, 912.

The EU's sustainable finance strategy has therefore turned to capital markets regulation. One aspect of this policy movement is the nudging of institutional investors to become engaged shareholders in their investee companies. In the UK, this expected level of investor conduct is known as 'stewardship' and covers a range of shareholder engagement behaviour in relation to companies' corporate governance as well as their footprint in environmental, social and governance (ESG) matters.[25] In the EU, the Shareholders' Rights Directive 2017 introduced a comply-or-explain regime for institutional investors[26] in order to nudge[27] them towards more engaged behaviour and the overall promotion of the long-term interests of beneficiaries.[28] To support investors' engagement role, the EU has introduced concomitant regulations requiring[?] listed companies to make relevant 'non-financial disclosures' in relation to environmental impacts, impact on employees, human rights, and anti-corruptions matters.[29] Further, shareholders' powers have also been increased by harmonised legislation, such as shareholders' mandatory say on executive pay every four years,[30] and powers to approve related-party transactions in order to mitigate strong managerial powers.[31] Tridimas[32] argues that the 'shareholder' in the EU context is framed as a gatekeeper and facilitator of EU policy strategies in capital markets regulation for the Single capital market.

The group of shareholders to be galvanised are institutional investors, whether in pension, wealth or retail investment management. There are different incentives and structures at work that affect these intermediaries' behaviour when engaging with companies generally,[33] and targeted engagement on sustainability issues is only emerging in some European countries,[34] with the trend ob-

25 Principles 9 – 11, UK Stewardship Code, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf.

26 Art 3 g.

27 *Marina Madsen* Behavioural Economics in European Corporate Governance: Much Ado about Nudging, European Business Law Review, 2021, 32, 295.

28 Arts 3 h and 3i.

29 Art 19a, enhanced by amendments in the Taxonomy Regulation 2020 to align environmental disclosures.

30 Article 9a and 9b.

31 Article 9c.

32 Keynote speech at Enforcing Shareholder Duties Conference, Glasgow, September 2017.

33 See *Roger M Barker/Iris H-Y Chiu*, Investment Management and Corporate Governance, 2019, which discusses significant investment fund vehicles and the structures, incentives and obstacles to shareholder engagement by them.

34 *Ian Hamilton/Jessica Eriksson*, "Influence Strategies in Shareholder Engagement: A Case Study of All Swedish National Pension Funds" Journal of Sustainable Finance and Investment, served to be weaker in Anglo-American jurisdictions.[35] However, a common barrier to engaging with sustainability issues, except for funds expressly reserved for 'socially responsible investing' (SRI),[36] is the legal interpretation of investment intermediaries' fiduciary duties to their clients. A narrow interpretation focuses upon the need to invest prudently and in a diversified manner in order to achieve financial return to meet beneficiaries' needs.[37] This could mean that non-financial considerations that may interfere with that primary discharge of fiduciary duty are not permitted.[38] Although legal interpretation with regard to investment intermediaries' fiduciary duties has changed with times in order to allow more modern and salient considerations to factor into the discharge of fiduciary duties,[39] risk aversion can still affect investment intermediaries.[40] Alternatively, such risk aversion may be an excuse for those that do not wish to change from the conventional manners of financially-driven investment management methodologies.[41]

In an opposite, bottom-up development, some investment intermediaries have identified market opportunities for SRI. The universe of SRI is however populated with financial products of varying standards in terms of selection and performance,[42] and mis-selling risks to well-meaning investors exist.[43]

2011, 1, 44; *Frank A J Wagemans/ CSA (Kris) van Koppen/Arthur PJ Mol*, "Engagement on ESG issues by Dutch Pension Funds: Is It Reaching Its Full Potential?" Journal of Sustainable Finance & Investment, 2018, 8, 301.

35 *Beate Sjåfjell*, Achieving Corporate Sustainability: What is the Role of the Shareholder? In: *Hanne S Birkmose* (ed), Shareholders' Duties, 2017, ch. 18.

36 There are a number of strategies in this universe, from exclusion to stock-picking, and to shareholder activism.

37 In the UK see *Cowan v Scargill* [1985] Ch 270.

38 *Friederike Johanna Preu/Benjamin J. Richardson*, "German Socially Responsible Investment: Barriers and Opportunities" German Law Journal, 2011, 12, 865; *Benjamin Richardson/Wes Cragg*, "Being Virtuous and Prosperous: SRI's Conflicting Goals" Journal of Business Ethics, 2010, 92, 21.

39 UNEPFI report, 2019.

40 *Joakim Sandberg*, "Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective" Journal of Business Ethics, 2011, 101, 143.

41 *Kenneth Amaeshi*, "Different Markets for Different Folks: Exploring the Challenges of Mainstreaming Responsible Investment Practices" Journal of Business Ethics, 2010, 92. 41, arguing that sustainable finance requires different methodologies and mindsets altogether in its management.

42 *Julia Puashunder*, "On the Emergence, Current State, and Future Perspectives of Socially Responsible Investment (SRI)" Consilience, 2016, 16, 38; *Henry Schäfer*, "Sustainable Finance", 2012, http://ssrn.com/abstract=2147590; *Christin Nitsche/ Michael Schröder*, Are SRI Funds Conventional Funds in Disguise Or Do They Live Up to Their Name? in: Sabri Boubaker, Douglas

The harmonised legislative instrument in the Sustainability Disclosures Regulation 2019 intends to achieve two policy goals: legal clarification and market regulation. It introduces a mandatory duty with regard to sustainability risks for investment intermediaries. This duty supports and accompanies the governance regime for the marketing of sustainably-labelled financial products, which need to meet minimum standards.

2.2 Mandatory Responsibility for Investment Intermediaries

Financial markets participants who engage in portfolio management or fund management (whether as mainstream pension or collective investment schemes, or as alternative investments funds)[44] must make mandatory disclosures as to how they integrate sustainability risks in their investment decision-making.[45] This also includes financial services providers who offer investment-based products as part of an insurance product. In this manner, through mandatory disclosure, the Regulation has arguably brought about a new expectation for investment intermediaries in terms of their investment management conduct. This expectation cannot be avoided by narrow pursuits of financial performance in the name of compliance with fiduciary duties. This is a 'baseline' standard applicable to all investment intermediaries within the scope above. Large investment intermediaries are subject to additional regulatory obligations as follows.

Investment intermediaries of a certain scale, defined as having at least 500 employees or being a parent company of such an undertaking,[46] are mandated to account for adverse sustainability impacts, from 30 June 2021. This applies whether or not such financial services providers engage with sustainably-labelled products. They must account for any adverse impact of their investment decision-making processes on sustainability risks, how adverse impacts are discovered and what due diligence policies are deployed.[47] Smaller providers may declare that they do not consider adverse impacts on sustainability risks in their investment decision-making process, but must clearly explain why and

Cumming, and Duc Khuong Nguyen (eds), Research Handbook of Investing in the Triple Bottom Line, 2018, ch19.

43 'Report finds some ethical funds are 'misleading' investors' (5 Nov 2019) at https://www.moneyobserver.com/news/report-finds-some-ethical-funds-are-misleading-investors.

44 Sustainability Disclosures Regulation 2019, Art 2.

45 Ibid, Art 3.

46 Arts 4(3), (4), ibid.

47 Art 4(1)(a), ibid.

whether this practice cuts across all their products.[48] This means that smaller providers still need to disclose how they integrate sustainability risks as discussed above, but are not specifically tied to the prescribed mandatory disclosures of due diligence policies and measurement of adverse sustainability impact.

Further, by 30 December 2022, financial services providers mandated to integrate and disclose sustainability risks in relation to adverse impacts must also make that information available at the level of each financial product.[49] These disclosures are also regarded as pre-contractual in nature.[50]

As the integration of sustainability risks refers to material sustainability risks, it is arguable that the transparency obligation for large investment intermediaries to disclose adverse sustainability impact imposes on them the duty to account for double materiality. This means that large firms are accountable for not only material sustainability risks relevant to investment performance but other adverse sustainability impact as such. Mandatory disclosure in relation to adverse sustainability impact would be made according to the highly prescribed template proposed by the European Securities and Markets Authority (ESMA). ESMA's technical standards[51] provide for templates of types of adverse impact that investment intermediaries should engage with and measure. The prescriptive measure can on the one hand result in a compliance-based mindset, as investment intermediaries seek to meet the requirements of each 'box to tick.'[52] However, compelling those intermediaries to engage with a standardised set of sustainability risks in this manner allows them to learn and develop knowledge in areas that they cannot be selective about, so that the connection to public interest goals can be made. Such disclosures theoretically attract regulatory enforcement and also allow for the exercise of market discipline. Investors are able to enjoy comparability in disclosures made by investment intermediaries in order to facilitate choice and competition. Further, the list of adverse impacts that need to be measured is not inflexible, as it would be introduced in delegated Commission legislation that can be amended relatively easily. Designating the information to be disclosed as pre-contractual disclosures would allow investors

48 Art 4(1)(b), ibid.

49 Art 7, ibid.

50 Art 6, ibid.

51 draft technical standards as of 23 April 2020, at https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.

52 *Kimberly D Krawiec*, "Cosmetic Compliance and the Failure of Negotiated Governance" Washington University Law Quarterly, 2003, 81, 487.

to exercise *ex post* discipline in litigation for misrepresentation or mis-selling.[53] Retail investors in the UK can be a force of discipline to be reckoned with as they can seek redress from the Financial Ombudsman in out-of-court remedy for up to £150,000 in case of misrepresentation or mis-selling.[54] Nielsen and Parker argue that such compliance can produce a changed culture in time, as the need to change processes and methodologies could permeate organisational strategies and activities.[55]

However, the mandatory duty discussed above applies only to larger investment intermediaries. As mentioned above, smaller providers are able to declare and explain why they do not consider adverse impacts on sustainability risks in their investment decision-making process.[56] This exception is arguably based on proportionality, i.e. the cost of compliance for smaller firms may be significant. This exception thus leaves it to market discipline to determine if smaller investment intermediaries who are agnostic about ESG risks are sufficiently competitive or may be 'penalised' by investor choice. Regulators might also take enforcement action in view of poor or inadequate explanations. However, the inadequacy of a disclosure is often difficult to pin down if there is no falsehood or misrepresentation. Nevertheless, smaller firms are still subject to the general duty to integrate sustainability risks as a baseline. However, the lack of prescription in relation to what 'integration' means and how this should be implemented may result in a meta-regulatory phenomenon of fragmented and uneven implementation amongst firms. Firms may opt to implement the regulation in a manner suitable for their business models. In a positive way, firms could take advantage of the flexibility to develop standards and processes suitable for their business models. [57] However, it is also possible that meta-regulatory implemen-

53 This would overcome investment management arrangements seeking to exclude advisory duties, for eg *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm).

54 Part XVI, Financial Services and Markets Act 2000. Retail redress is often the precursor for hard law reforms for conduct of business, *Eilis Ferran*, "Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK" European Business Organisations Law Review, 2012, 13, 247.

55 *Christine Parker/Vibeke Lehmann Nielsen*, "Corporate Compliance Systems: Could They Make Any Difference?" Administration and Society, 2009, 41, 3.

56 Art 4(1)(b), Sustainability Disclosure Regulation 2019.

57 *Christine Parker*, The Open Corporation, 2000 offers a positive view of meta-regulatory implementation.

tation can result in minimalist self-regulation,[58] such as being a mere signatory to the UN Principles of Responsible Investment.[59]

As the threshold for a 'large' investment intermediary is set at 500 employees minimum, many investment fund and portfolio managers would not be caught within the more stringent tier of compliance. It is queried if this can normalize the market practice of declaring agnosticism with regard to adverse sustainability impact. For example, well-known names in the asset management industry such as Jupiter or Acadian have fewer than 500 employees. The efficacy of the mandatory duty may be perceived to be more marginalised as one realises that a large quarter of the investment sector consists of mid-size firms that are therefore not covered within the Regulation's scope. However, it may be argued that the more stringent tier of compliance only applies to large investment fund managers because their ownership of corporate equity is likely extensive. In this way, their sustainability stewardship would have a systemic impact upon corporate sector behaviour. Examples of such investment fund managers would be Fidelity, Blackrock, State Street and Vanguard. These firms also have the capacity and resources to significantly enhance their research and due diligence capabilities to adhere to the Regulation's demands.[60]

On the other hand, excluding smaller firms from the stringent tier of compliance would arguably prejudice them, as larger firms subject to these duties have the opportunity to distinguish themselves. As discussed below, the compliance burden of the mandatory duty can be seen as a building block for market opportunities in sustainably-labelled financial products. In this manner, the market-building agenda in the EU Regulations can be rather skewed in favour of large investment intermediaries, equipping them to dominate the market for sustainably-labelled products. The competitive effects of this Regulation ought to be further studied.

Nevertheless, can it be argued that that imposing a mandatory duty upon larger investment intermediaries to integrate sustainability risks does not advance sustainable finance as such? Such a duty does not necessarily lead to a

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58 *Julia Black*, "Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis" Modern Law Review, 2012, 75, 1037.

59 *Soohun Kim/Aaron Yoon*, Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3555984.

60 For example large investment firms such as State Street is already equipping itself for ESG analytics, see 'State Street enhances ESG data and analytics offering' (30 May 2019), https://www.institutionalassetmanager.co.uk/2019/05/30/276154/state-street-enhances-esg-data-and-analytics-offering.

positive channelling of finance to sustainable projects, activities or outcomes, a similar critique levelled against SRI. Many SRI strategies can be exclusion-based,[61] i. e. designed not to channel funds to industries or companies with questionable ESG impact. Exclusion does not necessarily change behaviour, especially at the macro level, for discernible outcomes in sustainability.[62] However, the mandatory disclosure duty should be regarded as a baseline, so that firms wishing to offer sustainably-labelled products would need to do more to prove their credentials. In this manner, the Regulation provides opportunities (as well as compliance burdens) for the building of product markets with distinguished standards.

2.3 Market-building for Sustainable Finance

Market-building in sustainably-labelled investment products is underpinned by minimum standards to cater to market confidence and credibility. In this manner, the mainstreaming agenda of the Regulations' reforms is 'enabled' by regulative standards. Regulative standards contain two aspects: one relates to the substantive quality of sustainably-labelled financial products, and the second relates to marketing and disclosure standards at point of sale and post-sale.

Moving away from the market's minimalism in accepting SRI as based only on exclusion, it may be argued that the Regulations provide higher minimum standards for sustainably-labelled finance in that such investment products should positively achieve specified sustainable outcomes and at least do 'no significant harm' to environmental and social objectives as a whole.[63] The definition of 'sustainably-labelled' includes:

'an economic activity that contributes to an environmental objective, … [such as], by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, …

61 *Alan Lewis/Carmen Juravale*, "Morals, Markets and Sustainable Investments: A Qualitative Study of 'Champions'" Journal of Business Ethics, 2010, 93, 483.

62 *Sander Quak/Johan Heilbron/Jessica Meijer*, "The Rise and Spread of Sustainable Investing in the Netherlands" Journal of Sustainable Finance & Investment, 2014, 4, 249. On divestment see *Liz Cooper*, Determining How to Invest More Responsibly As an Institution in: *Tessa Hebb/James P. Hawley/Andreas G. F. Hoepner/Agnes L. Neher/David Wood* (eds), The Routledge Handbook of Responsible Investment, 2015, ch 34.

63 Art 2 (17), Sustainability Disclosure Regulation 2019.

[such as] tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.'[64]

This higher departure point, i.e. the achievement of positive characteristics and the avoidance of significantly negative ones,[65] arguably accords more with investors' expectations in meeting hybrid objectives.[66] ESMA's disclosure template[67] would require investment intermediaries to measure their investments' positive contributions to sustainable objectives[68] and the methodologies for attaining them. Further, investees' companies' corporate governance, remuneration policies, tax compliance and employee relations need to be evaluated. At the very least, the template would also compel investment intermediaries to measure and ensure that no significant harm is done to sustainable objectives in general. The Taxonomy Regulation's provisions, however, represent a 'ceiling' benchmark of substantive quality for environmental sustainability. It prescribes six objectives that 'environmentally sustainable' financial products should meet, and relevant indicators for each. Investors would have the confidence that investments are being channelled to defined environmental outcomes.[69] However, the Taxonomy Regulation, being relatively more developed for output legitimacy in environmentally sustainable objectives, is only catching up to social objectives.[70]

64 *Ibid.*

65 Discussed critically below.

66 *Peer Osthoff*, What Matters to SRI Investors?' in: Tessa Hebb/James P. Hawley/Andreas G. F. Hoepner/Agnes L. Neher/David Wood (eds), The Routledge Handbook of Responsible Investment, 2015, ch54; *Lei Delsen/Alex Lehr*, "Value Matters or Values Matter? An Analysis of Heterogeneity in Preferences for Sustainable Investments" Journal of Sustainable Finance & Investment, 2019, 9, 240; Some investors are prosocial and willing to tradeoff financial returns, see *Andrea Hafenstein/Alexander Bassen*, "Influences for Using Sustainability Information In the Investment Decision-Making of Nonprofessional Investors" Journal of Sustainable Finance & Investment, 2016, 6, 186; *Gunnar Gutsche/Andreas Ziegler*, "Which Private Investors Are Willing to Pay for Sustainable Investments? Empirical Evidence from Stated Choice Experiments" Journal of Banking and Finance, 2019, 102, 193.

67 *EBA, ESMA, EIOPA, Consultation on Environment, Social and Governance Disclosure Rules* (2020), https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.

68 Art 2(17), Sustainability Disclosure Regulation 2019.

69 Taxonomy Regulation 2020, arts 5–11.

70 This is being addressed by the Social Taxonomy project in development, see *European Commission*, "Platform on Sustainable Finance" (2021), https://ec.europa.eu/info/sites/default/files/

Social objectives may be of a wider, vaguer scope and can be more susceptible to disagreement. Nevertheless, the EU's commitment to the United Nations' Sustainable Development Goals in its Agenda 2030,[71] and the Commission[72] as well as ESAs[73] are developing greater standardisation of environmental and socially sustainable indicators for mandatory transparency and evaluation. Empirical research also finds that there is a genuine need for developing socially-focused products, which have fallen by the wayside due to policy-makers' focus on the environment.[74] This is however not the approach taken in the UK, which has preferred to sidestep the vast and vaguer universe of social objectives, focusing on developing regulation for environmentally sustainable investment products, notably in relation to climate change.[75]

The question remains whether there is still a market for other socially-responsible investment products that are not sustainably-labelled. It is arguable that 'ESG-like' products that do not meet the requirements of the sustainable label, such as products in the current universe of SRI funds,[76] can still be offered. This is because the Taxonomy Regulation seems to allow providers to clearly distinguish their marketing disclosures in such a way that aspects of products that do not meet the Taxonomy's standards can be articulated.[77] Hence the Regulation's approach is geared towards incentivising markets for high standards and reserving the sustainability label for products that meet those standards, rather than outlawing 'lower-level' offerings. It provides incentive-based regulation for products, rather than product regulation as such. Products labelled as 'SRI', 'ESG' or 'hybrid value' may still be available within the gap that the Reg-

business_economy_euro/banking_and_finance/documents/finance-events-210226-presentation-social-taxonomy_en.pdf.

71 *European Commission*, "The 2030 Agenda for Sustainable Development and the SDGs" (2012), https://ec.europa.eu/environment/sustainable-development/SDGs/index_en.htm.

72 *European Commission*, "Proposal for a Corporate Social Reporting Directive" (2021), https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en#csrd.

73 *ESAs Consult on Environmental, Social and Governance Disclosure Rules* (2020), https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.

74 *Rajna Gibson Brandon/Philipp Krüger*, "The Sustainability Footprint of Institutional Investors" (ECGI Working Paper 2018), https://ssrn.com/abstract=2918926.

75 *Financial Conduct Authority*, "Enhancing Climate-Related Disclosures by Asset Managers, Life Insurers and FCA-Regulated Pension Providers" (2021), https://www.fca.org.uk/publications/consultation-papers/cp-21-17-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions.

76 *Geoffrey Jones*, Profits and Sustainability: A History of Green Entrepreneurship, 2017, (ch. 8. Can Finance Change the World?)

77 Art 7, Taxonomy Regulation 2020.

ulations leave. The enabling nature of the Regulations therefore facilitates competition in quality but also arguably in cost, as lower-level products are less demanding in terms of compliance.[78]

In marketing sustainably-labelled financial products, mandatory disclosure is introduced to ensure that investors obtain clear pre-sale and post-sale information to make their choices, discussed below.

Investment intermediaries who provide sustainably-labelled products must explain how the environmental or social characteristics promoted by each product meets its characterisation, whether in active or passive management. In an actively managed product, disclosure is to be made of the strategies designed to meet the relevant characteristics, including how the financial services provider defines the sustainability objective,[79] and how it measures its attainment or otherwise.[80] ESMA will prescribe a template[81] for such disclosure so that such disclosure attains certain standards and comparability. In relation to a passively managed product, the financial services providers must disclose if the environmental or social characterisation is derived by benchmarking against indices for sustainable finance.[82] It is not sufficient that financial services providers merely refer to a designated index satisfied by a product's environmental or social characteristics. They must disclose how the index is aligned or consistent with those characteristics and how alignment with it differs from a broad market index.[83] Although financial services providers are in substance relying on an index provider's diligence and evaluation, there needs to be some level of intelligent engagement with indexers' various methodologies[84] and perhaps with their track record.

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78 *Christin Nitsche/Michael Schröder*, Are SRI Funds Conventional Funds in Disguise Or Do They Live Up to Their Name? in: Sabri Boubaker/Douglas Cumming/Duc Khuong Nguyen (eds), Research Handbook of Investing in the Triple Bottom Line, 2018, ch19; *Arnim Wiek/Olaf Weber*, "Sustainability Challenges and the Ambivalent Role of the Financial Sector" Journal of Sustainable Finance & Investment, 2014, 4, 9.

79 As defined in Art 2(17), Sustainability Disclosure Regulation 2019.

80 Art 8, 10, above.

81 draft technical standards as of 23 April 2020, at https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules.

82 Art 8, 9, Sustainability Disclosure Regulation 2019.

83 Art 9(1)(b), ibid.

84 *Robert J. Bianchi/Michael E. Drew*, "Sustainable Stock Indices and Long-Term Portfolio Decisions" Journal of Sustainable Finance & Investment, 2012, 2, 303 on the differences between indices.

On the one hand, the above reform underpins confidence in the marketing of pan-European products such as UCITs[85] and other alternative investment funds that are sustainably-labelled and benefit from a European passport.[86] The perspective from the law and finance thesis discussed above would support higher expected levels of investor and market confidence as a result of such regulatory standardisation. Further, because the disclosures are designated as pre-contractual disclosures, investors can exercise discipline in relation to *ex post* litigation for misrepresentation and mis-selling. Further, in the UK for example, large scale mis-selling can result in the regulator's imposition of consumer redress schemes[87] that compel firms to compensate customers in an out-of-court but collective manner. However, investment intermediaries would pass the increased cost of transparency and compliance to investors, and it is uncertain whether institutional allocation will be attracted[88] by virtue of the substantive standards or put off by the increased cost. Institutions could continue to invest in 'lower-level' products labelled as SRI or ESG without meeting the sustainably-labelled standards. However, the existence of higher standards may cause beneficiaries to put pressure on institutions, in turn generating demand for sustainably-labelled investments above the market minimalism of SRI or ESG.

Some posit that in response to the market-building agenda in the EU's Regulations, investment intermediaries and institutions may converge upon passively-managed, sustainably-labelled products as a middle ground to signal change in their investment behaviour. This is because the compliance burden for passively-managed products, although needing to meet the enhanced requirements of being sustainably-labelled, are relatively less onerous than for actively-managed products. The market is already skewed[89] in this manner and it is uncertain if legislation should reinforce this.

The demands for mandatory disclosure could prove burdensome for actively-managed products. Would investment intermediaries have to undertake sustain-

85 Regulated by the UCITs Directive 2009, Consolidated text: Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast).

86 Art 2, Sustainability Disclosures 2019 which refers to the European-regulated investment fund providers.

87 S404, Financial Services and Markets Act 2000.

88 See citations in fn. 23 on the increased popularity of sustainable finance products with pension funds.

89 'Europeans make record investments in sustainable funds' (Financial Times, 30 Jan 2020) at https://www.ft.com/content/c2952357-c28b-4662-a393-c6586640404f.

able outcomes evaluations themselves,[90] or can they rely on third-party gatekeepers like social responsibility ratings providers? The building up of in-house expertise is not likely a short-term achievement that can be attained, and different methodologies exist within the diverse social responsibility ratings industry.[91] If investment intermediaries rely on particular ratings providers, would that be sufficient for showing that investment products meet sustainability characteristics? Without due governance and accountability of ratings providers, can regulators and the market be convinced of the sustainable performance claimed in an investment product? Further, active management relies heavily on research, the practices for which have been impacted after the UK and EU's reforms to unbundle research charges from brokerage.[92]

This reform was meant to address the problem that brokerage customers paying for trading charges and fees generally pay an extra percentage that firms would then use to subsidise payment for research. Over the years, the benefit to customers has not justified the bloated amounts passed off as research charges.[93] Besides, in an environment of low yield since the global financial crisis 2007–2009, charges and fees could erode returns for investors. Commission legislation was ultimately introduced under the parent Markets in Financial Instruments Directive 2014[94] to compel investment firms to unbundle research charges from brokerage charges and fees. Firms are to set aside an annual research budget and obtain clients' consent to contribute to this on an *ex ante* basis, or otherwise absorb such costs themselves.[95] This reform adversely affect-

90 Elizabeth Corley, Sustainable Investment: The Golden Moment in *London Institute of Banking and Finance*, Banking on Change: The Development and Future of Financial Services, 2019, ch6 on innovation being modest in sustainable finance.

91 *Robert G. Eccles/Judith C. Stroehle*, "Exploring Social Origins in the Construction of ESG Measures", 2019, http://ssrn.com/abstract=3212685; *Robert G. Eccles/Jock Herron/George Serafeim*, Reliable Sustainability Ratings in: Tessa Hebb/James P. Hawley/Andreas G. F. Hoepner/Agnes L. Neher/David Wood (eds), The Routledge Handbook of Responsible Investment, 2015, ch 48; *Boonlert Jitmaneeroj*, "Reform Priorities for Corporate Sustainability: Environmental, Social, Governance, or Economic Performance?" Management Decision, 2016, 54, 1497.

92 Art 13, Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits.

93 'Invest £10,000, pay £14,227 in fees: how fund charges erode your money by stealth' (The Telegraph, 22 June 2017) at https://www.telegraph.co.uk/investing/funds/invest10000-pay14227-fees-fund-charges-erode-money-stealth/.

94 Fn. 92.

95 Implemented in the UK FCA Handbook COBS 2.3B.

ed the lucrativeness of research, and the business models for research have been reorganised. For example, some investment firms moved research in-house and limited its scope, for example by focusing only upon listed companies. Specialist research firms have also emerged, but there is concern that a wide range of research such as covering niche or smaller companies has become less available.[96]

The research reform may affect the marketising of sustainably-labelled, actively-managed products in two ways. First, investment intermediaries who have little capacity to build up such specialist research would forego this market, as outsourcing to specialist firms can also be expensive. Second, the lack of research coverage of smaller or niche companies[97] may affect new and innovative enterprises with sustainable goals,[98] and the lack of coverage for them would adversely affect their access to funding. Investment intermediaries who wish to market sustainably-labelled products may not include these smaller companies if research on them is too thin, a problem that heightens intermediaries' legal risk in relation to their compliance with the disclosure requirements above. This issue is gaining attention, and policy-makers are proposing exemptions from research payment rules in order to promote bond and small company research.[99] However, as the Sustainability Disclosure Regulation compels large investment firms to become accustomed to taking stock of and measuring adverse sustainability impact in a rather prescribed manner, complying with the duty would arguably force large investment firms to build up relevant evaluative expertise in sustainability matters. Large investment intermediaries may not find it too forbidding to build upon their compliance needs and develop competitive research and evaluative capacities for sustainable outcomes, in order to support actively-managed products. Further, niche investment firms can also develop specialized products in the actively-managed space, such as impact investing.[100] In this manner, the Regulation can provide a mobilisation opportunity for marketing such products, therefore taking these products from fringe to mainstream, opening up opportunities for investors in a broad active management universe.

96 'MiFID II research rules 'hitting sector coverage and quality' (18 Feb 2019), https://www.ipe.com/mifid-ii-research-rules-hitting-sector-coverage-and-quality/10029553.article; 'UK and EU fund managers at odds over MiFID II revamp' (Financial Times, 25 May 2020), https://www.ft.com/content/dc7b9a26-83d4-484d-bb26-0c651c41f240.

97 See fn. 96.

98 *Francisco Szekely/Zahir Dossa*, Beyond the Triple Bottom Line: Eight Steps toward a Sustainable Business Model, 2017, ch9.

99 'EU fund managers back fee changes to Mifid II trading rules' (28 July 2020), https://www.ft.com/content/a0e8195e-aae1-4370-b8bb-82363e01cc93.

100 *Olaf Weber*, Impact Investing; Maximilian Martin, Building The Impact Investing Market in: Othmar M Lehner (ed), Routledge Handbook of Sustainable and Social Finance, 2016.

Many investment intermediaries may more likely be incentivised to provide passively-managed sustainably-labelled products. Although investment intermediaries still need to show that indices chosen would meet sustainable objectives in terms of the 'positive contribution' and 'do no significant harm' thresholds, the measurement obligations are arguably a shared burden, as index providers keen to compete in this market would go some way towards providing such evidence[101] that investment intermediaries can leverage upon in their disclosures. Established index providers such as the FTSE4Good or Dow Jones Sustainability Index[102] have significant evaluative expertise to draw upon, even if meeting ESMA's template requirements or the Taxonomy Regulation requirements would demand more. In this manner, Steven Maijoor has already opined that service providers in ratings and indices could play fundamental roles in securing market confidence in sustainable finance, and regulatory governance ought to be extended over them.[103] Of course such a pronouncement can be a double-edged sword, as it legitimates this industry but at the same time imposes compliance requirements and cost, which would have to be reflected in the cost of investing in these products.

In its market-building agenda, EU reforms could skew towards incentivising the development of the market for passively-managed sustainably-labelled products.[104] This may result in an adverse impact to innovation and choice. However, the reforms also achieve an elevation in the quality in passively-managed products as passive managers cannot totally rely on index providers' innovations. They are subject to an obligation to provide a comparative discussion between (a) the overall sustainability-related impact of the financial product with the impacts of the designated index and (b) the impacts of a broad market index through sustainability indicators. This disclosure is to be made in periodic reports to investors.[105] This may mean that the passively-managed product provider must nevertheless undertake measurement of the sustainability impact of the

101 There are different levels of sophistication and maturity in indices, see *Bianchi/Drew*, 2012.
102 *Steve Lydenberg/Alexi White*, Responsible Investment Indexes in: Tessa Hebb/James P. Hawley/Andreas G. F. Hoepner/Agnes L. Neher/David Wood (eds), The Routledge Handbook of Responsible Investment, 2015, ch40.
103 *Steven Maijoor*, 'Sustainable financial markets: translating changing risks and investor preferences into regulatory action' (Speech at European Financial Forum, 12 Feb 2020).
104 This trend is already on the rise, with large investment firms dominating the landscape, such as Blackrock's 6 new Exchange-traded Fund products that are both passively-managed and exchange-traded for liquidity, see 'BlackRock Expands and Enhances iShares Sustainable ETF Product Line' (12 Feb 2020), https://www.businesswire.com/news/home/20200212005388/en/%C2%A0BlackRock-Expands-Enhances-iShares-Sustainable-ETF-Product.
105 Art 11, Sustainability Disclosure Regulation 2019.

index-aligned financial product and not merely rely on the performance of the index.

Policy-makers require such disclosure as the Regulation's Preamble refers to investors' lack of information in relation to various sustainability outcomes apart from financial metrics.[106] Such comparison allows investors to see the sustainability difference that their investment has made. Indeed, this obligation is possibly the key obligation that forces providers of passively-managed products to account for sustainable performance. It is queried how investment funds are to discharge such a burden. What level of granularity and measurement should be undertaken for comparison, and can funds be prevented from adopting imprecise or broad-brush approaches, such as by referring merely to differences in portfolio composition? Where product providers select a particular sustainability index to align with, such as the FTSE4Good Index, would the FTSE All-share index serve as a comparable broad market index that they should adopt? It is queried to what extent providers may select a comparator, in order to enhance the comparative results they would like to present. As this requirement is placed in periodic reports, the quality expected of financial reporting in periodic reports may provide some guidance for the reporting of such comparison. The quality of financial reporting in periodic reports is condensed from annual reporting, but adheres to the same standards of financial rigour and prescription, although unaudited.[107] On this basis, it is arguable that the periodic reporting of sustainable performance for passively-managed funds is not expected to be vague and broad-brush, and should contain indicators and metrics against which the sustainable characterisation is measured—the same metrics applied as a comparison with a broad market index. ESMA's development of a template for periodic disclosure may signal towards this approach, which would prevent passively-managed product providers from merely relying on index providers to vouch for sustainable performance. In this manner, it is arguable that marketing sustainably-labelled products entails obligations of quality monitoring and adherence that make it impossible to be 'merely passive' in the conventional sense of investment management. It is arguable that such obligations come close to a form of product regulation and transform the nature of 'passive investment,' achieving a mid-way between active stock-picking and portfolio curation and slavish adherence to indices. Further, Gordon[108] argues that

106 Preamble 24, ibid.

107 eg see the quality of periodic reports for UCITs funds, Art 69(4), Directive 2009/65/EC (UCITS).

108 *Jeffrey Gordon*, "Rethinking Stewardship" (ECGI seminar, 23 Oct 2020), https://ecgi.global/content/rethinking-stewardship.

passive managers have the incentive to manage 'systematic' portfolio risks such as ESG risks that apply generally to the corporate sector, in demonstrating their engagement with investee companies consistent with the Shareholders' Rights Directive expectations.

A market distinguished by higher standards goes hand in hand with cost implications, differentiated from the market minimalism of SRI or ESG.[109] Would institutional investors respond and increase their demand, or would there be a race to the lower levels of the market which are not outlawed?

Institutions should engage in the best practices of structuring mandates for asset managers to incorporate sustainability objectives, including their interface with institutions' financial objectives,[110] and any trade-offs.[111] In this respect, the

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109 *Benjamin Richardson*, Keeping Ethical Investment Ethical: Regulatory Issues for Investing for Sustainability, Journal of Business Ethics, 2009, 87, 555.

110 *Nitsche/Schröder* (2018), ibid; *Xing Chen/Bert Scholtens*, "The Urge to Act: A Comparison of Active and Passive Socially Responsible Investment Funds in the United States" Corporate Social Responsibility and Environmental Management, 2018, 25, 1154.

111 There is significant concern in empirical research trying to establish if socially responsible funds perform better or worse, *Federica Ielasi/Monica Rossolini/Sarah Limberti*, "Sustainability-themed Mutual Funds: An Empirical Examination of Risk And Performance" The Journal of Risk Finance, 2018, 19, 247 (positive); *Michael Schröder*, "Financial Effects of Corporate Social Responsibility: A Literature Review" Journal of Sustainable Finance & Investment, 2014, 4, 337 (positive); *Matthew W. Sherwood/Julia L. Pollard*, "The Risk-Adjusted Return Potential of Integrating ESG Strategies into Emerging Market Equities" Journal of Sustainable Finance & Investment, 2018, 8, 26 (positive); *Pablo Durán-Santomil/Luis Otero-González/Renato Heitor Correia-Domingues/Juan Carlos Reboredo*, "Does Sustainability Score Impact Mutual Fund Performance?" Sustainability Journal, 2019, 11, 2972 (positive); *Benjamin Tobias Peylo/Stefan Schaltegger*, "An Equation With Many Variables: Unhiding the Relationship Between Sustainability and Investment Performance" Journal of Sustainable Finance & Investment, 2014, 4 110 (finding an inverted u-shaped performance trajectory of sustainable finance funds initially performing better than conventional ones and then dips).

But more granular research at company level shows mixed results in relation to connecting ESG and financial performance, see *Marien de Haan/Lammertjan Dam/Bert Scholtens*, "The Drivers of the Relationship Between Corporate Environmental Performance and Stock Market Returns" Journal of Sustainable Finance & Investment, 2012, 2, 338; *Roger C. Y. Chen/Shih-Wei Hung/Chen-Hsun Lee*, "Does Corporate Value Affect the Relationship Between Corporate Social Responsibility and Stock Returns?" Journal of Sustainable Finance & Investment, 2017, 7, 188 (negative); for positive accounts, see *Gregor Dorfleitner/Sebastian Utz/Maximilian Wimmer*, "Patience Pays Off – Corporate Social Responsibility and Long-Term Stock Returns" Journal of Sustainable Finance & Investment, 2018, 8, 132; *N. C. Ashwin Kumar/Camille Smith/Leïla Badis/Nan Wang/Paz Ambrosy/Rodrigo Tavares*, "ESG Factors and Risk-Adjusted Performance: A New Quantitative Model" Journal of Sustainable Finance & Investment, 2016, 6 292; *Gunnar Friede/Timo Busch/Alexander Bassen*, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies" Journal of Sustainable Finance & Investment, 2015, 5, 210.

UK's open-ended Stewardship Code provides a template for institutions and their asset managers to integrate sustainability into their strategic and governance frameworks for investment management, a.k.a. 'stewardship'.[112] There also needs to be better integration of investors' sustainability preferences into the investment advisory duty so that retail investors' needs can be met. This is especially pertinent to the digital finance market for sustainable finance, particularly in the passively-managed range.

3 Connecting with the Digital Single Market for Finance

We argue that further policy thinking can be developed in the market-building for sustainably-labelled products, particularly where these are passively-managed products likely to appeal to retail investors in mutual funds. Leveraging connections between digital finance and sustainable finance could promote market development in the retail sector and galvanise EU citizens towards participating in sustainable objectives via finance. This approach potentially contributes to meeting Single market as well as public good objectives, integrating economic/financial lives with a wider purpose of social mobilisation.

Digitalisation can serve as a key means to attract retail investors. Retail investors have developed a keen appetite for digital access to financial services, as fintech revolutions, first in payment services, have provided user-friendly and low-cost options to consumers in a jaded market for payment services that features significant rent extraction.[113] On the investment front, robo-advisers have captured significant market share by offering user-friendly interfaces for invest-

112 UK Stewardship Code 2020, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf, Principle 7. Existing literature has criticised the mixed quality of 'stewardship' in relation to investment intermediaries actively monitoring investee companies and influencing their conduct, see eg *Arad Reisberg*, "The UK Stewardship Code: On the Road to Nowhere", Journal of Corporate Law Studies, 2015, 15, 217. However, the 2020 Code explicitly empowers asset owners to shape their contractual mandates, such as including sustainability concerns. This can provide new impetus for asset managers to address sustainability in their offerings.

113 *Christopher Dula/David Kuo-Chuen Lee*, Reshaping the Financial Order in: Christopher Dula/David Kuo-Chuen Lee (eds), Handbook of Blockchain, Digital Finance and Inclusion, 2018, ch1.

ors.[114] Although robo-advisers do not provide comprehensive and tailor-made financial advice, and only offer highly standardised products in view of regulatory risk,[115] they have become very popular amongst retail investors.

Robo-advisers managed assets valued at about USD145 m in Europe in early 2020,[116] a figure growing at 38 % year over year and expected to grow at least 24 % in the following year. The most popular robo-adviser in the UK, Nutmeg, saw its assets under management grow by 41 % in the year 2019,[117] despite the industry averaging at a growth rate of 13 %. Moneyfarm, another popular robo-adviser in the EU and UK, also saw assets under management grow by 80 % from 2018 to 2019.[118]

Retail investors' interest in digitalised modes of investing is not confined to conventional financial returns-based investing. This is reflected in retail investors' keen participation in online equity crowdfunding—where monies are directly channelled to projects or causes they identify with and support—as a matter of social and personal mobilisation, and not merely financial instrumentality.[119] Indeed, there is significant interest in reward-based crowdfunding where projects usually pertain to social or environmental causes.[120] The introduction of the EU Regulation on Crowdfunding, which standardises investor protection such as mandatory disclosure by issuers and duties for platforms, is widely expected to improve market confidence and galvanise growth in this area.[121]

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114 Public Attitudes to Financial Advice Survey, 2016, https://bandce.co.uk/wp-content/uploads/2016/02/201602-Public-attitudes-to-advice.pdf; *Benjamin P. Edwards*, "The Rise of Automated Investment Advice: Can Robo-Advisers Rescue the Retail Market" Chi.-Kent L. Rev, 2018, 93, 97.

115 *Iris H-Y Chiu*, Transforming the Financial Advice Market – The Roles of Robo-advice, Financial Regulation and Public Governance in the UK, Banking and Finance Law Review, 2019, 35, 9.

116 https://www.statista.com/outlook/337/102/robo-advisors/europe.

117 'Nutmeg tops £2 m AUM' (31 Jan 2020) at https://www.moneymarketing.co.uk/news/nutmeg-tops-2bn-aum/.

118 'Moneyfarm goes from strength to strength' (26 Sep 2019), https://blog.moneyfarm.com/en/moneyfarm-news/moneyfarm-raises-36-million-as-it-launches-one-of-the-largest-digital-wealth-management-partnerships-in-europe/.

119 *Matthew Hollow*, "Crowdfunding and Civic Society in Europe: A Profitable Partnership?" Open Citizenship, 2013, 4, 68.

120 *Saman Adhami/Giancarlo Giudici/Huy Pham Nguyen Anh*, "Crowdfunding for Green Projects in Europe: Success Factors and Effects on the Local Environmental Performance and Wellbeing", 2017, http://www.crowdfundres.eu/wp-content/uploads/2017/11/Crowdfunding-for-green-projects-in-Europe-2017.pdf.

121 EU Crowdfunding Regulation 2020 text based on July 2020 version, see https://www.consilium.europa.eu/en/press/press-releases/2020/07/20/capital-markets-union-council-adopts-

Digital and sustainable finance can be connected by mobilising the availability of indexed sustainably-labelled financial products through digital platforms and robo-advice channels. However, this policy needs to be supported by clarifying how investment advisory duties can be discharged in a manner integrating investors' financial and sustainability needs. This may involve an amendment to the duty of suitability imposed on investment advisors, which will help to clarify and support the concerns of this industry in relation to their legal risk.

3.1 Integrating Sustainability Objectives into Investment Advice

A regulatory duty to advise of 'suitable' investments applies where a personalised recommendation has been made to a customer,[122] excluding forms of more informal,[123] generic or marketing information. Further, an investment services provider must categorise clients into one of three groups: the retail client, the professional client and the eligible counterparty.[124] The professional client is defined as certain financial and corporate institutions as well as natural persons meeting certain quantitative criteria such as investible assets and frequency of financial transactions carried out previously, as well as qualitative criteria in relation to his or her expertise, knowledge and experience with financial services and transactions.[125] The eligible counterparty would be regarded as belonging in a peer level to financial institutions.[126] These two categories of customers are owed a lesser extent of (a) the duty of suitability in relation to investment advice or portfolio management, and (b) the duty of appropriateness for other financial transactions or services.[127]

For advisory and portfolio management services, financial services providers have to ensure that their service or advice is 'suitable' for the customer,[128] but

new-rules-for-crowdfunding-platforms/. The relevance of investor confidence to market growth may be attributed to the 'law and finance effect', discussed in La Porta et al (2006).

122 Art 25, Markets in Financial Instruments Directive 2014/65/EU (MiFID); Art 9, MiFID (Markets in Financial Instruments Directive) Commission Delegated Regulation 2017/565.

123 *Redmayne Bentley Stockbrokers v Isaacs & Ors* [2010] EWHC 1504 (Comm).

124 FCA Handbook COBS 3.4, 3.5, 3.6.

125 FCA Handbook COBS 3.5.

126 FCA Handbook COBS 3.6.

127 Art 25(3), MiFID 2014, Arts 54, 55, MiFID Commission Delegated Regulation 2017/565.

128 'Suitability' is interpreted as meeting the client's investment objectives and risk tolerance, and that the client understands the nature of the product or service engaged with and is finanretail customers benefit from a more comprehensive information collection exercise than other customers, and the obligation of 'suitability' is more extensively owed to retail customers.[129] The duties of suitability and appropriateness have been developed in a highly procedural manner.

Where investment advice or portfolio management is concerned, firms need to collect three areas of prescribed information from customers—investment objectives, risk appetite and financial profile—in order to recommend products that meet the customer's investment objectives, suit his or her risk appetite, and whose risks are reasonably understood by the customer.[130] For other financial transactions, firms need to collect information on the customer's knowledge and understanding of the risks of the transaction concerned in order to proceed with the transaction. In sum, the duties of suitability and appropriateness, even when they apply in full, are highly procedural, and can mitigate a firm's legal risk as compliance is evidenced by adhering to sound procedures and systems[131] that give rise to the ultimate recommendation, providing *ex ante* safety against *ex post* allegations of negligence. Further, firms need to provide a suitability report[132] to their customers ahead of customers' decision-making in order to fully inform them of the basis for recommending certain products as suitable. This provides *ex ante* information to the customer but also plays a significant role in mitigating *ex post* litigation risk for the firm.

The duty of suitability is framed in financial terms as customers' investment objectives and risk tolerance, which are determined by eliciting relevant proxy indicators such as duration of investment horizon and purpose of saving (e. g. for a housing deposit or for education). Further, customers' risk tolerance is also defined in consideration of customers' financial ability to bear loss.[133] Sustainability objectives need to be integrated into investors' preferences and suitability assessments.[134] The potential complexification of legal risk for investment

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cially able to bear those risks. For a retail customer, the financial services provider must be satisfied that all three elements are achieved and explained in a suitability report to the customer. See Art 54, Commission Delegated Regulation (EU) 2017/565.

129 See legislation citations, ibid. Sophisticated customers are assumed to be able to bear their own financial risk and to have requisite levels of knowledge regarding investment products.

130 Art 54, 55 MiFID Commission Delegated Regulation 2017/565.

131 *Maple Leaf Macro Volatility Master Fund v Jacques Rouvroy* [2009] EWHC 257 (Comm); [2009] 1 Lloyd's Rep 475.

132 Art 54, MiFID Commission Delegated Regulation 2017/565.

133 Art 54, MiFID Commission Regulation 2017/565.

134 See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-advisors needs to be addressed if the demand for investment advice on sustainably-labelled financial products increases. In a robo-advice context, the financial nature of the duty of suitability is singularly adhered to by adopting a procedural approach. Adjustments should be made to the duty of suitability in order to facilitate investment advice that supports the sustainably-labelled product market, and the robo-advice industry in particular can benefit from such adjustments.

3.2 Integrating Investors' Sustainability Objectives into Robo-advice?

Robo-advice is the shorthand for automated forms of investment management interfaces. A robo-adviser can provide an algorithm-generated list of investment options to customers based on customer data, leaving customers to take further action. Robo-advisers also include automated wealth management services where portfolios are constructed by algorithmic intelligence, monitored according to programmed parameters and automatically rebalanced according to those parameters.[135]

It has been observed that robo-advisors are accessible on-demand, 24/7 in the comfort of one's environment.[136] This seems to meet the access preferences of many investors.[137] Crucially, robo-advice is often accessible to those who have small amounts to save, exemplified by Nutmeg's promise to on-board customers saving from as little as £100 initially.[138] This has the potential to help with 'democratising finance' and increasing financial inclusion, an outcome already observed in the United States where robo-advisors have garnered over USD $400 billion assets under management and are looking to exceed USD$1.5 trillion by 2023.[139] The cost of use of robo-advisors is also generally lower than other forms of investment fund management, as annual charges can be three

2017-565; also "AI can drive ethical investment only if we grasp the messy reality" (Financial Times, 9 Nov 2020), https://www.ft.com/content/b238b8f2-8645-4654-a806-681c9a461d0b.

135 *Pablo Sanz Bayón/Luis Garvía Vega*, "Automated Investment Advice: Legal Challenges and Regulatory Questions" Banking and Financial Services Policy Report, 2018, 37, 1.

136 *Andrea L. Seidt/Noula Zaharis/Charles Jarrett*, "Paying Attention to That Man behind the Curtain: State Securities Regulators' Early Conversations with Robo-Advisers" U. Tol. L. Rev, 2019, 50, 501.

137 Public Attitudes to Financial Advice Survey (2016).

138 https://www.nutmeg.com/new-to-investing, but see Edwards, 2018, who finds that some robo-advisers allow savers to start investing from as low as $8.

139 *Facundo Abraham/Sergio L Schmukler/José Tessada*, "Robo-Advisors: Investing through Machines", World Bank Research and Policy Brief, 2019.

times lower.[140] From an affordability point of view, robo-advisers have the potential to incentivise access, and in the UK[141] and Germany,[142] the two largest robo-adviser markets in Europe, there is an upward trend in terms of growth in robo-advisers' market share.

However, robo-advice suffers from several limitations. Most robo-advisers are programmed to adopt diversification strategies adhering to Modern Portfolio Theory,[143] and recommend investing only in exchange-traded funds,[144] or in passive index-linked funds that are often seen as cost-effective and reliable in performance.[145] Further, they are often 'restricted advisers' that are tied to a limited range of products.[146]

Robo-advisers have benefited from the procedural implementation of the duty of suitability. Compliance with suitability entails the eliciting of customer information as prescribed, and then matching the profile of the customer with financial products that are categorised accordingly. The procedural approach in complying with suitability and appropriateness makes the advisory process programmable in terms of sequencing and matching. Indeed, financial products are sorted into only a few categories for matching purposes, principally by risk appetite,[147] and this allows the programming of a clear labelling strategy for robo-advisors in seeking matches with customers' profiles. Such strategies are highly standardised and designed to be cost-effective and fuss-free, meeting requirements of suitability and appropriateness. This business model presents a relatively low level of legal risk for robo-advisory firms. The incorporation of sustainability preferences presents new challenges in the design of questionnaires

140 *Wolf-Georg Ringe/Christopher Ruof*, "A Regulatory Sandbox for Robo Advice", ILE Working Paper, 2018, http://hdl.handle.net/10419/179514.

141 *Gregor Dorfleitner/Lars Hornuf/Matthias Schmitt/Martina Weber*, "The Fintech Market in Germany", 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2885931.

142 ibid.

143 *Michael Faloon/Bernt Scherer*, "Individualization of Robo-Advice" Journal of Wealth Management, 2017, 31.

144 Meaning that are liquid and traded on an exchange within the day, see *Philipp Maume*, "Regulating Robo-Advisory" Texas International Law Review, 2018/9, forthcoming.

145 The outperformance of passive index-linked funds has often been touted as superior to actively managed 'stock-picker' funds, *Kevin R James*, "The Price of Retail Investing in the UK", FSA Occasional Paper, 2000; *Burton G Malkiel*, Efficient Markets and Mutual Fund Investing: The Advantages of Index Funds in: John D Haslem (ed), Mutual Funds: Portfolio Structures, Analysis, Management, and Stewardship, 2010, ch 7.

146 For example the largest robo-adviser Nutmeg in the UK has over £800 m in assets under management but is a restricted adviser recommending its own products only.

147 *Faloon/Scherer* (fn. 143)*; Bernd Scherer*, "Algorithmic Portfolio Choice: Lessons from Panel Survey Data" Financial Markets Portfolio Management, 2017, 31, 49.

that would translate into clear decision pathways for robo-advisors, and may therefore raise legal risks for robo-advisers in discharging the duty of suitability, discussed below. We observe that many robo-advisors do not provide for clearly signposted 'sustainable' options. There is room for development in policy thinking to leverage retail investors' interest in digitalised investing and to provide a framework to mitigate providers' legal risk in offering such options.

First, the duty of suitability would have to accommodate investors' sustainable objectives. The duty as framed in the Markets in Financial Instruments Directive 2014 (MiFID) does not exclude sustainable objectives, although the conventional interpretation of investors' objectives relates to financial ones. Robo-advisors' conventional due diligence cannot accommodate such objectives at the moment. If 'sustainable' objectives are added to the mix, it may be complex for robo-advisers to map investors' objectives onto products. 'Sustainable' objectives can contain subjective elements, i.e. investors' personal preferences, and objective elements such as the time it takes for sustainable goals to be achieved. Further, investors' sustainable objectives can be vaguer than financial ones.

The Regulations arguably ameliorate the imprecision or complexity of sustainability objectives. The Regulations provide a minimum definitional framework for sustainable objectives under the Sustainability Disclosures Regulation 2019 and a 'ceiling' of precise objectives for environmentally-sustainable objectives under the Taxonomy Regulation 2020.[148] Investors' choice of sustainable objectives can be mapped according to the Regulations. In order to facilitate the robo-advisory market to incorporate sustainable objectives, legislative clarification is required to articulate that the duty of suitability *includes* investors' sustainable objectives. An amendment to the Commission Regulation as delegated legislation to the MiFID has been proposed, [149] and we make further suggestions in this article for more clarification.

In ascertaining investors' objectives, Article 25 of the MiFID also requires investment intermediaries to find out investors' ability to bear financial risks.[150] Robo-advisory models implement this aspect of the duty of suitability by ascertaining whether investors' financial profiles are consistent with their preferences along the risk/return trade-off spectrum. In light of the marketising agenda for

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148 Discussed in Sect. 2.

149 Art 54, Commission Delegated Regulation (EU) 2017/565; and consultation on amendment is at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017–565.

150 Ibid.

sustainable finance, it can be argued that this focus on customers' financial motivations and profiles is too narrowly-framed.

Empirical research shows mixed evidence regarding whether investing in sustainable objectives is aligned with financial performance,[151] and many investors may be willing to accommodate a trade-off in favour of sustainable objectives even if financial performance is somewhat sacrificed.[152] This preference should be fielded in robo-advisory questionnaires as this has an impact on categorisation of investors and selection of matching products. Sustainably-labelled products have been touted for entailing superior financial performance, but investors should not take this for granted.[153] Indeed, sustainably-labelled products may be managed with a restricted portfolio or constitute relatively less liquid investments. In this manner, certain fund compositions could entail a trade-off[154] between financial and sustainable performance of the product.

It is proposed that where investment intermediaries are aware of proxy characteristics in a product that may involve a trade-off between financial returns and attainment of sustainable objectives, they should provide investors with a clear warning that this may be expected and the reasons why, for example because of a more restricted portfolio. Such a warning can be attached to particular products offered on the robo-advisory platform. Robo-advisers developing their protocols with more integrated data on investors' sustainability preferences and product sustainability can ultimately provide more sophisticated categorisations to investors to match with a more comprehensive suite of conventional and sustainably-labelled products.

Thirdly, investment intermediaries need to ensure that investors understand the nature of the product they are investing in, so as to discharge the duty of suitability. It can be argued that sustainable finance may be more complex, given that it has mixed objectives and aims at creating hybrid value with perhaps trade-offs. This may intensify the need for investment intermediaries to be satisfied that investors understand these dilemmas. If investment intermediaries need to invest in educational tools, for example, in order to mitigate their legal risks, offering sustainable finance products can become burdensome and costly. It can however be argued that the Sustainable Disclosure Regulation 2019 ameliorates this risk. The Regulation's prescriptions for mandatory disclosure, to be made

151 See fn. 111.

152 *Hafenstein/Bassen* (fn. 66); *Gutsche/Ziegler* (fn. 66).

153 *Sekhar Amba*, "Corporate Sustainability: Do Executives and Investors Care?- An Empirical Study" International Journal of Management and Marketing Research, 2018, 11, 19; *de Haan et al*, 2012.

154 *Ielasi* et al (fn. 111).

more granular in Commission legislation, would provide pre-contractual information for investors in relation to both actively-managed and passively-managed products. Large firms subject to the mandatory duty to disclose adverse sustainability impact at product level from 2022 would in addition be able to inform investors that way. Further, the Commission is introducing amendments to product governance rules to ensure that manufacturers and distributors of investment products clearly envisage sustainably-labelled products for the appropriate target market.[155] In this manner, the reforms we propose to the duty of suitability build upon the advancements already made, but achieve more pinpoint protection for investors.

Further, it may be optimal for Commission legislation to specify that the mandatory disclosures be made in a manner that a lay person can access, in both non-technical and technical language. In an online context, cross-referencing to mandatory disclosures may be tiresome for an investor and robo-advisors have to give some thought as to how information can be signposted. Investors should be made to read salient information in a user-friendly interface.

Adjustments to the duty of suitability would be necessary to accommodate investors' needs in sustainable finance generally, as ESMA already foresees.[156] Providers of robo-advisory protocols can also be encouraged to develop more competitive and sophisticated data management and profiling programmes for appealing to a wide market of investors, as demand is increasing in this area.[157] The implementation of an adjusted duty of suitability in robo-advisory protocols is necessary to connect digital and sustainable finance. We think further policy frameworks may be necessary in due course, such as the development of a market for comparison websites for mutual funds and robo-advisors,[158]

155 *European Commission,* "COMMISSION DELEGATED DIRECTIVE (EU) …/… amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations" (2021), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=PI_COM:C(2021)2612.

156 *ESMA, Guidelines on Certain Aspects of the MiFID II Suitability Requirements* (2018), https://www.esma.europa.eu/sites/default/files/library/esma35-43-869-_fr_on_guidelines_on_suitability.pdf, p6.

157 'Sustainable investing is set to surge in the wake of the coronavirus pandemic', CNBC News, 7 June 2020, https://www.cnbc.com/2020/06/07/sustainable-investing-is-set-to-surge-in-the-wake-of-the-coronavirus-pandemic.html.

158 These are now subject to regulation by the FCA in the UK, see FCA, PS16/15: Feedback on CP15/33 – Consumer credit: proposals in response to the CMA recommendations on high-cost short-term credit, 2016, https://www.fca.org.uk/publications/policy-statements/ps16-15-feedback-cp15-33-consumer-credit-proposals-response-cma in relation to comparison websites for high-cost short-term credit; FCA, Guidance on the: Selling of General Insurance Policies Through and improvements to robo-advisors in relation to post-sale services like investor engagement.[159] These are however beyond the scope of this paper for now.

4 Conclusion

The EU has developed a pioneering framework for marketising and regulating sustainably-labelled financial products. This article critically analyses the resulting regime and argues that the interaction between its regulative and enabling aspects creates mixed messages for governance and market-building. The Regulations adopt an incentive-based approach towards market-building for quality sustainable finance, but lower-level products are not shut out. The article predicts that market-building may be concentrated in passively-managed indexed products, but such products cannot be developed along the same passive trajectories as in conventional fund management, given the positive obligations attached to monitoring and reporting on quality. Moreover, the introduction of more stringent governance for large investment intermediaries may lead to fragmentation in compliance and market fragmentation in favour of the domination of large investment fund houses. These regulatory reforms need to be complimented by mobilising institutions to demand quality sustainably-labelled investment products, and by making them available to retail investors too. Where retail investors are concerned, we argue that the policy gap lies in bridging sustainable and digital finance. Investment advice provided to retail investors must incorporate the needs of sustainable finance, and the legal duty of suitability should be adjusted. Although this is in progress at the level of the Commission, the proposed amendments seem minimal and can be further clarified to take into account of the complexities of sustainable investments. We further discuss how our proposals are necessary to and can be implemented in digital finance, via robo-advisory channels that are growing in popularity with retail investors. The connection between digital and sustainable finance can be highly synergistic in attracting both institutional and retail demand.

Price Comparison Websites, 2011, https://www.fca.org.uk/publication/finalised-guidance/fg11_17.pdf.

159 the question of whether investors in pooled funds can feed in preferences for institutional shareholder engagement for example, as argued in *E. McGaughey*, "Does Corporate Governance Exclude the Ultimate Investor?" Journal of Corporate Law Studies, 2015, 16, 221.