

TECC 2022

ESG challenges & opportunities for Compliance

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Agenda of today's session

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Integration of ESG into S&A Assessment

II

Impact of ESG framework on index funds focused products and provider

III

ESG and crypto-asset investment

IV

Questions & Answers

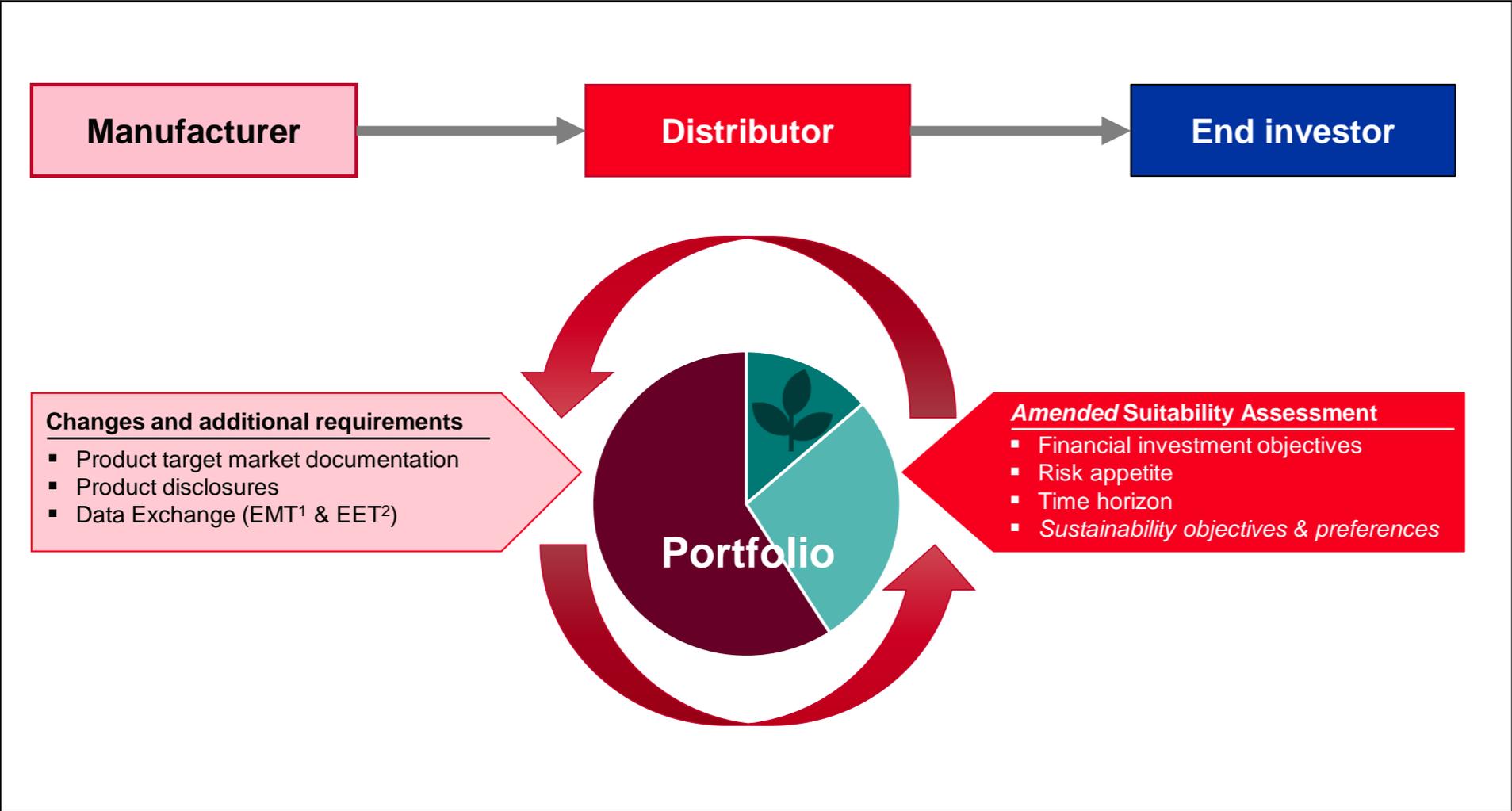
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As the regulation discussed in these slides is partly still in consultation all discussed solutions and impact-analysis reflect the status-quo of the ongoing discussion and might change if regulation or guidance from the regulator change.

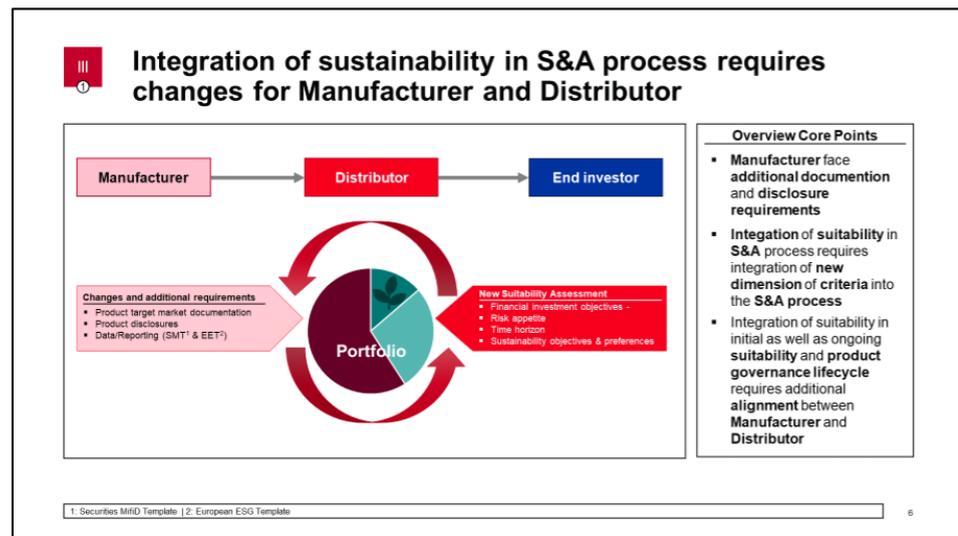


Integration of sustainability in S&A¹ process requires changes for Manufacturer and Distributor



- ### Overview Core Points
- **Manufacturer** face **additional documentation and disclosure requirements**
 - **Integration of suitability** in **S&A** process requires integration of **new dimension of criteria** into the **S&A process**
 - Integration of suitability in initial as well as ongoing **suitability** and **product governance lifecycle** requires additional **alignment** between **Manufacturer** and **Distributor**

Collecting sustainability preferences requires a client friendly information collection process



Client's General Sustainability Preferences (Level 1)

- Collect information whether client has any sustainability preferences through generic Yes/No option
- Collect information whether client has **specific sustainability preferences** through wordings like „without any specific preferences“ / „with specific preferences“

Collection of Specific Interests (Level 2)

- **Various approaches** are currently rolled-out on the (German) market from detailed PAI-factor¹ selection option to aggregated high-level selection option
- While detailed selection is close to ESMA recommendations, wording and level of detail require enhanced understanding of underlying sustainability target

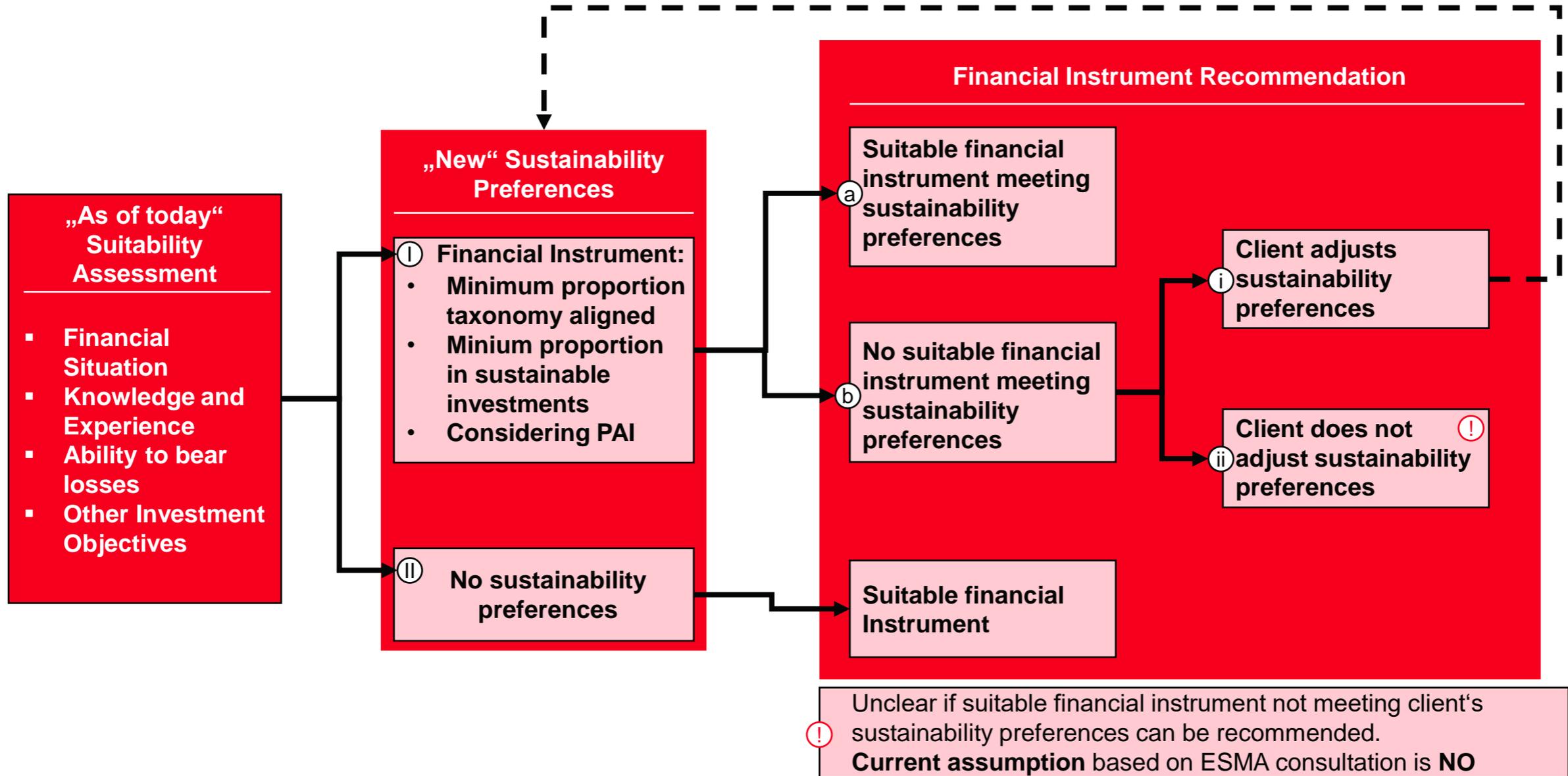
Allocation of Asset-Percentage

- Enable client to select the percentage of his investment which shall be allocated in sustainable products (various from 10% – 100%)

Distributors without an offer fulfilling the sustainability requirements can use a fall-back option



I 3 Exemplary Flowchart for distributors without a sustainable dpm-offer





Deep-Dive Amendment Sustainability Assessment

SUMMARY (SUITABILITY ASSESSMENT):

- Client's **sustainability preferences** to be assessed as **part of the suitability assessment** conducted for clients, to take into account:
(i) investment experience/knowledge; (ii) their ability to bear losses; and (iii) their risk tolerance
- The information about the investment objectives of the client or potential client shall include, where relevant, their sustainability preferences
- The following should be explained as part of the clients suitability assessment:
 - a financial instrument for which the client or potential client determines that a **minimum proportion** shall be invested in environmentally sustainable investments under the **Taxonomy Regulation**, i.e. an Article 8 or 9 fund under SFDR which is Taxonomy aligned
 - a financial instrument for which the client or potential client determines that a **minimum proportion** shall be invested in sustainable investments as defined under **SFDR**, i.e. an Article 8 'plus' or Article 9 fund under SFDR, which invests in sustainable investments as defined under SFDR
 - financial instruments that consider **principal adverse impacts** on sustainability factors where **qualitative or quantitative elements** demonstrating that consideration are determined by the client or potential client
- Financial instruments without these specific features **will not** be eligible for recommendation to existing or prospective clients that have individual sustainability preferences
- In order to allow for further recommendations to existing or prospective clients, where financial instruments do not meet a client's sustainability preferences, the client should have the possibility to adapt information on his or her sustainability preferences
- Suitability reports to be updated to explain how the recommendation meets the client's sustainability preferences

RULE REFERENCE: Articles 54(2), (5), (9), (10), (12) and (13) MiFID Delegated Regulation



Deep-Dive Amendment Product Governance (1/2)

SUMMARY:

Product manufacturers and distributors should consider sustainability factors in:

- (i) the product approval process of each financial instrument;
- (ii) in other product governance and oversight arrangements that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile

PRODUCT MANUFACTURER REQUIREMENTS:

1) Target market:

- specify the type(s) of client whose needs, characteristics and objectives (including any sustainability related objectives), the financial instrument is compatible
- the financial instrument's sustainability factors (where relevant) must be consistent with the target market
- ensure the financial instrument's sustainability factors (where relevant) are consistent with the target market

2) Negative target market: not required where financial instruments consider sustainability factors

IMPACT:

- As part of the product governance process, it should be considered if the financial instrument remains consistent with any sustainability related objectives of the target market



Deep-Dive Amendment Product Governance (2/2)

Indirect Impact: Roll-out of **European ESG Template (EET)** reflecting sustainability information while **European MiFID template (EMT)** keeps the relevant **MiFID information**.

Please see the following link with respect to the latest EMT: <https://findatex.eu/> and best practice guide to completing EET.

RULE REFERENCE: Article 9 MiFID Delegated Directive

PRODUCT DISTRIBUTOR REQUIREMENTS:

1) Target market requirements:

- (i) compatible with the needs, characteristics, and objectives (including any sustainability related objectives) of an identified target market; and
- (ii) the intended distribution strategy is consistent with the identified target market

2) **Negative target market:** identify any group of clients whose needs, characteristics and objectives are not compatible with the product or service provided (**except** where financial instruments consider sustainability factors)

IMPACTS:

- As part of the product governance process, it needs to be assessed: (i) whether the product or service remains consistent with the needs, characteristics and objectives (including any sustainability related objectives) of the identified target market; and (ii) whether the intended distribution strategy remains appropriate

RULE REFERENCE: Article 10 MiFID Delegated Directive

Disintegrated Timeline for ESG Regulation roll-out creates additional challenges for Asset Managers



Impact on Industry

- Distributors face **two level uncertainty** (manufacturer level and asset level)
- Sustainability reporting** for companies mainly voluntary creating **huge divergence** in company **data quality**, **sustainability rating design** and company's **sustainability rating**
- Reduction of investment universe** from circa 10.000 stocks to 2500 – 3000 stocks⁴ and increased concentration in dedicated assets and stocks
- Current **limitation** of green fixed income products reduces the **client's investment strategy options** or requires higher allocation in volatile asset classes
- Substantially **higher pricing for sustainable products** than for conventional products⁴
- Trend from green-washing to green-bleaching to reduce transparency requirements⁵

Risks:

- Complaints**
- Intensified investment advice process**
- Law Suits**
- Public campaigns**
- Reduction of digital offerings and competitive pricing**

1: Corporate Sustainability Reporting Directive | 2: International Sustainability Standards Board | 3: European Financial Reporting Advisory Group | Source: Börsen-Zeitung Page 4 04/09/2022 | 5: Bloomberg 14/09/2022 & ESMA Consultation Paper on „certain aspects of the MiFID II suitability requirements“



Joint Target Market Definition of German Banking, Derivative and Asset Manager Association

Other Products – Not part of the MiFID target market		
Non-ESG	Basic	ESG strategy
No information or data provided & declared as non-sustainable	Consideration of transparency about sustainability risks  Product manufacturer takes into account a recognized industry standard	Product follows a dedicated ESG strategy  Product manufacturer takes into account a recognized industry standard

Products targeting clients with sustainability-related objectives		
PAIs (consideration of principal adverse effects) ¹	Sustainable investments compliant to SFDR	Environmentally sustainable investments inline with EU-taxonomy
Dedicated ESG strategy with consideration of standard PAIs on environmental and/or social topics  Minimum exclusions  Product manufacturer considers a recognized industry standard	ESG strategy with share of impact-related investments in line with SFDR: <ul style="list-style-type: none"> • <i>Concrete Percentages</i> • No serious violations of UN Global Compact, democracy & human rights  Product manufacturer considers a recognized industry standard	ESG strategy with share of impact-related investments within the meaning of EU-taxonomy : <ul style="list-style-type: none"> • Specific Percentages • No serious violations of UN Global Compact & democracy & human rights  Product manufacturer considers a recognized industry standard

1: Art. 2 No. 7 lit. c MiFID II DR | 2: Art. 2 No. 7 lit. b MiFID II DR | 3: Art. 2 No. 7 lit. a MiFID II DR



Overview of Minimum Exclusion Requirements on product and portfolio level

Products aimed at clients with sustainability-related objectives pursuant to Art. 9 para. 9 sub-para. 1 MiFID II-DR		
PAIs (consideration of principal adverse effects) ¹	Sustainable investments compliant to SFDR	Environmentally sustainable investments inline with EU-taxonomy
<p>Dedicated ESG strategy with consideration of standard PAIs on environmental and/or social topics</p> <p>+</p> <p>Minimum exclusions</p> <p>+</p> <p>Product manufacturer considers a recognised industry standard</p>	<p>ESG strategy with share of impact-related investments in line with SFDR:</p> <ul style="list-style-type: none"> Concrete Percentages No serious violations of UN Global Compact, democracy & human rights <p>+</p> <p>Product manufacturer considers a recognised industry standard</p>	<p>ESG strategy with share of impact-related investments within the meaning of EU-taxonomy:</p> <ul style="list-style-type: none"> Specific Percentages No serious violations of UN Global Compact & democracy & human rights <p>+</p> <p>Product manufacturer considers a recognised industry standard</p>

Industry Activities

- Weapons > 10%¹ (banned weapons < 0%)
- Tobacco Production > 5%
- Coal > 30%¹

Social Company Standards

- Serious violations of UN Global compact (without positive perspective)
- Protection of international human rights
- No complicity in human rights abuses
- Upholding the freedom of association and the right to collective bargaining
- Elimination of forced labour
- Elimination of discrimination when hiring and employing
- Combats all forms of corruption

Environmental Standards

- Precautionary approach in dealing with environmental problems
- Promote greater environmental awareness/responsibility
- Development and propagation of environmentally friendly technologies

Sovereign Issuers: Violation of democracy and human rights

1: Percentage of turnover from production and/or distribution

Sustainable funds definition according BaFin's drafted guidelines for German sustainable funds

Investment conditions of sustainable German retail funds will only be approved by the BaFin if the investment conditions of the respective fund complies to one the conditions defined below:

1

The investment restrictions require **at least 75 percent of the fund's investments are invested in sustainable investments** („nachhaltige Vermögensgegenstände) – in order to determine a sustainable investment, the requirements set forth in Art. 2 sec. 17 SFDR shall be taken into account

2

The investment restrictions require **at least 75 percent of the fund's investments are invested in sustainable investments** („nachhaltige Vermögensgegenstände) – in order to determine a sustainable investment, the requirements set forth in Art. 2 sec. 17 SFDR shall be taken into account

3

- I. The investment conditions contain, where a sustainable index is tracked as part of a passive investment strategy, a **detailed explanation of the sustainability character of the respective index**
- II. Environmental and social objectives referred to in Art. 2 Sec. 17 SFDR or in Art. 9 EU-Taxonomy Regulation shall be significantly harmed and governance aspects shall be taken into account

ESG and Crypto-Asset investment

Opening-Up for Institutional Investors

German Fund Location Promotion Act (Fondsstandortgesetz) enabled institutional investors to invest up to 20% of their assets in crypto assets



Sustainability Reporting Requirements

- CSRD reporting applies for „traditional“ companies only
- Integration of crypto-assets in sustainability reporting uncertain

Open Points

- **Collection & controlling of sustainability information** from crypto-asset issued like foundations or Decentralized Autonomous Organizations (DAOs)
- **Integration Crypto-Assets** with dedicated **sustainability use cases** (e.g. carbon compensation)
- Current **limitation of sustainable fixed income products** requires a **further reduction of allocation in crypto-assets** to ensure 75% threshold due to crypto-assets inherent volatility

Questions and Answers

