MiFID II

Integrating sustainable preferences into MiFID II

private banking
asset management
investment banking
asset services

Degroof Petercam
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Responsible editor: Sabine Caudron. Editorial date: January 2024.
Legal address: Bank Degroof Petercam nv, Nijverheidsstraat 44, 1040 Brussels.
VAT: BE 0403.212.172 (Company Register Brussels) - FSMA 040460 A.

The energy transition and the myriad environmental and social challenges we face mean that an increasing number of investors are considering factors other than purely financial ones when making their decisions.

At Degroof Petercam, this approach fits into a long tradition of sustainable investment. Our mission as a wealth manager across generations has led us to advocate a long-term perspective for 150 years.

Every challenge can also create opportunities, and brings prosperity to those who embrace them. Combining prosperity with sustainability creates an impulse for your investments.

We integrate environmental, social, and governance criteria into our analysis, whether concerning the products we offer or the management we carry out on behalf of our clients. We are also trying to contribute to a better society by reserving part of our investments for companies whose activities impact the environment and social issues.

As you will read in this brochure, by amending the MiFID II Regulation, the European authorities now allow you to express yourself on these crucial matters. Accordingly, you are invited to express your sustainable investment preferences in the context of the management of your portfolio or the investment advice you receive.

Expressing your preferences begins with understanding sustainability concepts and how we define and translate them into our investment policy. That is the purpose of this brochure.

And of course, as with other topics, you can rely on your private banker to guide you through this process.

Sabine Caudron
Head of Private Banking

My preferences in terms of sustainability?

> The goal is to create a more sustainable society

As of August 2, 2022, new European rules regarding sustainable finance came into effect for investments executed under investment advice or discretionary portfolio management.

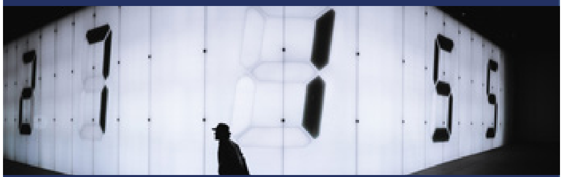
The goal is to create a more sustainable society, and as an investor, you have the opportunity to participate in this transition actively.

Following changes to the rules of the European MiFID II Directive, you can now express your views on sustainability within your investments. Via a new questionnaire, you will be asked to determine your preferences regarding sustainable investments by answering several questions.

Bank Degroof Petercam will consider these preferences in its discretionary portfolio management and investment advice services.

Summary

MiFID II : MiFID stands for “Markets in Financial Instruments Directive.” This regulation came into force in 2007. The MiFID II Directive, which complements this regulation, came into force in 2018.
MiFID II consists of strengthening the European rules as follows:

For investors:	On the stock markets:
	
✓ by providing them with better protection thanks to stricter rules on conflicts of interest; ✓ more transparent information on investment services to be provided by investment firms.	✓ by increasing investor protection and strengthening the rules of conduct and competition in the trading and settlement of financial instruments; ✓ by increasing transparency and supervision of financial markets.

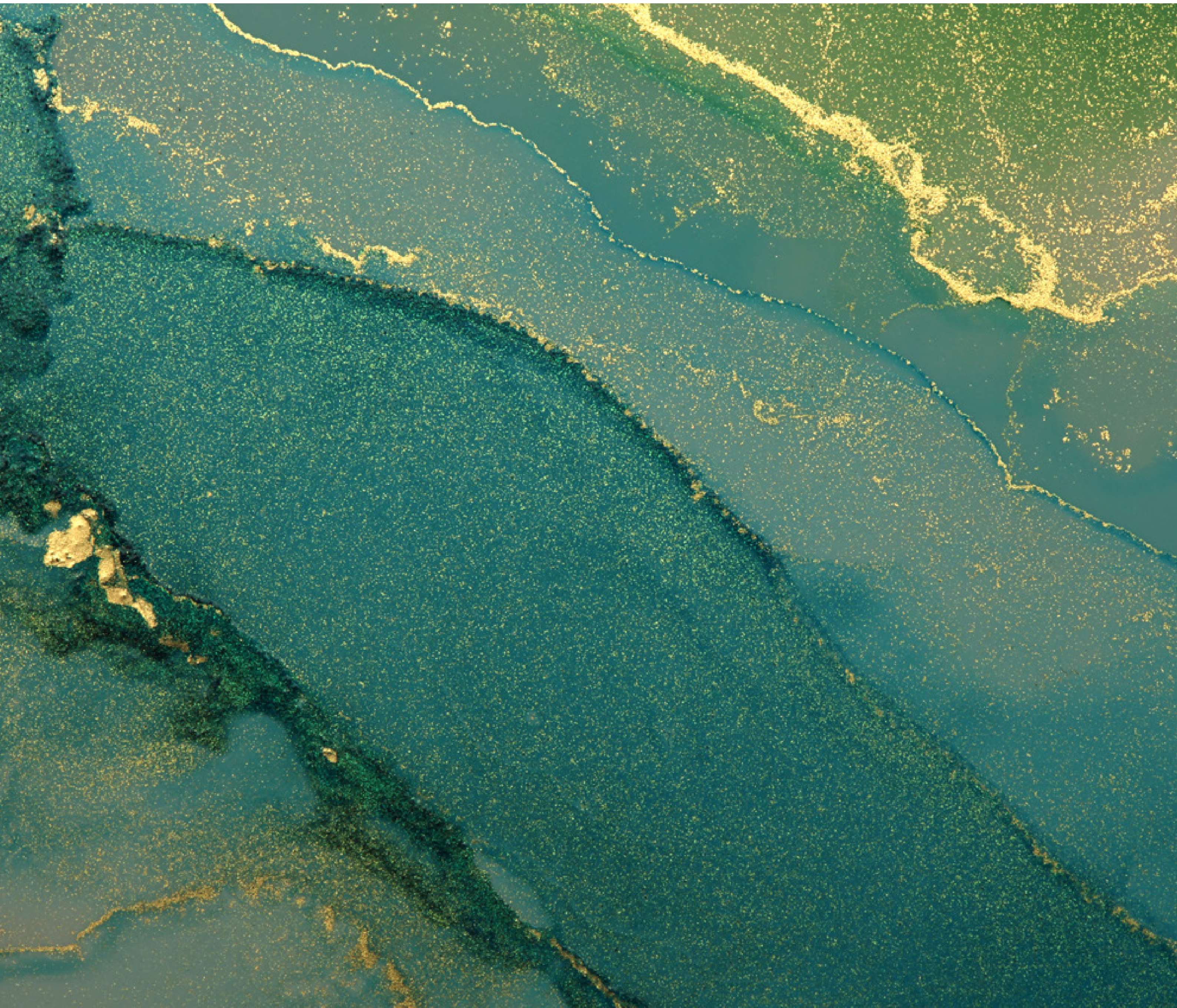
The purpose of this brochure is to provide you with more information on the challenges associated with sustainable investments, and their various practical concepts that are also linked to each other. The aim is for you to be able to determine your preferences regarding sustainability in an informed manner.

Indeed, you have the possibility, if you wish, to express your preferences according to different concepts:

- ✓ Alignment with Taxonomy.
- ✓ Sustainability based on SFDR.
- ✓ Taking into account the main negative indicators on sustainability ‘Principal Adverse Impacts’ (PAI).

Are you not familiar with these technical terms? We explain everything in more detail in this brochure so that you can make the best choices for your future investments.

Introduction:
What’s the overall context?



Sustainability and the multitude of environmental and social challenges concern us all. Not only in our daily lives as consumers, but also as investors.

That's why we have assumed responsibility at the bank level to take extra-financial factors gradually into account in our investment policies. This action ensures that we are not complicit in controversial conducts or sectors and can promote best practices and beneficial activities, ensuring positive input to society. In fact, we firmly believe that sustainable investment is the way forward to reduce risk, anticipate tomorrow's successes, and contribute to a better society.

Beyond this internal commitment, there is also an external willingness on the part of governments and the European Union, which in recent years have set ambitious targets, in particular to become climate-neutral by 2050. An action plan has been drawn up with different regulations destined for the various stakeholders to achieve these goals and redirect capital flows towards investments that allow more sustainable growth.
A wave of new regulatory texts in this area has been progressively adopted in recent years:

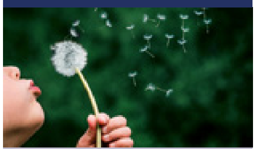
- First, for the companies, through new reporting requirements for extra-financial data such as their carbon footprint or their water use (CSRD Regulation[1]).
- Second, for investment companies like Degroof Petercam to clarify which underlying activities contribute to the achievement of Europe's environmental goals (Taxonomy Regulation[2]) and to what extent do they consider extra-financial factors in the investment products they offer to clients (SFDR[3]).
- Finally, for individual investors, enabling them to express their sustainability preferences (Delegated acts amending MiFID II Regulation[4]).

[1] CSRD (Corporate Sustainability Reporting Directive): a European directive that establishes new standards and obligations for non-financial reporting for major European companies.
[2] Taxonomy: European regulation which lays down criteria for the selection of environmentally sustainable economic activities.
[3] SFDR (Sustainable Finance Disclosure Regulation): disclosure requirements for sustainability-related data and policies at an organization, services and product levels to standardize sustainability performance.
[4] MiFID II (Markets in Financial Instruments Directive): a European directive that sets out the rules financial institutions are required to follow when offering or advising on investment products.

This latest regulation, which concerns you directly, is now adding a new layer to the MiFID questionnaire you know already. These are now supplemented by questions that allow you to express your preferences in terms of sustainable investments.

Through these initiatives, the European Union is building a common reporting framework and ensuring that companies disclose reliable and comparable extra-financial information to help investors evaluate extra-financial performance of companies and redirect investments towards activities that enable sustainable prosperity.

All these regulations are therefore interlinked and feed into each other.

Companies	Asset Managers	Private Bankers	Investors
			
Provide more information on sustainability	Provide information about how sustainability is addressed in financial products	Discuss sustainability preferences with their clients	Investing sustainably
Extra-financial reporting (CSRD +Taxonomy) ❯	SFDR & Taxonomy ❯	Sustainability preferences in MiFID II ❯	More sustainable investments

What's changing?

The European Union requires financial institutions offering investment services to take sustainability risks into account in their organization and also to consider the sustainability preferences of the client within their suitability process[5].

Investment firms must, therefore, in addition to the traditional elements of financial capacity, knowledge, and experience, also collect information on their clients' sustainability preferences. The goal is to ensure that the instruments advised or used within the discretionary management of the portfolio are aligned with sustainability preferences (or lack thereof).

Moreover, the new rules stipulate that only "sustainable investment instruments" can be used to answer investors' specific sustainability preferences. In this sense, three types of these instruments have been defined (we discuss them in more detail in this brochure).

[5] For clients who use «execution only» services (execution order on your initiative, without advice), nothing will change.

When?

I am a new client

When opening a new investment portfolio, the Bank will define a profile with you based on some questions (the investment profile), which will now be supplemented with questions about your preferences linked to the theme of sustainability.

I am already a client

In this case, your private banker or your usual contact person will invite you to complete the sustainability questionnaire with them during the revision of your MiFID investment profile. Suppose you are already a client and want to open a new investment portfolio. In that case, we will immediately ask you about your sustainability preferences so that the proposed investments align with your sustainable investment objectives. These objectives may vary from portfolio to portfolio.

How?

As an investor, you can determine your sustainability preferences by answering some questions about your interests in various sustainability issues. The aim is to ensure that the financial instruments recommended to you or purchased under a management mandate are suitable for you taking into account these preferences.

The existing MiFID questionnaire (PFI[6]) will not change. Your sustainability preferences will be determined through a new questionnaire.

You must know that you can change your sustainability preferences at any time through your regular contact person.

As part of your onboarding or your re-profiling, you should answer at least the first question of the questionnaire.

"Do you have any sustainability preferences for your portfolio that should be taken into account?"

- **Answering no to this question** means that you have no sustainability preferences for the portfolio covered by this questionnaire. Then you will be considered a 'neutral investor', meaning that your services do not change, and you can use both sustainable and unsustainable instruments in this portfolio.

- **If you answer yes to this question,** it means that you have sustainability preferences, and you want to integrate them into your investment portfolio. In this case, the Bank will analyze them based on more detailed additional questions.

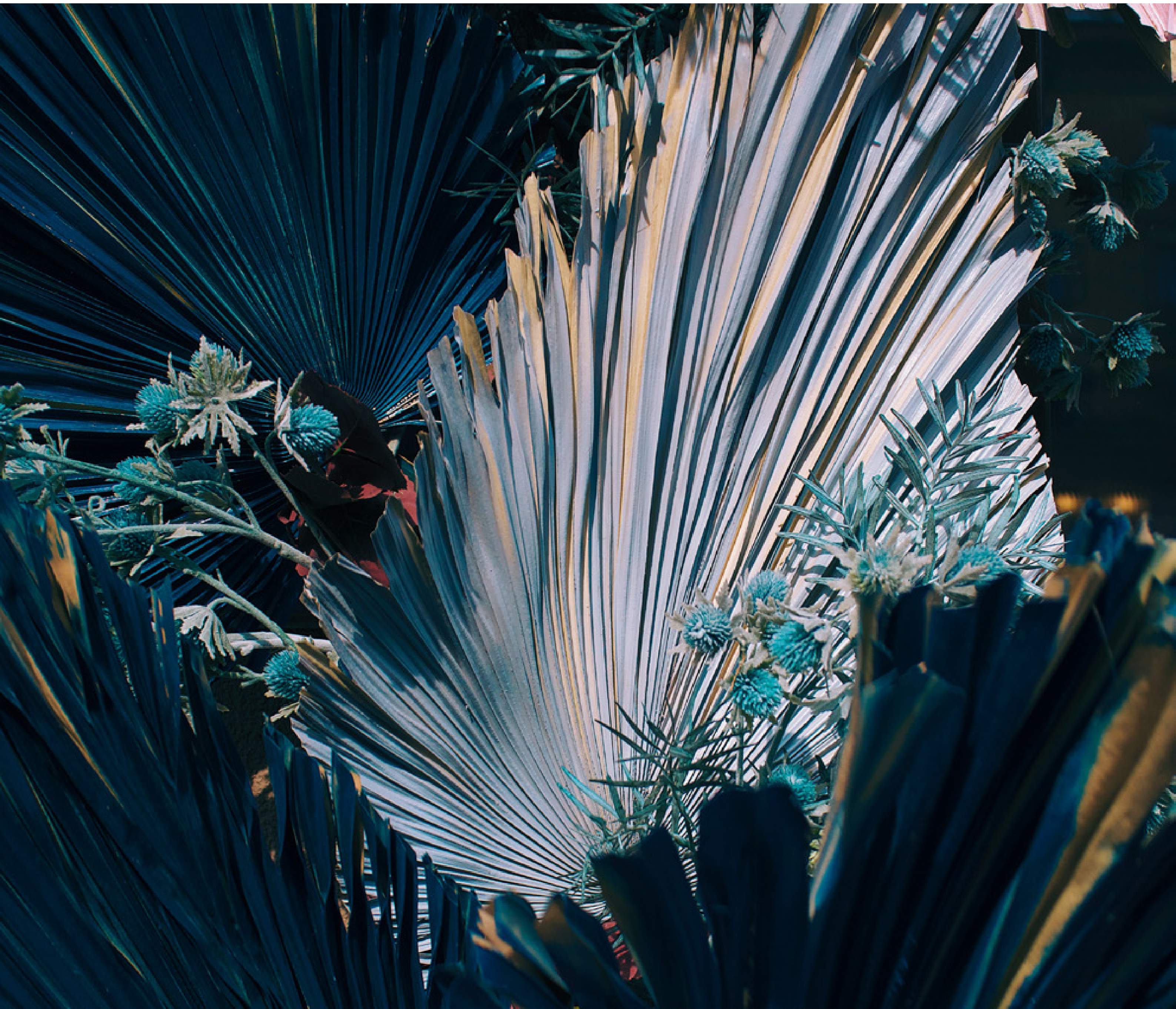
In line with our portfolio approach, you first have the option to determine the minimum percentage you want to invest sustainably within the portfolio.


[6] Personal and Financial Inventory

Then, you can pass on your specific preferences regarding the financial instruments themselves:
- Alignment with Taxonomy.
- Sustainability based on SFDR.
- Considering the main negative sustainability indicators 'Principal Adverse Impacts' (PAI).

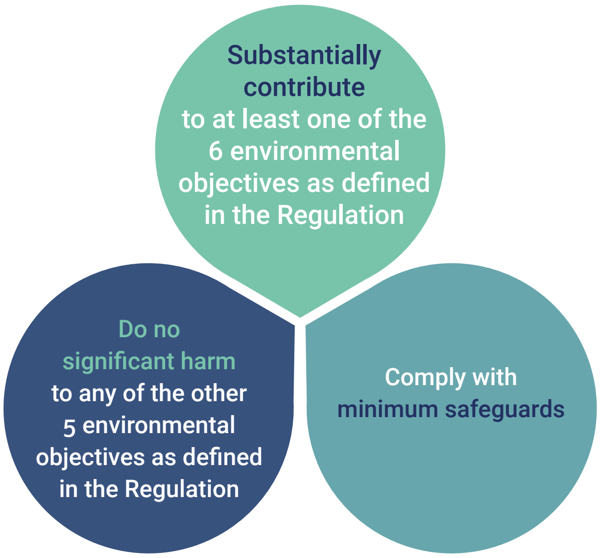
Bank Degroof Petercam has also developed an 'in-house' methodology for clients who have sustainability preferences but do not wish to express themselves at the level of specific instruments (Taxonomy, SFDR, PAI).

Alignment with Taxonomy



The European Taxonomy Project aims to establish a classification system for economic business activities that are considered 'sustainable' from an environmental or social perspective, with a strong emphasis for the time being on climate change mitigation and adaptation.

An activity can be classified as 'sustainable' in the Taxonomy if it contributes substantially to one of the six environmental objectives (including by meeting technical screening criteria), without causing significant harm to any of the other five objectives. In addition, an activity must also meet basic social criteria to be considered 'sustainable' (alignment with OECD[7] guidelines).



The 6 sustainable goals according to the Taxonomy:

Climate change mitigation	Pollution prevention and control	Transition to a circular economy
Sustainable use and protection of water and marine resources	Climate change adaptation	Protection and restoration of biodiversity and ecosystems

[7] The Organisation for Economic Co-operation and Development

If your sustainability preferences as an investor align with the Taxonomy, then you are investing in the activities of a company qualified as sustainable. The reason is that its activities contribute materially to one of the sustainability objectives, do not detract from another objective, and are conducted in compliance with minimum guarantees (social or governance). The aim is, therefore, to make a positive contribution.

Specifically, a company will have to verify that its activities are included in the Taxonomy List (however, the provisionally listed activities are very specific and represent only a small part of the real economy) and/or meet all the set conditions. Only activities that pass all the stages can be used to calculate the company's alignment rate with the Taxonomy.

As for you as an investor, you can determine the level of alignment with the Taxonomy you want, and then they are compared: if the level of alignment with the Taxonomy of a company is lower than your expressed preferences, then the investment is not suitable for you.

IMPORTANT TO KNOW:

The Taxonomy story is still at the beginning:

- Only two environmental objectives (climate change mitigation and adaptation) have all the criteria to assess an activity completed; the other four are expected to be completed later in 2023, so very few activities can be considered "aligned with the Taxonomy".
- The inclusion of nuclear power and gas remains controversial.
- The Social Taxonomy is still in the consultation phase and is not yet final.
- Companies are not yet required to report Taxonomy-related information, so there is currently important information missing to start determining the Taxonomy level of a company or business.
- Given all these points, the current impact of Taxonomy on the market is limited for now, but in the coming years, we expect this element will undoubtedly increase in importance.

Alignment with the SFDR

Alignment with the Sustainable Finance Disclosure Regulation (SFDR) Through its Sustainable Finance Disclosure Regulation (SFDR), which came into force on March 10, 2021, the European Union has introduced a set of binding rules on transparency of sustainability risk integration and terminology.

SFDR defines sustainable investment as "an investment in an economic activity that contributes to an environmental objective, or an investment in an economic activity that contributes to a social objective, provided that such investments do not cause significant harm to any of these objectives and that the companies invested in apply good governance practices".

The SFDR regulation and recent market developments also introduced new typologies for funds and portfolios under management according to their intrinsic ESG[8] or sustainable characteristics:

Products that have a sustainable investment objective

- **What:** Products that have one or more defined objectives with regard to sustainability themes and wish to exert a positive impact in doing so
- **SFDR Reference:** Article 9
- **Concrete:** In line with the ambitions, these products should provide the most detailed information. In doing so, they take into account that -in support of their objective- they need to focus on underlying sustainable positions that all take into account the principle "do not significantly harm other sustainability objectives".

Products promoting ESG characteristics

- **What:** Products that elaborate ESG elements (exclusions, ESG analyses, PAI integration,...) in heir investment policy without making additional sustainable investments
- **SFDR Reference:** Article 8
- **Concrete:** This type will provide more information on its ESG policy where the underlying investments respect the principles of good governance, but also indicates that it does not make sustainable investments.

  This is clarified on the first page of the mandatory pre-contractual and periodic documents.

Products promoting ESG characteristics and making sustainable investments

- **What:** Products that elaborate ESG elements (exclusions, ESG analyses, PAI integration,...) in their investment policy and additionally making additional sustainable investments
- **SFDR Reference:** Article 8
- **Concrete:** This type will provide more information on its ESG policy where the underlying investments respect the principles of good governance. Besides, this type will also explain its sustainable investments (specifically, these investments must also comply with the principle "do no significantly harm other sustainability objectives").This is clarified on the first page of the mandatory pre-contractual and periodic documents.

[8] ESG : Environmental, social, and corporate governance

Products that do not pursue sustainable objectives and do not promote ESG characteristics

- **What:** Products that have no ambitions in this area nor advance ESG elements
- **SFDR Reference:** In accordance with Article 6, these products do have to define their sustainability risk policies
- **Concrete:** This type may not publicise ESG or sustainability but will indicate how it manages any relevant risks.

Sustainable investment therefore goes beyond ESG investment, as this approach not only integrates ESG characteristics but also seeks to have a tangible positive impact.

Do the concepts of investments in line with the Taxonomy and sustainable investments according to SFDR seem identical to you?
The two concepts have similar objectives that seek positive environmental and/or social impacts. However, the methodology for identifying companies and financial products that contribute to these objectives differs. With Taxonomy, we evolve within a technical framework, precisely defined by European regulations where strict conditions apply. With sustainability, according to SFDR, financial institutions have more freedom in the analysis method they want to use, provided they do so in complete transparency. Transparency, then, is the primary goal of this SFDR regulation. Below you will find more information.

Suppose you choose to invest sustainably as an investor according to SFDR. In that case, you invest in financial instruments that contribute to an environmental and social objective and respect good governance practices. The goal is, therefore, to make a positive contribution.

IMPORTANT TO KNOW:

There is currently no harmonized definition or rating methodology at the EU level to determine what, according to SFDR, constitutes a sustainable investment.

This situation means that each fund or portfolio manager is free to develop its valuation methodology, leading to differences between players in the financial world. The types are therefore not homogeneous categories in terms of working method or parameters, and it is recommended that the predetermined ambitions and the methodology used for this are carefully read for each product.

However, we see a market trend to use the SDG (Sustainable Development Goals) as a reference value. Therefore, for the time being, this is also the methodology used by Bank Degroof Petercam in this area. The SDG, or the seventeen Sustainable Development Goals, were adopted in 2015 by the United Nations member states to eradicate poverty, fight inequality, ensure access to water and education, reduce major pandemics, and safeguard the planet.

Alignment with the PAI

Another key concept defined by SFDR is that of Principal Adverse Impacts (PAI).

It concerns a list of indicators defined by Europe that allows investment funds to assess and manage the negative impact of their investment decisions on environmental issues relating to workers, respect for human rights, and the fight against active and passive corruption.

The integration of PAI means that the fund aims to limit its negative impact on the selected themes by monitoring the indicators and reducing their impact.

Climate and other environment-related indicators	
ADVERSE SUSTAINABILITY INDICATOR	
GHG emissions	✓ GHG emissions ✓ Carbon footprint ✓ GHG intensity of investee companies ✓ Exposure to companies active in the fossil fuel sector ✓ Share of non-renewable energy consumption and production ✓ Energy consumption intensity per high impact climate sector
Biodiversity	✓ Activities negatively affecting biodiversity-sensitive areas
Water	✓ Emissions to water
Waste	✓ Hazardous waste ratio

Social and employee, respect for human rights, anti-corruption and anti-bribery matters	
ADVERSE SUSTAINABILITY INDICATOR	
Social and employee matters	✓ Violations of UN Global Compact principles and OECD Guidelines for Multinational Enterprises ✓ Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises ✓ Unadjusted gender pay gap ✓ Board gender diversity ✓ Exposure to controversial weapons

Suppose you, as an investor, choose to invest and incorporate the PAI. In that case, it means you wish to limit your impact in a selected area by monitoring it and trying to reduce the level of impact. Developing PAI is, therefore, relevant if you wish to limit your future "investment footprint" for some themes.

IMPORTANT TO KNOW:

European legislation does not prescribe how financial products should take into account PAI.

However, this can be done in various ways, such as monitoring indicators, setting a threshold (think best-in-class score for indicators), applying exclusions related to indicators, engaging with issuers on indicators, and establishing a voting policy based on indicators or a combination of different methods.

At present, many funds have only just begun to announce which PAIs they will include and have not yet determined which quantitative criteria they will use. As a result, assessing how the fund industry will develop this element is complex.

Points of attention for the informed investor

Determining your **sustainability preferences** is not optional. Indeed, it must be done in an objective and considered manner, as it can have important implications for your portfolio and its configuration.

Limiting the investment universe

The higher or more demanding your sustainability preferences are, the more limited your investment universe will be. After all, only the most sustainable instruments can then be used, and given the current state of the market, you will have a more limited choice. The integration of sustainable criteria into the advisory structure or management of your portfolio may therefore limit your investment universe and exclude some specific -more polluting- sectors.

Concentration risk

Only a limited number of products on the market incorporate sustainability criteria, which can lead investors with very strong sustainability preferences to invest in the same instruments. Consequently, we could potentially face concentration risk in individual lines or funds due to the limited selection of instruments available.

Adaptation of the existing portfolio

As sustainability preferences are part of the suitability process under MiFID II Regulation, high sustainability preferences may also mean that your existing portfolio needs to be adjusted to meet your preferences. These adjustments may result in arbitrage transactions, which may result in costs, charges, or taxes.
However, the Bank will make these adjustments in stages, considering the associated costs, and always acting in your best interests as an investor.

To facilitate the integration of sustainability preferences, Bank Degroof Petercam has also developed its reference framework defining what constitutes a "sustainable financial instrument".

In summary, the Bank considers the following instruments to be sustainable in terms of suitability requirements:

- ✓ Issuer of which a minimum of the income is derived from sustainable economic activities as defined in the European Taxonomy Regulation, and/or
- ✓ The issuer of the instrument or the instrument itself (fund) contributes positively to the Sustainable Development Goals (SDG) defined by the United Nations and/or
- ✓ The instrument is aligned with the principles of sustainable bonds (green, social, or transition).

Through the specific questionnaire, you have the opportunity to align your sustainability preferences with the Bank's methodology.

Conclusion

As an investor, since August 2, 2022, you can express your preferences on sustainability regarding your investments through a new questionnaire.

Bank Degroof Petercam will consider these preferences in its discretionary portfolio management and investment advice services.

Three concepts can be used to define sustainable investments:
- Aligned with Taxonomy: substantial contribution to at least one of the sustainability objectives defined by the European Union.
- Sustainable according to SFDR: investments in companies that contribute to environmental or social objectives. We use the Sustainable Development Goals as a framework for estimating this contribution.
- PAI integration: list of indicators defined at the European level and used to assess the negative impact of investments on environmental and social issues.

Sustainable finance is nevertheless still under construction. Currently, very little data is available on the market, and several regulatory uncertainties remain.

Sustainability is here to stay and will influence how we invest in the future.

You have a role to play if you wish. If you have any questions about sustainability, don't hesitate to get in touch with your private banker or your usual contact.

ANTWERP
Van Putlei 33 - 2018 Antwerpen
pbantwerpen@degroofpetercam.com
T +32 3 233 88 48

Business center d'Offiz
Parklaan 46 - 2300 Turnhout
pbturnhout@degroofpetercam.com
T +32 14 24 69 40

BRUSSELS
Rue de l'Industrie 44 - 1040 Brussels
pbbru@degroofpetercam.com
T +32 2 287 91 11

Avenue des Aubépines 1 - 1180 Uccle
pb.brusouth@degroofpetercam.com
T +32 2 662 88 40

Chaussée de Malines 455 - 1950 Kraainem
pb.brueast@degroofpetercam.com
T +32 2 662 89 20

EAST FLANDERS
Moutstraat 68 bus 701 - 9000 Gent
pbgent@degroofpetercam.com
T +32 9 266 13 66

FLEMISH BRABANT
Mgr. Ladeuzeplein 29 - 3000 Leuven
pbleuven@degroofpetercam.com
T +32 16 24 29 50

Neerhoflaan 8/0 - 1780 Wemmel
pbwemmel@degroofpetercam.com
T +32 2 204 49 20

HAINAUT
Rue du Petit Piersoulx 1 - 6041 Gosselies
pbhainaut@degroofpetercam.com
T +32 71 32 18 25

Chaussée de Tournai 52 - 7520 Ramegnies-Chin
pbhainaut@degroofpetercam.com
T +32 71 32 18 25

LIÈGE
Boulevard Gustave Kleyer 108 - 4000 Liège
pbliege@degroofpetercam.com
T +32 4 252 00 28

LIMBURG
Runkstersteenweg 356 - 3500 Hasselt
pbhasselt@degroofpetercam.com
T +32 11 77 14 60

NAMUR
Avenue de la Plante 20 - 5000 Namur
pbnamur@degroofpetercam.com
T +32 81 42 00 21

WALLOON BRABANT
Les Collines de Wavre
Avenue Einstein 16 - 1300 Wavre
pbwavre@degroofpetercam.com
T +32 10 24 12 22

WEST FLANDERS
President Kennedypark 8 - 8500 Kortrijk
pbkortrijk@degroofpetercam.com
T +32 56 26 54 00

Kalvekeetdijk 179 Bus 3 - 8300 Knokke-Heist
pbknokke@degroofpetercam.com
T +32 50 63 23 70

linkedin.com/company/degroofpetercam
@degroofpetercam
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