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Concerned your ICS is not fully ready for ESG yet?

Keep calm – here are some insights into next steps!

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Legend:

ICS	Internal Control System
ESG	Environmental, Social and Governance
FINMA	Swiss Financial Market Supervisory Authority
MIFID I/II	Markets in Financial Instruments Directive
SFDR	Sustainable Finance Disclosure Regulation

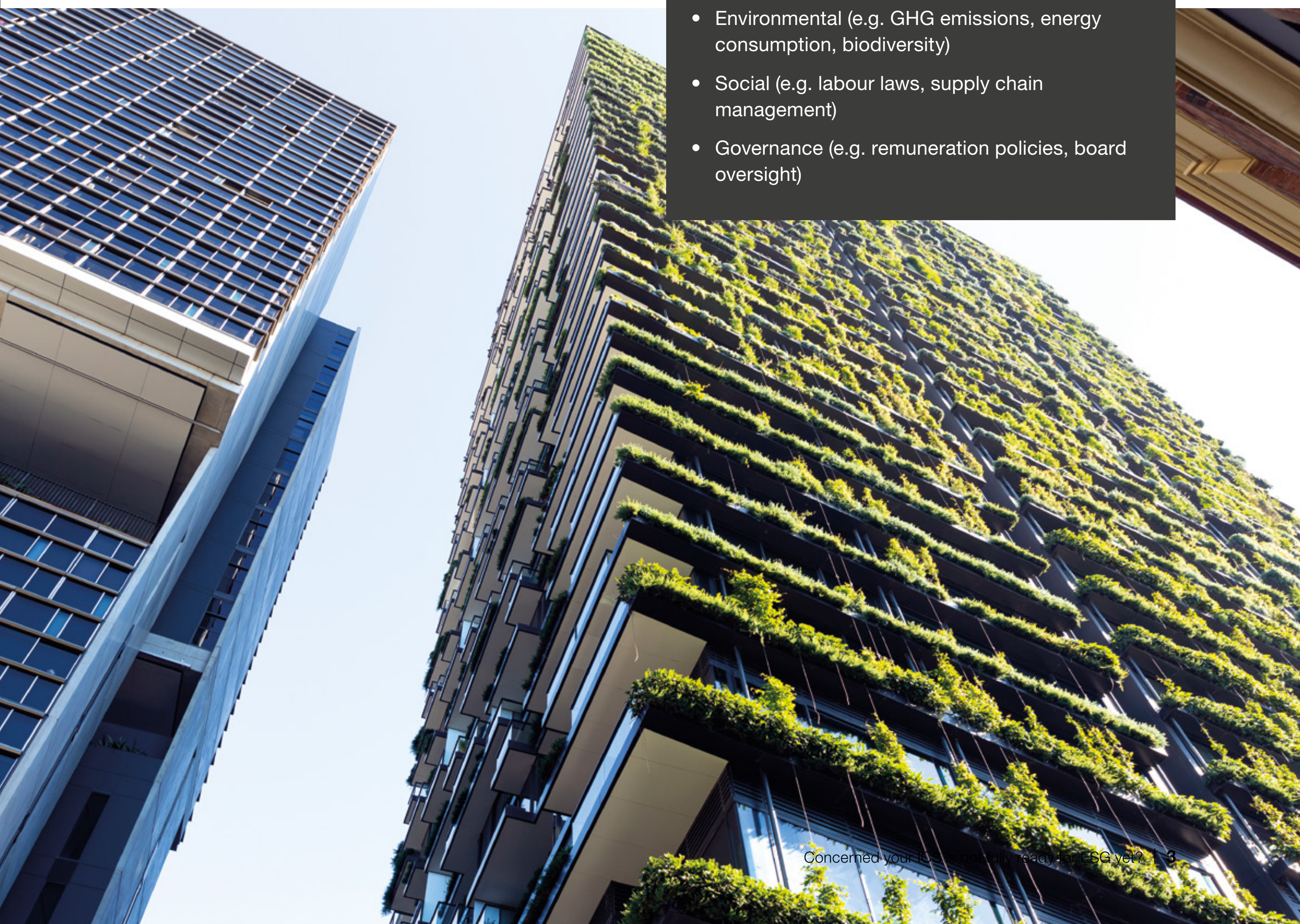
I. ESG is here to stay

ESG is a hot topic in the banking, asset management and insurance world. Sustainability-focused financial products and services are on the rise in Switzerland and internationally. Furthermore, financial institutions worldwide have increasingly joined ESG market initiatives and committed to ambitious sustainability goals, reflecting their part in the fight against climate change and contribution to the UN's Sustainable Development Goals. Financial institutions' key role in the transition to a more sustainable economy has triggered new regulatory obligations to increase transparency and foster the integration of non-financial factors into the investment and financing process. At the same time, the increased quantity and variety of ESG products and services have prompted regulators to focus on preventing greenwashing and strengthening investor protection.

But what are the implications for the legal and compliance function arising from these developments? How is ESG related to ICS? What internal controls are necessary to ensure compliance with the green regulatory tsunami and the fast-paced ESG market environment? And why should all three lines of defence pay attention to this trend?

ESG stands for environmental, social and governance. Sustainable finance integrates ESG criteria into business and investment decisions. Some examples of indicators used in ESG are:

- Environmental (e.g. GHG emissions, energy consumption, biodiversity)
- Social (e.g. labour laws, supply chain management)
- Governance (e.g. remuneration policies, board oversight)



II. The ESG regulatory tsunami

The following main aspects are typically regarded as critical parts of financial institutions' duty to establish an ICS:

- **rules governing their organisational and operational structure**
- **controls and compliance monitoring**
- **mitigating the risk of non-compliance**

A variety of ESG-related regulatory provisions extend these duties to ESG and impact a variety of existing frameworks and obligations. Such provisions may implicitly or explicitly include the requirement for institutions to integrate measures for preventing greenwashing and ESG risks into their internal control systems. The following overview covers the key ESG regulatory provisions impacting ICS.

As a frontrunner in driving the Sustainable Finance topic, the European Union has enacted the Sustainable Finance Disclosure Regulation (SFDR) and the new EU taxonomy for environmentally sustainable activities. They have introduced increased and harmonised ESG disclosure requirements at both entity and investment product level. Although driven by efforts to improve transparency, these obligations have had a massive impact on the manufacture and governance of investment solutions, including the underlying processes, policies and controls. In parallel, the EU has introduced a series of new regulatory provisions within existing legal frameworks, ranging from the mandatory inclusion of the client's sustainability preferences in the investment process and investment and insurance advice to the integration of ESG into certain organisational requirements and operating conditions[1].

In Switzerland, FINMA has put an initial focus on the prevention of greenwashing and management of climate-related financial risks. In its Guidance 05/2021 on Preventing and combating greenwashing, FINMA provides the regulatory expectations for preventing greenwashing, focusing on products, organisational requirements and the point of sale. Further regulatory actions are also expected. On the other side, the Swiss industry associations have stepped up and established ESG self-regulation on mandatory ESG client profiling and organisational and product ESG obligations in the asset management industry. This is in addition to the growing participation of Swiss financial players in international ESG sustainability initiatives such as net-zero commitments[2].

The common denominator for both the EU and Switzerland is the promotion of transparency and ultimately investor protection. But how should all these regulations be incorporated into the compliance framework? And what controls are necessary to ensure compliance with the relevant laws and commitments?

1 Established through a series of Commission Delegated acts amending existing Level 2 legislation on MiFID II, UCITS, AIFMD, IDD and Solvency II.

2 Setting sail for a carbon-neutral future: Net Zero Insights 2022: https://www.pwc.ch/en/insights/fs/net-zero-insights-2022.html

III. Is your internal control system ready for ESG?

Financial institutions need to ensure written procedures, policies and controls in relation to compliance with sustainability-related obligations.

Are your controls geared towards the achievement of objectives, or do they need appropriate modifications?

An internal control system (ICS) is key to functioning Corporate Governance. It covers a variety of organisational measures to meet a business's objectives. The aim of an ICS is to ensure proper and efficient management, to enable reliable financial reporting (internal and external), to ensure effectiveness and efficiency of operations, and to prevent violations of and guarantee compliance with legal requirements. With the new ESG obligations, the ICS will now have to include adequate and broad sustainability-related aspects to ensure compliance.

Compliance with all ESG-related obligations and commitments should be effectively monitored by appropriate controls. This starts with the implementation process, where first and second line of defence functions should be actively involved in setting up the necessary procedures, policies and amendments. The implementation process includes the assessment and introduction of new internal controls to ensure that the institution is compliant with the internal and external sustainability regulations. Appropriate ESG-related controls need to be introduced in the three lines of defence. Once implementation is completed, monitoring needs to be ensured on an ongoing basis.

For instance, it is crucial to implement controls to mitigate greenwashing risk. These may include:

- increased scrutiny in the development of sustainability products and integration of ESG in the investment process, including implementation of an ESG investment strategy and its binding elements
- monitoring the substance and correctness of external sustainability reporting, at both corporate and client level. This includes voluntary ESG reporting
- ensuring the matching of the client's ESG preferences with suitable products as part of the suitability process to avoid mis-selling
- vigorous checks around marketing and communication related to sustainability. This may include, for example, scrutiny of the fund's marketing material and factsheets compared with its legal documentation, a regular check on the substance of corporate sustainability claims, and a review process for the publication of blogs and articles related to sustainability on the financial institution's website.

As part of a robust Corporate Governance system, institutions will also need to identify, assess, manage, and monitor the negative impact of ESG factors on an asset's value or the institution itself ("outside-in" ESG risks), as well as the negative impact of the institution on these ESG factors ("inside-out" ESG risks). In a further step, the identified ESG risks need to be addressed and appropriately mitigated in the existing ICS.

Once the controls are implemented, they need to be monitored and assessed on a regular basis: are they geared towards the achievement of objectives, or do they need appropriate modifications? Insufficient controls increase the risk of greenwashing, non-compliance with regulatory obligations and breach of fiduciary duties.

IV. Greening your ICS

Drawing on our in-depth ESG regulatory and market knowledge and extensive ESG and ICS project experience, our experts have seen the good, the bad and the ugly. We can support you in your ESG transformation journey and in greening your ICS. First, we will get an understanding of your business specifics, ESG positioning and environment. We will then identify any gaps and assess the internal controls that are needed to address your own ESG obligations. We will determine the materiality and develop regulatory and strategic implementation measures that are adapted and customised to your own specifics and ESG ambitions. Specifically, our support could focus on, but is not limited to, the following actions:

ESG ICS review	Review of the robustness of your existing ICS and current and planned controls and measures around ESG obligations within the three lines of defence.
ESG controls design	Assessment and design of ESG internal controls within your existing ICS framework, incl. definition of monitoring processes and policy amendments.
ESG investment monitoring	Implementation of controls and monitoring procedures to ensure implementation of the ESG investment strategy.
Greenwashing prevention	Design of internal controls and provisions for prevention of greenwashing, including: • setting up a greenwashing prevention framework and guidance based on regulatory expectations and best market practice • review of external communications and client disclosures • policy amendments and checklists.
Regulatory monitoring	Monitoring of new and upcoming regulatory obligations, supervisory expectations and key market initiatives, incl. a first impact assessment.
Status quo analysis and SME support	• Gap analysis and definition of suitable gap-closing measures for the integration of ESG regulatory provisions into the organisation. • Interpretation of upcoming ESG regulations. • Provision of peer benchmarking and best ESG market practice.
Yearly review of your corporate ESG reporting	• Review of your corporate sustainability reporting, incl. ESG strategy and claims, governance, KPIs, granularity of information, and compliance with regulatory expectations and market standards you have committed to.

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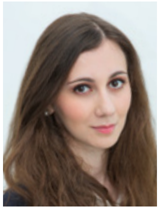

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