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ESG: UK regulatory initiatives for asset managers

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ESG: UK regulatory initiatives for asset managers

With ESG being such a hot topic, it is good that the UK is now progressing development of its specific regulatory requirements. Whilst UK asset managers have focussed on implementing the EU SFDR provisions over recent months, UK asset managers can now consider what is being proposed for disclosures in the UK.

This is one of the first examples of areas for which the UK may be developing its own way forwards post Brexit. The FCA is looking to establish a new "Environmental, Social and Governance (ESG) Sourcebook within the FCA Handbook: initially it will cover climate-related disclosures but they anticipate that it will expand to cover other climate-related and wider ESG topics over time.

In addition, on 19 July, the FCA issued a letter to Authorised Fund Manager chairs commenting on how they would like to see applications for authorisation of investment funds with an ESG or sustainability focus to be improved.

In this Briefing Paper, we focus on

- FCA Consultation Paper 21/17 and its relevance to asset managers – encompassing investment portfolio managers, UK UCITS management companies, full scope UK AIFMs and small authorised UK AIFMs; and
- the FCA's letter to AFM chair of 19 July 2021 regarding authorised ESG and Sustainable Investment Funds: improving quality and clarity.

Background to CP21/17

We reported on the changes which were coming in relation to ESG and the UK TCFD Taskforce in our update Briefing Paper UK regulation of asset managers: change is coming of January 2021. Key points to note were as follows:

- The Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) published a set of Recommendations in 2017 and the UK Government was one of the first to endorse these recommendations.
- In November 2020, HM Treasury published its Interim Report of the UK's Joint Government-Regulator TCFD Taskforce – the Taskforce for Climate Related Financial Disclosures. (It is a publication by the Department for Business Energy and Industrial Strategy, the FCA, the DWP and the Pensions Regulator.)

  In Chapter 2 of CP 21/17, the FCA go to some trouble to explain the wider context for these proposals. It provides interesting reading for the whole context of the TCFD recommendations and the UK Government's Green Finance Strategy published back in 2019.

  Chapter 2 set out a Roadmap towards mandatory climate-related disclosures. An indication of the likely approach for asset managers was included on page 16 of the Interim Report. It included the largest UK authorised asset managers being within the actions targeted for 2022 and other UK authorised asset managers within 2023.

The FCA's CP21/17 proposals

We now have details of the FCA's proposals in the FCA Consultation Papers published in June:

- Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers - CP21/17; and
- Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets - CP21/18

In this Briefing Paper, we focus on CP21/17 and the initial plans for the ESG Sourcebook.

- **looking for international consistency**

  The global approach being taken by the FCA is made clear. The FCA is approaching the design of the UK regime within international consistency in mind – referencing the TCFD's Recommendations which they indicate are now widely accepted internationally.

- **a wide-range of in-scope firms**

  The intention is that TCFD reports should, as far as possible, cover the full range of asset management activities conducted in the UK, although appreciating that less information will be available for some products marketed in the UK by non-UK asset managers and in which some occupational pension scheme trustees may invest.

  The proposals are quite wide-ranging. They encompass portfolio management – and investment advice provided by a UK entity to institutional clients where substantive investment decisions are based on that advice. It will bring into scope asset management activities conducted by private equity and other private market firms.

  Whilst the proposed rules will not apply directly to overseas firms, those in the Temporary Permissions Regime (TPR) will be required to seek full authorisation longer term and so these firms should be caught eventually.

- **two levels of disclosures**

  The key elements of the proposals are:

  – **entity level disclosures** to be published annually – a "TCFD entity report" – on how firms take climate-related risks and opportunities into account in managing or administering investments on behalf of clients and consumers. This would be on the firm's website and cover the entity level approach to all assets managed by the UK firm

  – **product or portfolio level disclosures** – also to be produced annually with consistent and comparable disclosures for products and portfolios – including a core set of metrics. These could either be published in a TCFD public report on the firm's website and referenced from an appropriate communication or be made available to certain eligible institutional clients.

- **appreciation of need for some consistency with EU SFDR**

  At paragraph 2.20, the FCA indicate that they appreciate that firms have to make considerable efforts to comply with EU SFDR and Taxonomy. Whilst these are not on-shored provisions, given this fact, the FCA will aim to ensure consistency both with the EU and internationally as far as possible where disclosure requirements under EU rules cover matters similar to those under the TCFD's recommendations, for example certain carbon emissions metrics.

- **a potential for product labels**

  There are some indications that looking at some of the surrounding issues may inform the FCA's future actions. So, for example, there is an indication at paragraph 2.27 that product level information in firms' disclosures under these proposals might be used as a basis for potential future product labels – care would need to be taken with this, given the current debates, now asset managers have gone through the EU Regulation 6, 8 or 9 categorisation – and some asset managers are already looking at potential re-categorisation of their funds.

  In the meantime, we now have the FCA's first indication of their expectations for authorised ESG and sustainable investment funds – on which we comment further below.

- **not undertaken in isolation**

  There is an appreciation that these disclosures cannot be viewed in isolation – the FCA acknowledge the flow of information that is required along the investment chain.

  So, for example - these disclosures may be required to support disclosures required under the DWP's draft regulations and statutory guidance for in-scope trustees of occupational pension schemes. - It is also noted that some firms may also be in-scope for the disclosure requirements in their capacity as listed issuers or entities within a listed issuer group, where disclosures are to be focussed on how firms in-scope manage climate-related risks and opportunities in their corporate businesses on behalf of their shareholders.

Further, the FCA is to allow flexibility by allowing firms to make disclosures at group level in respect of their global business if they wish to do so.

- **focus on the process?**

  The focus is on disclosures, with the target audience being investors including:

  – institutional clients – pension scheme trustees, employers and corporate investors – collectively referred to as "clients" in the CP by the FCA, and

  – end-user consumers (e.g. pension scheme members, retail investors) – collectively referred to as "consumers" by the FCA.

  The three outcomes the FCA identify that they are seeking to achieve are:

  - better outcomes for clients and consumers because the transparency created by the disclosures should help investors make better choices and hold providers to account;
  - deeper consideration of climate-related risks and opportunities by in-scope firms – so that managers consider climate-related risks and opportunities in a more structured way and so improve investment outcomes; and
  - coordinated information flow along the investment change. The proposals for asset managers, taken together with the complimentary TCFD aligned disclosure rules and guidance for listed issuers, are aimed to promote information flow from companies in the real economy to asset managers and asset owners, and then asset managers can onward share relevant information for the use of clients and consumers – and indeed clients may require such information to help fulfil their own regulatory obligations.

  The FCA purport to seek to increase transparency and enable clients and consumers to make considered choices while remaining proportionate for firms.

  As with the Assessment of Value initiative for UK authorised investment funds, it looks as though the FCA is focussing on comprehensive disclosures but, in fact, the vast majority of the initiative is focussed more on requiring managers to go through a comprehensive process to generate the disclosures. That process is itself expected to engender new behaviours in relation to the topic in question. CP21/17 simply moves on the topic in question to the need to try and transition to cleaner energy and less carbon intensive economy as the outcome, rather than the value delivered by the asset managers.

TCFD entity reports

Chapter 4 of the Consultation Paper sets out more detail about the entity level disclosure rules and guidance which are proposed:

- **principles based**

  Thankfully, the FCA is tending towards a largely principles based approach in the TCFD's recommendations as the basis for the proposed entity level disclosure rules. This allows the UK to fit in with the globally accepted framework and also, hopefully, enable innovation in this area and to keep pace with ongoing developments and advances in climate science.

- **cross-references permitted**

  The TCFD entity report would allow firms to cross-refer to disclosures in another report where there is relevant content in some circumstances (where disclosures are made somewhere else or are made as part of a complimentary report to the annual financial report, or investment decisions are taken by another entity in the same group or a delegated manager). The rationale for making such a reference though would need to be set out. Also, there would need to be a clear signpost and relevant hyperlinks. Consequently, there could be cross-referencing to group or affiliate reports or a complementary report to the annual financial report.

  (For asset owners, they could cross-reference to other group level third party or delegate reports where appropriate. Nonetheless, the asset owner would remain responsible for monitoring the asset manager and its TCFD entity report must explain how climate-related considerations have influenced its decisions.)

- **governance, strategy and risk management**

  The FCA acknowledge that the disclosures made under the governance, strategy and risk management pillars (including the TCFD's supplemental guidance) may either be broad, covering a wide range of investment strategies, asset classes or products, or may need to be more tailored. Firms are to be asked to explain any material differences in their approach

to governance, strategy or risk management for their specific investment strategies, asset classes or products, where relevant.

Firms are asked to consider their own reader base and think how best to explain their disclosures.

There is further acknowledgement that entity level disclosures consistent with the TCFD Recommendations are most likely to be suited to a sophisticated institutional audience but this might underestimate some of the remainder of the audience. The FCA encourage firms to consider information on tangible outcomes: for example, use of case studies for a less sophisticated audience, but firms perhaps should take their own view as to the level at which to pitch their disclosures to their particular client base.

- **scenario analysis**

  It is noted that recommended disclosure (c) for scenario analysis under the strategy pillar is still developing and, until best practice is established and adopted, there will be different approaches between firms but nonetheless an attempt must be made.

- **metrics and targets**

  The gradual move towards metrics and targets and the fact that asset managers and asset owners may have already publicly committed to transitioning their portfolios to net zero emissions by a certain date, most likely 2050, is noted. The FCA ask that firms not yet setting climate-related targets must explain why not. Where there is a target, the firm must describe it including key performance indicators it uses to measure progress in the TCFD entity report.

- **AFM responsibilities**

  The fact that authorised fund managers will likely delegate to investment management and possibly to third party portfolio managers is acknowledged.

  The authorised fund manager is to remain responsible for producing the TCFD entity report so it will need to explain the reasons for selecting the delegate and include climate-related matters that have been taken into account in selecting delegates and relying on their products and services – plus give hyperlinks and cross-references to climate-related financial disclosures made by the delegate to the managers, where available.

  In practice, one can see many firms which have such arrangements trying to impose their own approach on any delegated investment managers so as to ensure a consistent approach. It is useful though that the FCA acknowledge the practicalities involved and the fact that some overseas firms will not have the mandatory climate-related disclosure obligations that will apply in the UK.

TCFD product reports

Chapter 5 of the Consultation Paper sets out more details of the product or portfolio level disclosure rules and guidance which are proposed:

- **in-scope products and portfolios**

  The products and portfolios proposed to be in-scope are:

  – UK authorised funds but excluding feeder funds, and excluding sub-funds in the process of winding up or termination;

  – unauthorised AIFs; and

  – portfolio management services.

  Overall, the combination of entity level and product and portfolio level disclosures should cover a wide-range of circumstances. The entity level disclosures would, for example, include activities of an asset manager in respect of overseas funds and other overseas assets.

  (For asset owners, in-scope activities would encompass insurance-based DC pension schemes, non -insurance based DC pension schemes and SIPPs.)

- **minimum baseline disclosures**

  Note there is a proposed minimum baseline set of consistent, comparable product or portfolio level disclosures, including a core set of metrics. Firms could exceed this minimum if they wish to do so.

- **public reports**

  There will be a combination of public and on-demand TCFD product reports.

  The public TCFD product reports must be made available in a prominent place on the firm's main website and also include an appropriate form of client communication which follows most closely after the annual reporting deadline of 30 June:

- the annual long form or half-annual report for UK authorised funds, provided that the disclosures are always included in the annual report;
- a periodic client report;
- an annual report to with-profits policyholders;
- or an annual pension benefit statement or pension drawdown statement.

For a listed unauthorised AIF, there must be product or portfolio level disclosures in the TCFD entity report.

Similarly there are a specific proposals for asset owners. Product level metrics should be applied at the level of the individual fund or pre-set investment portfolio within the pension or life insurance wrapper. The life insurer or FCA regulated pension provider would prepare product level disclosures for all funds or investment strategies they design or manage and, where there are underlying funds managed by appointed asset managers, the in-scope firm could cross-refer to these relevant disclosures.

- **cross-references permitted**

  Usefully, there could be a hyperlink to relevant product or portfolio level disclosures made on the website in the appropriate client communications, so long as these disclosures are "prominently cross-referenced and adequately contextualised".

  The reality of the delegation to third party portfolio managers is again acknowledged – and there could be cross-reference to disclosures made by the delegate provided the rationale is included and material deviations are outlined.

- **core metrics**

  The FCA propose a baseline set of core mandatory, carbon emissions and carbon intensity metrics to be disclosed – a sub-set of the metrics listed in the TCFD's Recommendations with the descriptions, formulas and methodologies set out in TCFD's supplemental guidance.

  The slight differences between the TCFD's Recommendations and the EU SFDR, including some metrics, are considered by the FCA – Appendix 3 to CP21/17 sets out the detail. The FCA is proposing that where there is a difference, they be reported according to the formulas under both regimes so as to promote consistency and comparability with both EU and international firms – and reflect the global reach of many in-scope firms' assets under management.

  Considerable work will be needed to develop these reports – and indeed there is a moving target. The TCFD guidance and metrics targets and transition plans technical supplement on measuring portfolio alignment are still in the consultation phase (the TCFD consultation being published in June 2021). The finalised versions of these documents will be referenced by the FCA when they finalise their policy position.

- **additional metrics?**

  The obligation will be for firms to supplement the core mandatory metrics with certain additional metrics on a "best efforts" basis – covering Climate Value at Risk (VaR); metrics that show climate warming scenario with which a product or portfolio is aligned, e.g. Implied Temperature Rise, and other metrics which might be consistent with the TCFD's supplemental guidance.

  Again this is a moving target and the FCA plan to reference a final version of the TCFD's Portfolio Alignment Team's published technical supplement on measuring portfolio alignment once this is available.

- **governance, strategy and risk management**

  If the approach on governance, strategy and risk management for specific products or portfolios might materially differ from the overarching report described in the entity level TCFD report, deviations must be set out or referenced in the product or portfolio level disclosures.

- **scenario analysis**

  The developing nature of the scenario analysis (the recommended disclosure (c) under the strategy pillar) is discussed in the CP and how this should best fit with the DWP requirements of trustees to assess and disclose the potential impacts and resilience of their scheme's assets in at least two climate-related scenarios. The FCA propose:

  - a particular approach for portfolios with concentrated exposures or high exposures to the more carbon intensive sectors, and
  - for other portfolios, at a minimum, providing qualitative scenario analysis outcomes – no threshold is indicated for concentrated or higher exposures.

  The emphasis seems to be for the FCA to let the industry develop its relevant policy in this area.

Reporting to clients on demand

Given the wide-range of in-scope products and services, it is helpful that the FCA acknowledge that public disclosures will not be appropriate for all in-scope products and services. On-demand TCFD product reports will be possible, for example, where firms provide discretionary portfolio management services to individuals or institutional investors – disclosures to be made to the client upon request once per year. These should be appropriate for:

- investment portfolio managers regarding discretionary portfolio management services; and
- full scope UK AIFMs or small authorised UK AIFMs in respect of non-listed unauthorised AIFs.

Clients will be enabled to request and firms would be required to provide product or portfolio level disclosures to those clients once in each twelve month period, specifying a calculation date no earlier than 1 July 2023. The firms will be obliged to respond in a reasonable time and reasonably accepted format.

It goes without saying of course that firms could volunteer to do more than is required – the FCA is simply setting minimum standards.

One issue here is that these on-demand proposals appear to reply to clients but not consumers, even though it is acknowledged that clients will probably request them for their own or their clients or their customers' disclosure obligations. This may leave some consumers potentially more in the dark than most clients? If so, this could be unfortunate. Some clients could agree terms for provision of additional services, but some consumers will not have the ability in practice to do so. The FCA allowing firms to decide what is best for their own businesses is welcome. Perhaps the best way of looking at it is there are additional on-demand disclosure available for clients who are more likely to require them – but this is a point to keep under review so as to ensure a level playing field for information provided both to clients and consumers.

Provision of data on request

Asset managers should note that all in-scope firms are also to be expected to provide data on their underlying holdings of their products to clients that request it to satisfy their own climate-related financial reporting obligations. Quite what might be requested and ready access to this will need to be assessed. This could become quite an onerous requirement as clients' own reporting obligations develop. It is important to encourage the flow of information along the investment food chain but the work involved in meeting such requests will need to be worked into asset managers' reporting and client relationship processes.

Threshold for application of the requirements

The proposals will not apply to asset managers and asset owners that have less than £5 billion in assets under management or administration on a three year rolling average, to be assessed annually, with respect to their business activities relating to products and portfolios.

The FCA expect to capture 98% of the UK asset management marketplace and so do not consider this would materially impede the results they are trying to achieve – and believe this is a proportionate approach.

Question 1 asks for comments on this £5 billion threshold for asset managers and asset owners.

Phased implementation

The FCA aim to review feedback and then publish a Policy Statement later in 2021.

Recognising regulatory change burdens, it is good that a phased implementation is proposed. This will begin with the largest, most interconnected firms and extending the application one year later to the remaining firms above the proposed £5 billion threshold for assets under management or administration.

The first phase is to be effective from 1 January 2022 covering:

- asset managers with assets under management of more than £50 billion – note there is to be an enhanced SM&CR threshold based on the firm's AuM calculated on a three year rolling average (see SYSC 23, Annex 1)
- asset owners with £25 billion or more in assets under management or administration in relation to in-scope business, although a lower threshold is designed to reflect what the FCA describe as a different, more concentrated market structure of these sectors – and to take a proportionate approach in introducing disclosures. (The FCA indicate this would capture twelve firms with £1.12 trillion in AuM.)

On-demand disclosures to institutional clients must be provided from 1 July 2023.

The second phase is to be effective from 1 January 2023 and will catch the remaining firms above the proposed £5 billion threshold for both asset managers and asset owners. For these, there will be a publication deadline of 30 June 2024 for the first disclosures to be made. Subsequent disclosures will be made by 30 June each calendar year thereafter. On-demand disclosures must be provided from 1 July 2024.

A good new approach?

Generally, the approach taken in the FCA's CP21/17 proposals is welcome with

- their principles based approach
- focus on the TCFD's Recommendations and so looking to take a global approach and
- a welcome lack of over-prescription.

Nonetheless, there will inevitably be concerns with the detail.

The quantity of the work involved in developing the disclosures should not be underestimated. As AFMs can well attest given the efforts required to produce good assessments of value for authorised funds, developing the processes required, and the analysis involved, is an onerous undertaking.

It is not just a case of providing good disclosures. Firms need to undertake a comprehensive process and also be able to demonstrate that process.

What may start out as a disclosure exercise is in truth a set of requirements for the process leading to such disclosures, such process in itself in driving new behaviours. Indeed the FCA acknowledges this consequence in one of their indicated aims: deeper consideration of climate-related risks and opportunities by in-scope firms which will actually change the way in which investment managers consider climate-related risks and opportunities.

The FCA's views on authorised ESG and Sustainable Investment Funds

Distinct from implementing the new proposals outlined above, the FCA have just issued a "Dear AFM chair" letter, on 19 July, which identifies that they are currently concerned that a number of applications for authorised ESG and Sustainable Investment Funds have been poorly drafted and have fall below their expectations.

The letter seeks to reinforce the FCA's expectations pre and post authorisation and sets out in its Annex guiding principles for the design, delivery and disclosure of responsible and sustainable investment funds.

The guiding principles set out in the Annex should be considered in relation to any FCA authorised investment fund pursuing a responsible sustainable investment strategy and claiming to pursue ESG/sustainability characteristics, themes or outcomes - targeted at funds that make specific ESG-related claims, rather those that integrate ESG considerations into their mainstream investment processes.

In reality, not much is new:

- The themes mentioned are already well-known from the Asset Management Market Study, and in particular the value assessment process. The FCA emphasise that they want firms to be putting consumers at the heart of their businesses, offering products and services that are fit for purpose and which they know represent fair value. In addition though, a well-functioning ESG and sustainable investment fund is, they note, important for the

proper allocation of capital in pursuit of a net zero economy. There are serious long-term consequences if the market does not function properly in the face of the global challenge with which we are presented. The challenge is to ensure that investors can assess whether authorised funds meet their needs and preferences, both at the point of purchase and on an ongoing basis.

- In identifying some of the areas where the FCA indicate that applications they have received have been poorly drafted, the FCA are not raising any new issues. One example focusses on the name being misleading – and the fact that the name of an authorised fund should not be misleading has been in the rules for decades. Other examples concern lack of clarity or cogency in explaining the selected strategy – a desire to see measurable non-financial objectives alongside the financial objective or strategy, with information on how impact could be measured and monitored and explaining clearly the context and rationale for a fund.
- The guiding principles are founded on existing legal requirements, including the high level Principle 7 that there must be clear, fair and not misleading communications.

There is one overarching principle and three supporting principles:

- **Consistency is the overarching principle.**

  A fund's focus should be reflected consistently in its design, delivery and disclosure – being reflected consistently in its name, stated objectives, its documented investment policy, and strategy and its holdings.
- **Principle 1: References to ESG (or related terms) in a fund's name, financial promotions or fund documentation should fairly reflect the materiality of ESG/sustainability considerations to the objectives and/or investment policy and strategy of the fund.**

  Within this principle is encompassed the choice of fund name; details of the investment objectives and policy; the investment strategy; and the stewardship approach, with the requirement for adequate and effective strategies for exercising voting rights to the exclusive benefit of the fund and in accordance with the investment objectives of the fund.

  Note AFMs are subject to the requirements in COBS 2.2B implementing the Shareholder Rights Directive ("SRD") and so AFMs must either develop an engagement policy or explain why they have not done so.

  The Annex sets out various interpretation application examples which are helpful. For example, the FCA indicate that if the fund uses the word "impact" in its name, it should only do so if it is seeking a non-financial real world impact, and if that impact is being measured and monitored.
- **Principle 2 requires that the resources (including skills, experience, technology, research, data and analytical tools) that a firm applies in pursuit of a fund's stated ESG objectives should be appropriate.**

  The way that a fund's ESG investment strategy is implemented, and the profile of its holdings, should be consistent with its disclosed objectives on an ongoing basis. This principle is very much focussed on delivery of funds and ongoing monitoring of holdings. The FCA is clearly looking for information on resources and analytical tools etc which will support the fund delivery process to be put in place and explained to them.
- **Principle 3 is that ESG/sustainability-related information in a key investor information document should be easily available and clear, succinct and comprehensible, avoiding the use of jargon and technical terms when everyday words can be used instead. Generally, a fund should disclose information to enable consumers to make an informed judgement about the merits of investing in the fund. Periodic fund disclosures should include evaluation against the stated ESG/sustainability characteristics, themes or outcomes, as well as evidence of actions taken in pursuit of the fund's stated aims.**

  In a way, all of these pre-contractual and ongoing periodic disclosures comments should apply to any investment fund – just, in this instance, reference is made to the ESG/sustainability related elements.

  In the examples they give, the FCA focus on easy availability, pre-contractual disclosures and ongoing performance reporting. Clearly, terms will need to be explained so, for example, if a fund aims to create positive sustainability impact, they expect disclosures

to include clear examples of the real world impact that it is pursing, how it proposes to achieve the target impact, and how performance against the stated objective will be evaluated on an ongoing basis. For ongoing reporting with quantifiable targets, ongoing reporting should include relevant KPIs on the characteristics. If there are less measurable non-financial aims, performance against these should be evidenced and evaluated, with examples of actions taken in pursuit of the aim. Where stewardship is an integral part of a strategy, the firm should articulate clearly, on an ongoing basis, how the execution of its stewardship strategy has supported the achievement of its stated objectives. All of this seems to go towards proper follow up on a detailed basis so that investors are fully informed.

Having such signposting from the FCA as to their expectations is helpful. In truth, none of this is new but the Dear AFM chair letter does clearly indicate the FCA's expectations on the level of detail to be included both in the application for authorisation and in the initial and ongoing disclosures to investors.

Kirstene Baillie
Partner, Asset Management and Funds — London
+44 (0)20 7861 4289
kirstene.baillie@fieldfisher.com