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ESG regulation for UK Asset Managers:
- the new climate-related disclosures
- plans for SDR and Investment Labels

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ESG regulation for UK Asset Managers:

- the new climate-related disclosures
- plans for SDR and Investment Labels

UK asset managers can now plan for making climate related disclosures for their UK business and products. UK asset managers can also see the likely direction of travel to which the FCA is now working on the wider sustainability disclosure requirements and product labels. The FCA's approach on various ESG initiatives is becoming clearer with various publications in the last few months.

In particular, Policy Statement 21/24 issued in December 2021 sets out their requirements for mandatory climate-related disclosures on an annual basis at entity and product level for asset managers, and also life insurers and FCA regulated pension providers. The FCA hope that this regulatory intervention will accelerate progress in providing for the information needs of clients and consumers. In this Briefing Paper we take a close look at Policy Statement 21/24.

Also, we outline the proposals set out in the FCA's Discussion Paper DP 21/4 on the subject of SDR and Investment Labels.

Climate-related disclosures

The FCA have now published their Policy Statement and made rules for a new ESG Sourcebook in PS 21/24 published late in December 2021. This follows up on the Consultation (CP 21/17) which we covered in our July 2021 Briefing Paper – ESG: UK regulatory initiatives for asset managers

There are some changes from the Consultation proposals, with the finalised rules providing some clarification on points raised in responses to the Consultation.

The new ESG Sourcebook

The introduction of the new Environmental, Social and Governance Sourcebook – ESG Sourcebook – pursuant to Policy Statement 21/24 is clearly only a first version: the FCA expect to expand on the TCFD aligned disclosure rules and guidance covering additional topics over time.

Also, the PS 21/24 climate-related disclosure requirements are of course only part of a broader strategic theme to promote transparency of climate change and wider sustainability along the value chain. The FCA announced "A strategy for positive change: our ESG priorities" in November 2021.

Specifically the PS 21/24 changes introduce a climate-related financial disclosure regime for asset managers and asset owners consistent with the TCFD's globally accepted Recommendations. In 2017, the TCFD published a set of Recommendations which have become the leading framework for client-related financial disclosures: see here the latest TCFD Status Report; and implementation annex; and Guidance on climate-related metrics, targets and transition plans was published in October 2021.

But PS 21/24 also fits in line with the Roadmap to mandatory TCFD aligned disclosures generally by 2025. Note the Government's Roadmap to Sustainable Investing is looking for the introduction of **Sustainability Disclosure Requirements ("SDR")** across the economy, including for asset managers and asset owners. Over time, initiatives will cover not just climate change but disclosures on other impacts which firms and their

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products may have on other sustainability topics.

All of this is part of course of the wider Green Finance Strategy (on which the UK Government set out its strategy in 2019). TCFD aligned rules for premium listed issuers came with Policy Statement 20/17; the Government issued regulations for climate-related financial disclosures within the Companies Act 2016; and requirements are in place for the trustees of occupational pension schemes which came into force on 1 October 2021 so the largest schemes and authorised master trusts must publish their first TCFD aligned disclosures within seven months of the end of the scheme year. Clearly it is important for asset managers to play their part so that information is available – for example to the pensions sector.

In-scope asset managers

The asset managers in scope cover investment portfolio managers, UK UCITS, management companies, full-scope UK AIFMs and small authorised UK AIFMs.

The FCA have kept the £5 billion threshold for asset managers and asset owners – the £5 billion threshold being calculated on a three year rolling average basis assessed annually for both assets under management and assets under administration. **Notably, the FCA have said that they will review the £5 billion AUM exemption threshold after three years' of disclosures.**

Within Phase 1, there is a £50 billion threshold. The rules apply to in-scope FCA authorised firms for the TCFD in-scope business carried out from an establishment maintained in the UK irrespective of where the client's products or portfolios are domiciled (but do not apply to third country branches).

The aim is to cover, as far as possible, the full range of asset management activities conducted in the UK. Note, for example, they have amended the definition of portfolio management services to clarify that the intention is to capture private equity and private market activities where investment advice is on a recurring or ongoing basis.

As regards product level scope, it catches authorised funds (excluding feeder funds and sub-funds in the process of winding up or termination), unauthorised AIFs and portfolio management services. A few items for clarification have been made so, for example, it is clarified that, for unauthorised AIFs, only those managed by a UK AIFM will be within scope of the TCFD product disclosure requirement. They have clarified that unauthorised AIFs listed on a recognised exchange will include investment trusts.

Institutional and retail audiences

Before diving into the detail of the required disclosures, it is perhaps worth looking at the nature of the audience for these disclosures and whether one size fits all.

In CP 21/17, the FCA referred to the need for firms to consider their own reader base and think how best to explain their disclosures. The FCA further acknowledged 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 encouraged 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.

Various responses to the Consultation raised the issue as to the need for differentiated disclosures to an institutional audience and retail investors. Referring to the new consumer duty for retail investors, might a different approach be needed for retail investors so that the information is accessible?

The FCA indicate on page 41 of the Policy Statement that they are working towards a tiered approach in which they envisage a separate layer of consumer facing disclosures which will be a subset of the more detailed disclosures aimed at a more sophisticated audience.

Required disclosures

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**" by the FCA, and
- end-user consumers (e.g. pension scheme

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members, retail investors) – collectively referred to as "**consumers**" by the FCA.

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

In the following paragraphs, we look at the specific requirements being introduced for entity level and product level disclosures.

Entity level disclosures

The new rules require an annual TCFD entity report published in a prominent place on the main website of the firm's business setting out how they take climate-related matters into account in managing or administering investments on behalf of clients and consumers.

- ### principles based

  Thankfully, the FCA is implementing the 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 will 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 will need to be set out. Also, there will need to be a clear signpost and relevant hyperlinks. Consequently, there can be cross-referencing to group or affiliate reports or a complementary report to the annual financial report.

  (For asset owners, they can cross-reference to other group level third party or delegate reports where appropriate. Nonetheless, the asset owner will 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.

- ### 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.

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- ### 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 acknowledged in CP 21/17 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.

Product level: public reports

In relation to a firm's products and portfolios, there must be disclosures (including a core set of climate-related metrics) made publicly available in a prominent place on the main website of the firm's business and included or cross-referenced in an appropriate client communication or made upon request to certain eligible institutional clients.

Depending on the type of firm and/or portfolio, the disclosures will either:

- be published in a TCFD product report in a prominent place on the main website for the firm's business, whilst also being included or cross-referenced and hyperlinked in an appropriate link communication, or
- be made available upon request to certain eligible institutional clients.

To set out some of the details:

- ### in-scope products and portfolios

The products and portfolios which are 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 can exceed this minimum if they wish to do so.

The FCA have included the most widely established climate-related metrics as a baseline. However, they acknowledge some differences in methodologies between TCFD's recommendations and the EU SFDR to which a lot of firms have already adapted for their EU business and so they appreciate the need to promote consistency of disclosures both across the EU and internationally. Given though respondents' concerns about disclosing metrics using two different methodologies, the FCA have amended the Final Rules to require disclosure using the TCFD's methodologies only.

The FCA comment on page 20 of the Policy Statement that their rules will not preclude disclosure against any other methodology in addition to that specified by TCFD so long as firms follow guidance on disclosure of "other metrics" under ESG Sourcebook 2.3.14G. The FCA are now

considering how to treat overseas funds marketing into the UK, including under the Overseas Funds Regime, as part of SDR.

- ## 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 requirements 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 will 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 can cross-refer to these relevant disclosures.

Given the wide range of in-scope products and services, it is helpful that the FCA has acknowledged that public disclosures will not be appropriate for all in-scope products and services.

We comment further on reporting to clients on demand below.

- ## cross-references permitted

Usefully, there can 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 can be cross-reference to disclosures made by the delegate provided the rationale is included and material deviations are outlined.

- ## core metrics

The FCA set out 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, were considered by the FCA – Appendix 3 to CP21/17 set out the detail. The FCA is requiring 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 product reports – and indeed there is a moving target. The TCFD guidance on metrics targets and transition plans technical supplement on measuring portfolio alignment was finalised in October 2021 – and is referenced by the FCA – but one suspects the guidance will develop over time.

- ## additional metrics?

The obligation is for firms to supplement the core mandatory metrics with certain additional metrics – covering Climate Value at Risk (VaR); metrics that show climate warming scenario with which a product or portfolio is aligned, e.g. Implied

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Temperature Rise, and other metrics which might be consistent with TCFD's supplemental guidance. **Thankfully, in PS 21/24, the FCA have changed this to be on a "as far as reasonably practicable" basis, rather than on a "best efforts" basis.**

The use of the phrase "reasonably practicable" can take into account matters such as the likely time costs, resources and practicalities.

- ### 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 require:

- 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.

Risk of misleading disclosure?

The risk of incomplete or misleading disclosures is acknowledged and in particular for certain asset classes it may not yet be possible to calculate meaningful, decision-useful climate-related metrics. Firms should review the FCA guidance – particularly as the FCA consider they only expect missing disclosures in three particular situations.

- Data availability is expected to increase in the near to medium term for instance in respect of corporate debt and loans, private equity, real assets and emerging markets. The FCA therefore expect the proportion of missing disclosures to reduce accordingly.
- Data and methodological issues are a medium term challenge for example for asset-backed securities. The FCA expects the proportion of missing data to reduce in time, owing to market pressure and some government initiatives.
- Some asset classes that present both methodological and interpretation challenges, such as currencies and certain derivatives. The FCA anticipate that these challenges may resolve themselves only over the longer term.

There is therefore acknowledgement of some data gaps or methodological challenges, at least in the early stages, which will not be capable of being addressed through use of proxies or assumptions or, if they were to do so, it would result in disclosures which could be misleading. For such time as this might occur, firms will be able to explain where and why they have not been able to disclose and the steps taken to improve the level of disclosures going forwards.

Reporting to clients on demand

The FCA have thankfully acknowledged that, in some client relationships, public disclosures are not appropriate – notably where firms are providing discretionary portfolio management services to individuals or institutional investors and unlisted unauthorised AIFs. Consequently, certain firms must provide product or portfolio level information to eligible clients – those that need the information to meet their own client-related disclosure obligations – on demand.

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.

So as to manage the potential burden with on-demand information, the FCA have changed the final Rules so that they enable clients to request a product level climate disclosure at a single reference point consistent with

public disclosures or at a date mutually agreed between the client and the firm. Firms must provide the data in a "reasonable" format considering the needs of the client. The rules will not though preclude information being provided in a different form or at a different time under contractual arrangements.

These individual reports 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.

An amendment has been made to the CP 21/17 proposal for the "on demand" obligation to require firms to provide a report to clients of a single reference point consistent with public disclosures or a date agreed between the client and the firm and in a reasonable format.

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

Allowing firms to decide what is best for their own businesses is welcome. Perhaps the best way of looking at it is that there will be 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.

Desired outcomes?

Despite the rules being focussed on required disclosures, the likelihood is that much of the result of implementing PS 21/24 provisions will be to improve the internal process within investment managers.

The three outcomes the FCA identified in CP 21/17 that they were seeking to achieve were:

- 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.

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. The new rules 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.

SDR and Investment Labels

Phased implementation

Whilst the ambitions for UK SDR and Investment Labels are, as explained below, still in the formulation stage, asset managers must plan to accommodate the phased implementation of PS 21/24 for climate-related disclosures now.

Recognising regulatory change burdens, it is good that there is to be phased implementation:

- It begins with the largest, most interconnected firms. The first phase is effective from 1 January 2022 covering:
  - asset managers with assets under management of more than £50 billion, where a firm meets the requirements of an enhanced scope SM&CR firm pursuant to SYSC 23 Annex 1 8.2R, paragraph 1 which provides an enhanced SM&CR threshold based on the firm's AuM calculated on a three year rolling average;
  - Asset owners with £25 billion or more in assets under management or administration calculated as a three year rolling average on an annual assessment in relation to in-scope business. The 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 is expected to capture twelve firms with £1.12 trillion in AuM.)

  The first public disclosures in line with the requirements must be made by 30 June 2023.

  On demand reports and data may be requested by a client no earlier than 1 July 2023 in respect of a reporting period of the firm which starts after 1 January 2022 (or if later the reporting period in which the client's arrangements with the firm commenced re the product concerned).

- The second phase is to be effective one year later - from 1 January 2023. It will catch the remaining firms above the £5 billion threshold for assets under management or administration. For these:
  - the first publication deadline for a TCFD Entity Report and a public TCFD Product Report is 30 June 2024. Subsequent disclosures will be made by 30 June each calendar year thereafter.
  - the earliest a person can request on-demand information is 1 July 2024. The earliest reporting period for which a person can request on-demand information is to commence from 1 January 2023.

  On demand reports and data may be requested by a client no earlier than 1 July 2024 in respect of a reporting period of the firm which starts after 1 January 2023 (or if later the reporting period in which the client's arrangements with the firm commenced re the product concerned).

SDR and investment labels

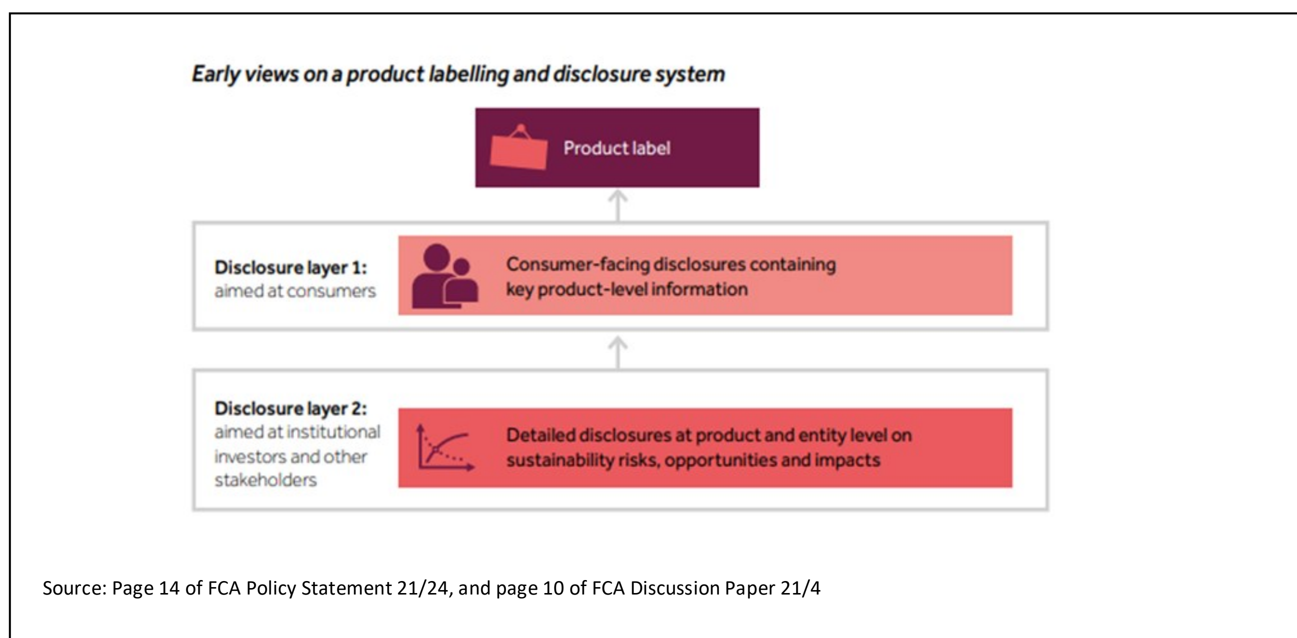
It would be remiss to look at PS 21/24 on Climate-related disclosures by asset managers and not also look at the Discussion Paper DP 21/4 published in November 2021 on Sustainability Disclosure Requirements (SDR) and Investment Labels. This Discussion Paper follows up on the "Dear Chair" letter to authorised fund manager chairs published in July 2021 which flagged up the risk of misleading ESG related claims by products and providers.

Almost inevitably there is thought being given to formalising a labelling and classification regime for investment products. The EU's lead on classifying Regulations 6, 8 and 9 products – and the almost immediate consideration of reclassification by some - perhaps should urge some caution in this area.

The FCA in their Discussion Paper DP 21/4 on the subject of SDR and investment labels seek views on a three tier system consisting of:

- product labels to help consumers navigate the range of investment products on offer;
- a consumer friendly layer of disclosure containing key decision useful information; and
- a more detailed layer of entity and product level disclosures building from TCFD requirements.

SDR and Investment Labels



Source: Page 14 of FCA Policy Statement 21/24, and page 10 of FCA Discussion Paper 21/4

Discussion Paper DP 21/4 sets out what the FCA think might be covered in the three tiers in more detail, including their interaction with existing initiatives and disclosure requirements.

The two initiatives for sustainability disclosure requirements and sustainable investment labels are, at this stage, ambitions.

- As regards Sustainable Investment Labels, the FCA plan a formal consultation in Q2 2022.
- As regards SDR, several regulators and government departments will have a role in implementing SDR.

Three "sustainable" product labels

The key proposals are in paragraph 3 of the Discussion Paper regarding labels. **The FCA's starting point is that an assertion that retail consumers appear to be strongly influenced by what they consider to be objective and reliable product labels.**

The FCA's proposal is to have some sort of five block approach, each block being supported by clear definitions and criteria.

- three headings of sustainable funds:
  - **Transitioning** – with sustainable characteristics, themes or objectives; low allocation to taxonomy – aligned sustainable activities;
  - **Aligned** – with sustainable characteristics, themes or objectives; high allocation to taxonomy – aligned sustainable activities; and
  - **Impact** – objective of delivering positive environmental or social impact.

  The differentiator between aligned and transitioning would be the proportion of assets considered sustainable (based on the UK taxonomy or other criteria): Transitioning products at the time of assessment would have a low allocation to sustainable activities while aligned products would have a higher allocation above a specified threshold.

These three sustainable categories of product would sit alongside two remaining categories:

- **those funds which are not promoted as sustainable**; and
- **those funds which might be classified as "responsible"** – and may have some sustainable investments – but which would not within the sustainable categories.

SDR and Investment Labels

The FCA's initial suggestions for the classification criteria are as follows:

Box 3: Classification criteria

Minimum 'entry-level' criteria at the relevant entity level:

In order to use a 'Sustainable' or 'Responsible' product label, the entity responsible for managing investments must demonstrate key attributes such as: meeting existing governance, systems and controls requirements; identifying how ESG considerations are integrated into investment processes to minimise risks and take advantage of opportunities; stewardship and using ownership rights (eg, voting and engagement).

Product-level classification definitions and minimum criteria:

1. **Sustainable** – products that pursue specific sustainability characteristics, themes or objectives alongside delivering a financial return. Divided into three types of product:

   a. **Sustainable – Impact** – Products with the objective of delivering net positive social and/or environmental impact alongside a financial return.

   Minimum criteria: Intentionality, theoretical ability to deliver and measure additionality through investment decision-making and investor stewardship, impact measurement and verification.

   b. **Sustainable – Aligned** – Products with sustainability characteristics, themes or objectives and a high proportion of underlying assets (measured according to a minimum threshold) that meet the sustainability criteria set out in the UK Taxonomy (or could otherwise be verifiably established to be sustainable, where a taxonomy is not yet available).

   Minimum criteria: See Transitioning criteria below, with the addition of minimum thresholds for asset allocation.

   c. **Sustainable – Transitioning** – Products with sustainability characteristics, themes or objectives that do not yet have a high proportion of underlying assets meeting the sustainability criteria set out in the UK Taxonomy (or can otherwise be verifiably established to be sustainable, where a taxonomy is not yet available). These products pursue strategies that aim to influence underlying assets towards meeting sustainability criteria over time, for instance through active and targeted investor stewardship. The expectation, therefore, is that this proportion will rise over time.

   Minimum criteria: Evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the investment policy or strategy and may include some combination of:

- restrictions to the investible universe, including investment limits and thresholds
- screening criteria (positive or negative)
- the application of benchmarks or indices and expected or typical tracking error relative to the benchmark
- the entity's stewardship approach as applied to the product

2. **Responsible** – Impact of material sustainability factors on financial risk and return considered to better manage both risks and opportunities and deliver long-term, sustainable returns. No specific sustainability goals.

   Minimum criteria: ESG integration, evidence of ESG analytical organisational capabilities and resources, demonstrable stewardship.

3. **Not promoted as sustainable** – Sustainability risks have not been integrated into investment decisions. No specific sustainability goals.

Source: Pages 17/18 of FCA DP 21/4 Sustainability Disclosure Requirements (SDR) and investment labels

SDR and Investment Labels

The existing EU SFDR initiative has established what are commonly referred to as Article 6, 8 and 9 funds and the FCA acknowledge that it is important to explore how products already classified under SFDR can map against the UK framework. The FCA suggest this might be as follows:

- Article 6 (not promoted as sustainable);
- Article 8 (responsible and sustainable "transitioning" categories);
- Article 9 (sustainable aligned); and
- Article 9 (sustainable impact – a small subset of Article 9 funds).

As is inevitable with a Discussion Paper, the FCA is seeking views on a number of topics. Input is requested on:

- entry level criteria before products can be considered as "responsible" or "sustainable" – and whether a higher entry level standard should be applied for sustainable products.
- the high level features of impact investing and whether fewer products would qualify for an "impact" level than those currently categorised as Article 9 funds under SFDR.
- views on potential criteria for "responsible" investment products. The general expectation of investment managers may be to consider material sustainability risks as part of risk management of an investment product but the degree to which managers integrate ESG factors and how they manage clients' investments varies. At the product level, the FCA see responsible products being characterised by their integration of ESG factors and stewardship directed towards delivery of long term sustainable investment decisions and returns. They could have high, low or no allocation to sustainable investment.
- Finally, how should those products that will not take sustainability considerations into account, even as a form of risk management, be described or labelled. It is acknowledged that there will be some types of products for which sustainability factors, objectives and characteristics may not be relevant or considered.

Sustainability disclosure requirements

The sustainability disclosure requirements, SDR, would build on the climate-related disclosure requirements where the policy position has already been finalised – as reported earlier in this Briefing Paper. The task the FCA is now considering is widening out the scope of the SDR disclosure requirements beyond climate to cover sustainability matters more generally.

Chapter 4 of the Discussion Paper sets out comment on consumer facing disclosures and detailed underlying disclosures at product level and entity level, extending beyond financial risks and opportunities to cover the impact firms and their investment products have on the environment and society.

It is useful that the FCA is undertaking this Discussion Paper exercise at an early stage before they formulate specific proposals for formal consultation.

Thankfully, again, they also acknowledge the need to consider interaction with other initiatives, notably entity and product level disclosure requirements already in place under SFDR – and they are willing to explore the extent of which the content of disclosure requirements in SFDR is relevant for the UK market and should therefore be captured under UK SDR.

Also they refer to the international sustainability standards in development by the IFRS Foundation. **One suspects that UK regulation might gravitate more towards the international approach (whilst accommodating some way of working alongside the EU's SFDR).**

The Discussion Paper indicates that the Government will create a mechanism to adopt and endorse ISSB issued standards for use in the UK. The FCA would remain consistent in their disclosure requirements for investment firms to support the flow of information along the investment chain.

ESG regulation for UK Asset Managers: - the challenges ahead…….

New international standards

Inevitably, there is a need for the UK to have regard to developing standards around the globe as asset managers operate globally.

The FCA acknowledge that various international standards are being developed:

- During COP26, the International Financial Reporting Standards (IFRS) Foundation launched the International Sustainability Standards Board (ISSB) which is to provide a global baseline of sustainability disclosure standards building on the TCFD's recommendations.
- IOSCO has welcomed the IFRS Foundation's progress and is to look to endorse the future ISSB standards.
- The ISSB standard is intended for corporate reporting but some asset managers and asset owners will disclose against those standards where they form part of a corporate group. The FCA expect that climate-relate disclosures for listed companies will be updated to reference the ISSB's reporting standards once endorsed for use in the UK.
- IOSCO published in November 2021 recommendations for regulators and policymakers to consider in developing sustainability related disclosures for asset managers – these are covering areas closely linked to the FCA rules for TCFD aligned disclosures and the development of proposals for SDR disclosures and investment labels.
- As regards ESG ratings and data products providers on which IOSCO issued recommendations in November 2021, the FCA plan to publish a Feedback Statement in H1 2022 – and the Government is considering bringing ESG data and ratings providers into the regulatory perimeter scope, with details expected to be published within 2022.

The challenges ahead

The immediate challenge for UK asset managers is to deal with the PS 21/24 requirements for climate-related disclosures.

A key task for UK asset managers which are already making voluntary TCFD aligned disclosures or have been working on plans aligned to the EU approach is to ensure that they adapt so as to meet the new FCA requirements.

The quantity of work involved in developing these disclosures should not be underestimated. Also, 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 driving new behaviours. Indeed the FCA acknowledges this consequence is one of their indicated aims: detailed 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.

And of course we are only at the start of the journey on ESG initiatives. UK asset managers must bear in mind the inevitable evolvement of ESG related requirements globally which will likely be reflected in UK regulation in due course. It is vital to monitor developments closely, and new initiatives should be anticipated if and to the extent practicable.

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ESG regulation for UK Asset Managers:
- the new climate-related disclosures
- plans for SDR and Investment Labels

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