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FCA Discussion Paper DP21/4: Sustainability Disclosure Requirements and investment labels

ClientEarth Response

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ClientEarth

1. About ClientEarth

ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid, Beijing, Luxembourg and Los Angeles, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.

ClientEarth's Climate Finance initiative analyses the legal duties of a wide spectrum of actors in the financial system – including companies, investors, banks, insurers, pension schemes and asset managers – to consider, manage and report their risks and impacts associated with climate change and the environment.

This paper sets out ClientEarth's response to the proposals set out by the FCA in Discussion Paper DP21/4[1] on the proposed UK Sustainability Disclosure Requirements (**SDR**) framework and investment labels. Please contact Robert Clarke (rclarke@clientearth.org) or Joanne Etherton (jetherton@clientearth.org) if you wish to discuss anything contained in our response.

2. Top Lines

ClientEarth welcomes the opportunity to respond to DP21/4 ahead of formal consultation by the FCA later in 2022. Overall, we are supportive of the initial proposals set out in DP21/4 for SDR and investment labels. However, we have several high-level concerns that we believe must be addressed in the design of the proposed SDR and labelling regime in order to ensure that it is robust, understandable to consumers and does not inadvertently facilitate or formalise greenwashing.

Our top line comments are as follows:

1. **Product labels must <u>not</u> facilitate or formalise greenwashing.**
2. **The labels must be clearly understandable to investors and consumers.**
3. **SDR disclosures must capture "double materiality", meaning both the financial risks posed to investment products by social and environmental factors <u>and</u> the impact of investment products and the companies they invest in on society and the environment.**
4. **The SDR and labelling regime must be underpinned by effective monitoring and enforcement from the FCA.**

After providing our general comments on the FCA's proposals below, this paper sets out our answers to the specific discussion questions in DP21/4.

[1] https://www.fca.org.uk/publications/discussion-papers/dp21-4-sustainability-disclosure-requirements-investment-labels

3. General comments

Our general comments on the proposed regime, which explain our top line concerns, are as follows:

1. **Product labels must <u>not</u> facilitate or formalise greenwashing**[2]

   Our overarching concern is that the product labels created by the FCA should not be structured or made available in a way that inadvertently facilitates or "formalises" greenwashing[3] or otherwise misleads consumers. Recent research[4] by the FCA's own economists highlights the risk that labels or medals erroneously certifying the sustainability credentials or impact of an investment fund can have a strong effect on consumers' investment choices.

   In this context, our concern is that the "Responsible", "Sustainable-Transitioning", "Sustainable-Aligned" or "Sustainable-impact" labels suggested by the FCA are made available to funds with weak sustainability features which would surprise consumers, and that the false impression of a fund's sustainability credentials given to investors cannot be corrected by more detailed information provided to investors in the layer 1 and 2 disclosures proposed by the FCA under SDR. The EU's experience under the Sustainable Finance Disclosure Regulation (**EU SFDR**) provides a useful analogy to highlight this risk.[5] There are concerns that the Article 8 category (for funds that promote environmental or social characteristics) is so broad that it leads to greenwashing due to the wide range of fund strategies labelling themselves as Article 8.[6]

   Our specific concerns and recommendations in relation to the "Sustainable-Impact", "Sustainable-Transition" and "Responsible" labels are discussed in our responses to questions 4, 7, 8 and 9. As explained in our responses to questions 8 and 9, we strongly suggest that the FCA: (a) provides significantly more clarity on how the "Sustainable-Transition" label is intended to apply to funds; (b) reconsiders whether the inclusion of the "Responsible" label is useful in the labelling framework; and (c) clarifies that the integration of material ESG risks into investment and risk management processes is a basic requirement of all fund managers and should not confer a responsible or sustainable investment label.

2. **The labels must be understandable to investors and consumers**

   Linked to the greenwashing risk, it is crucial that investors and consumers are able to understand clearly the investment product labels and that the labels do not give a misleading impression of the sustainability credentials of the products to which they apply.

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[2] Although typically used to refer to misleading environmental claims, we use "Greenwashing" throughout this response to refer to misleading environmental <u>or</u> social claims (as the context requires), as similar concerns arise in respect of claims regarding social impact made in relation to investment products.
[3] Greenwashing by corporates and investment funds can take many forms: see, for example, ClientEarth's '<u>Greenwashing Files</u>' (2021) in relation to corporate greenwashing, and the discussion in '<u>Is SFDR failing? Eight in ten 'sustainable' funds in Europe hold fossil fuel stocks</u>' (Capital Monitor, 29 June 2021) regarding the prevalent holding of fossil fuel stocks by funds classified as "light green" under Article 8 of the EU's Sustainable Finance Disclosure Regulation (**SFDR**).
[4] '<u>Sustainable investing: objective gradings, greenwashing and consumer choice</u>' (FCA Insight, 8 July 2021).
[5] Although the classification of funds under Articles 8 and 9 of SFDR is intended to trigger specific sustainability disclosure obligations, rather than to serve as a fund labelling regime, large numbers of European funds have sought to classify as either Article 8 or Article 9, and these classifications have become de facto investment product labels for EU funds – see '<u>How have fund managers been interpreting the Article 8 label under SFDR?</u>' (Portfolio Adviser, 23 September 2021) and '<u>SFDR: Four Months After Its Introduction</u>' (Morningstar, 27 July 2021).
[6] See '<u>SFDR: 'Vague' Article 8 definition increases risk of greenwashing</u>' (ETF Stream, 9 August 2021).

We have a general concern that, due to the meaning customarily given to "sustainability" in an investment context, and the fact that the broader UK Taxonomy framework may initially operate in relation to climate change mitigation and adaptation before being expanded to other topics (as is the case under the EU Taxonomy), the sustainable product labels may be misinterpreted by investors as indicators of the climate credentials of a particular fund, when in fact they relate to other sustainability criteria. In order to avert this confusion, the FCA should consider how explanatory statements, consumer-facing disclosures and detailed SDR disclosures can be structured to make it clear whether, and to what extent, a given fund supports climate change mitigation in line with a 1.5 degree pathway under the Paris Agreement. Further comments on this issue are included in our responses to questions 8, 13 and 15.

We have further specific concerns about how the "Sustainable-Transition" label will be understood, given the meaning customarily given to "transition" in a climate context, and its specific meaning under the UK Taxonomy (assuming it follows the EU Taxonomy in this respect). In our response to question 8, we suggest that the FCA considers how this label can be amended to aid understanding, and request further detail on how this label is intended to apply.

3. SDR disclosures must capture "double materiality"

It is essential that the disclosures required under SDR capture both: (a) the financial impact of social and environmental factors on investment products and firms; and (b) the impact of financial products and firms on society and the environment. This is crucial for investors and consumers to understand the impact associated with their investments. On this basis, we strongly support the inclusion of a robust set of mandatory sustainability impact metrics in the SDR regime. Our thoughts on this are set out in our responses to questions 13 to 17.

4. Effective monitoring and enforcement

The discussion of monitoring and enforcement is notably absent from DP21/4. However, we consider robust enforcement of sustainable labelling and disclosure standards by the FCA to be essential to ensure the effectiveness of the new regime and prevent greenwashing.

The FCA must consider how it will monitor and enforce compliance with the new regime, and what the consequences of failure and breach will be. We call on the FCA to publish a clear road map for enforcement in the next consultation phase, covering:

- When and how the criteria for investment product labels will be tested, including at the point of award and periodically throughout the life of a fund;
- the consequences of failing to meet labelling criteria, including loss of label, supervisory investigation, public statements, fines and other disciplinary action;
- how quality sustainability disclosure under SDR will be monitored and enforced; and
- how the FCA will ensure it has adequate resource and expertise to deliver these oversight and enforcement requirements.

Finally, we suggest that the FCA should consider its approach to the use of terms like "sustainability" and "transition" outside the scope of the labelling framework, to pre-empt greenwashing by firms using these terms to describe products that do not qualify for one of the investment labels on their merits.

These comments are developed further in our responses to the discussion questions set out in DP21/4.

4. Discussion Question Responses

Q1: What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.

We support a tiered system of disclosure and labelling. We see the value of consumer-facing product labels provided they do not inadvertently facilitate or formalise greenwash and genuinely help inform investors who wish to make more sustainable investment choices.

We agree in principle with the concept of "layer 1" disclosures aimed at consumers to provide a subset of standardised information on a product's key sustainability attributes, supplemented by more detailed "layer 2" disclosures at the entity and product level covering sustainability risks, opportunities and impacts.[7] We also accept the implicit assumption that the information needs of retail consumers, institutional investors and other stakeholders may differ, and consider it would be helpful for consumer-facing disclosures to include a simplified and streamlined element to help less sophisticated users identify and compare key product-level information.

However, we also believe that: (a) transparency (and the power it gives consumers, institutions and other stakeholders) will be good for the system as a whole; and (b) there are likely to be some consumers who are as interested in the more detailed layer 2 disclosures as institutions and other stakeholders and so the more detailed layer 2 disclosures should be available to retail consumers who want to see them. This is informed by recent research showing that consumers of retail investment and pension products increasingly want to understand how their investments support positive environmental or social outcomes while also providing a financial return[8] and the impact they have in the real economy.[9]

Moreover, access to detailed information may in some cases be necessary to counteract greenwash or other misunderstandings that may result from the use of product labels, and which is not otherwise cured by information provided in a consumer facing fact sheet or similar. For example, if an investor wishes to understand the climate impact of a product which is labelled as sustainable based on its contribution to social (or other environmental) factors.

We would support the development of a system for both layer 1 and layer 2 disclosures to be publicly available to interested stakeholders, and certainly for the full suite of sustainability information to be available to any consumers who are interested in digging deeper. A workable system would need to be developed for firms to make these disclosures, which gives investors the optionality described above, and does not prevent them from accessing the sustainability information they want and need.

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[7] See paragraph 2.5 of DP21.4.

[8] As shown by the FCA's own research. The results of the FCA's 2020 Financial Lives survey show that 80% of respondents wanted their money to 'do some good', while also providing a financial return, 71% wanted to 'invest in a way that is protecting their environment', and 71% 'would not put their money into investments which are unethical' – see paragraph 1.12 of DP21/4.

[9] Research by the 2 Degrees Investing Initiative (**2DII**) in 2020 found that 40-50% of consumers surveyed mentioned "having an impact in the real economy" as their main objective when choosing sustainable investments or mentioned scepticism about impact as the main reason for not choosing these products. See page 5 of 'EU Retail Funds' Environmental Impact Claims Do Not Comply with Regulatory Guidance' (2020, 2DII).

Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.

Our starting point is that the scope of application of the sustainability disclosure (including climate and TCFD) and labelling regime should be as wide as possible. In our response to FCA Consultation CP21/17 on climate-related disclosures by FCA regulated firms[10], we set out our view that the new disclosure rules should apply to all FCA regulated firms, regardless of size[11]. However, we also recognise the logic in aligning the scope of the SDR disclosure regime with the settled initial scope for the FCA's TCFD disclosure regime as set out in FCA Policy Statement PS21/24.[12]

We would like to emphasize the importance of the FCA's commitment to review scope (and potentially lower AUM-linked thresholds) after three years of disclosures[13]. We would expect similar review of the scope of the SDR and product labelling regime and strongly suggest that the FCA consider lowering AUM based thresholds over time to ensure that best practice in sustainability reporting spreads to smaller managers (whose sustainability risks, opportunities and impacts may be equally important to consumers). It is increasingly clear in a climate context that we must achieve rapid and deep emissions reductions globally and achieve net zero emissions by 2050 in order to limit global warming to 1.5 degrees by the end of the century, and averting other environmental and social harms is no less urgent. It is therefore important that the proposed regime is extended to full coverage of FCA regulated firms (alongside TCFD disclosures) without unnecessary delays.

In any event, the scope of application of the SDR and investment labels should be no smaller than that proposed in respect of TCFD disclosures.

In respect of labels, the inclusion of a "Not promoted as sustainable" label (which we broadly support – see our response to question 4) in theory means that the labelling regime should apply to the full spectrum of investment products, and not just those marketed to investors with some kind of sustainability claim. This mirrors the application of Article 6 of EU SFDR[14] which requires disclosures regarding how "sustainability" risks are managed (or reasons why they are not considered relevant) in the pre-contractual material for all funds, not just those marketed as sustainable. As explained in our response to question 4, it is our view that this would be an appropriate requirement for the UK market, including for funds to which the "Not promoted as sustainable" label applies.

We accept that there may, in certain limited circumstances, be types of funds which are not suited to sustainability labelling and that it will be difficult for any labelling regime to capture the nuances of every fund strategy. However, these limited exceptions should not be allowed to undermine the aim to achieve wide market coverage with the product labels proposed. We are not in a position to comment on specific examples at this time.

[10] https://www.clientearth.org/latest/documents/clientearth-response-to-fca-consultation-on-climate-related-disclosures-for-asset-managers-life-insurers-and-pension-providers-cp21-17/.
[11] See pages 3 to 5 of our response.
[12] See paragraphs 3.41 to 3.60. PS21/24 is available here: https://www.fca.org.uk/publications/policy-statements/ps-21-24-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions.
[13] See page 28 of PS21/24.
[14] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02019R2088-20200712.

Q3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?

We have no specific comments in relation to this question.

Q4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.

We welcome the introduction of an investment product labelling system provided it does not facilitate or formalise greenwashing and is genuinely helpful to inform investors who wish to make more sustainable investment choices. We are broadly supportive of the investment labels set out in Figure 3, and the design principles set out in paragraph 3.8, however we have a number of comments driven by our overarching concerns about the regime.

Our specific comments on the "Sustainable-Transition" and "Responsible" labels (where we have most concerns regarding the potential for greenwashing and misleading investors) are set out in our responses to questions 8 and 9. In summary:

- We recommend that the FCA considers changes to the nomenclature of the "Sustainable-Transition" label and its minimum criteria in order minimise the scope for investors to misinterpret the sustainability credentials of products to which the label applies. Our concern here is that the "Sustainable-Transition" label may otherwise mislead investors if it is interpreted by them as describing climate-related or UK Taxonomy-aligned criteria when in fact it is awarded to a product (and presented by product providers) on the basis of other environmental or social claims. We also suggest that the FCA develops robust eligibility criteria to prevent greenwashing under this label by funds that perpetually claim to be "in transition" but cannot demonstrate progress.

- We recommend that the FCA consider removing the "Responsible" investment label. This is on the basis that the integration of material sustainability risks in investment decisions and risk management is required for the managers of all funds (including those not promoted as sustainable) to meet their legal and fiduciary duties. Conferring a "Responsible" label on funds on this basis is likely to mislead consumers that a fund has adopted a more pro-active sustainability approach when in fact it merely integrates consideration of sustainability risks in its normal processes. For these reasons, the label is both unnecessary and confusing.

We welcome the inclusion of "Not promoted as sustainable" label but, as noted above, consider that the integration of material sustainability risks should be a requirement for this category. We would support a requirement for all funds to disclose how they integrate sustainability risks (or to explain why they are not required to do so). If the "Responsible" label is removed, this category would cover both funds that practice ESG integration and those that do not.

In terms of design principles, we agree with the FCA's proposal to focus on objective rather than subjective labelling criteria which are anchored in the nature of an investment products objectives or strategy. The labels should make the selection of investment products easier for consumers and investors, and support the clear presentation of sustainability related information, rather than imposing value judgement on those products. We also support the FCA's comments in bullet point 2 of paragraph 3.8 – the labelling regime should interact with and use the sustainability framework created by the UK Taxonomy where appropriate (e.g. for measures of alignment for the "Sustainable-Aligned" label) but in some respects will need to reflect other features of investment products such as impact intentions (for the "Sustainable-Impact" label), sustainability targets baked into investment objectives and strategies, and engagement and stewardship commitments.

Mapping to the EU SFDR may be useful for data users and fund managers seeking to streamline disclosures across jurisdictions. However, we urge caution when reading EU SFDR classifications across to the UK regime, both because EU SFDR was not intended as a labelling regime (though it has been interpreted as one) and because of the greenwashing concerns associated with the Article 8 and (to a lesser extent) Article 9 categories. As noted above, all funds are required to consider and integrate material ESG risks into their investment and risk management processes (and this obligation corresponds to the Article 6 disclosures required under EU SFDR) and so we do not agree that the proposed "Responsible" label maps neatly to Article 8 (which requires more than ESG integration).

More broadly, we are concerned that the labels should not contribute to greenwashing and should be clearly understandable to consumers. We have made comments and recommendations driven by these overarching concerns in our responses to the other specific discussion questions below.

As noted in our general comments, we also consider it essential that the labelling regime is underpinned by robust and effective enforcement.

Q5: What are your views on 'entry-level' criteria, set at the relevant entity level, before products can be considered 'Responsible' or 'Sustainable'? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.

We agree that entry-level criteria, set at the entity level, should play a role in the product labelling system set out in DP21/4.

In our view, this would help guard against the product labels contributing to greenwashing because it would help ensure that the firms behind labelled products have the structures and resources in place to deliver, at product level, against the claims that go with the relevant label.

Entity level criteria could include being a signatory of the UN Principles of Responsible Investment (**PRI**) or the UK's Stewardship Code (as suggested by the FCA in paragraph 3.18), though we would question the extent to which signatory status in either case is a reliable barometer of sustainability capability or performance. In addition, we agree with the FCA's suggestion (paragraph 3.17) that "*criteria could include matters relating to systems and controls, governance, ESG integration and stewardship*." We suggest the FCA consider entity criteria based on the resourcing and expertise necessary for sustainable investing, oversight of this at board and investment committee level and the existence of relevant policies. Although we recognise that there may be challenges in measuring such criteria in an objective way (in line with product label design principles), it should be possible to create criteria that allow reasonably objective comparison between firms while avoiding the addition of a "tick-box" exercise.[15] We are also conscious that entity-level criteria should not be defined in a way that could prejudice smaller firms.

[15] Note that requirements built around management responsibility, board oversight and resourcing should increasingly be familiar to entities from TCFD and other existing best practice frameworks. See for example the recommendation that firms disclose "*whether the organization has assigned climate-related responsibilities to management-level positions or committees; and, if so, whether such management positions or committees report to the board or a committee of the board*" on page 38 of the TCFD's Supplemental Guidance for the Financial Sector, available here.

We consider that this approach would be consistent with the guiding principles set out in the FCA's July 2021 'Dear Chair' letter to authorised fund manager chairs[16], in particular the principles 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.*

- *[A fund manager] must have and employ effectively resources to achieve the proper performance of its business activities.*

- *[The FCA expects] a firm managing a fund that pursues ESG/sustainability characteristics, themes or outcomes to apply appropriate resources to do so.*

Absent entry-level entity criteria of some kind, there is a higher risk these principles may be breached in practice.

Q6: What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

We have no specific comments in response to this question, save that we would welcome more developed proposals for prescriptive labelling criteria tied to the sustainability features of financial products, to provide as much clarity as possible to investors / consumers.

Q7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics:

- **Intentionality**
- **Return expectations**
- **Impact measurement**
- **Additionality**
- **Other characteristics that an impact product should have**

We support the inclusion of a "Sustainable-Impact" label and we agree with the high level features of impact investing set out in DP21/4 – intentionality, return expectations, impact measurement and additionality. We consider impact measurement and additionality to be especially important features to avoid the misuse of the "Sustainable-Impact" label in a way that may mislead consumers / investors.

As stated in our general comments above, our overarching concern is that none of the proposed labels should be structured or made available in a way that inadvertently facilitates or "formalises" greenwashing or otherwise misleads consumers / investors. It will be essential for the FCA to develop a robust definition of "impact" which is well understood by participants in the financial system both so that the label is coherent and made available to deserving financial products, and so consumers / investors are not surprised (and disappointed) by the features of funds to which the impact label applies.

In our view, the "Sustainable-Impact" label should be preserved for funds which are designed (including as to their purpose / objective) and adequately resourced to achieve meaningful and additional real-world

[16] The FCA's July 2021 'Dear Chair' letter is available here.

impact *through their investment activity*, which is demonstrable to investors and stakeholders through appropriate measurement, monitoring and reporting.

The risk in this context is that this label is made available to funds which, though they may have features commonly described as "ESG" or "sustainable" (for example, because they integrate ESG risks, exclude "unethical" companies from their portfolio, or apply positive screening to asset allocation decisions), or invest in a portfolio of assets which is aligned with the values of investors in the fund, cannot demonstrate that *the fund's investment activity itself* achieves impact.

This stems in large part from widespread confusion between: (a) the impact of a company or other asset in the fund's portfolio on the environment or society (**company impact**); and (b) the additional company impact created by the actions of investors themselves (investment, divestment, engagement etc.) (**investor impact**).[17] It is important to define (and measure) investor impact as 'the change in company impact achieved by investor activity' in order to properly assess the effectiveness of a particular fund's impact strategy.[18] Where a certain amount of company impact would have been achieved with or without the fund's decision to invest (or to take some other action), the fund's claim to achieve investor impact is weak.

Additionality and impact measurement should feature strongly in the "Sustainable-Impact" label criteria in order to cut through this confusion and ensure that the label is only available to funds whose investment activity or engagement and stewardship leads to a positive change in portfolio company impact on environmental or social factors (e.g. by providing economically viable funding for activity or growth which would otherwise not have access to funding, or causing a company to improve its environmental or social credentials through engagement).

That said, we are conscious of the difficulty of measuring (financial or non-financial) investor impact in a reliable way. The requirement for impact measurement should not be applied so as to prevent credible impact funds who act based on a robust theory of change in pursuit of an environmental or social impact objective from having access to the label, provided they are able to provide a respectable impact measurement methodology.

It is noted at paragraph 3.27 of DP21/4 that, if additionality were one of the necessary criteria for impact products, it is likely that fewer products would qualify for a "Sustainable-Impact" label than those currently categorised as Article 9 funds under EU SFDR. In our view, this is an acceptable consequence of the "Sustainable-Impact" label being a robust measure of genuine impact funds. Under EU SFDR, a large number of European funds have been classified as sustainable under either Article 8 or Article 9[19] and there are concerns that these categories are being misused by funds with weak sustainability features, owing to their breadth. A more robust labelling regime will guard against this risk in the UK context.

Finally, we would suggest that the "return expectation" characteristic suggested by the FCA[20] should not be applied so as to exclude either: (a) funds that expect to generate a market-rate return alongside positive social or environmental impact; or (b) funds that anticipate a sub-market-rate return as a result of the cost

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[17] See, for example, page 9 of 'I've got the power! Really?' (2DII, 2021) on the importance of this distinction. Investor or funder impact is framed as "*the change(s) induced through investing and lending activities in the impact of invested companies*".
[18] See page 557 of 'Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact' (2020, Organization & Environment, J. Kölbel et al.).
[19] Capital Monitor, citing research by Morningstar, has reported that as of the end of May 2021, up to 31% of all European Funds had been classified as either "light green" (i.e. falling under Article 8 of SFDR) or "dark green" (i.e. falling under Article 9 of SFDR). See 'Is SFDR failing? Eight in ten 'sustainable' funds in Europe hold fossil fuel stocks' (Capital Monitor, 29 June 2021).
[20] See paragraph 3.24 of DP21/4.

of implementing their impact strategies, from having access to the label. We do not consider the ability of a fund to generate market rate returns to be determinative of whether the fund has an impact strategy.

Q8: What are your views on our treatment of transitioning assets for:

a: the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label?

b: possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?

On balance, we support the inclusion of the "Sustainable-Transition" label and we agree that the product labelling system should recognise "products that [use] stewardship influence and other means to help investee companies become more sustainable over time"[21]. However, we have some serious concerns about: (1) how this label will be understood by consumers; and (2) the potential for greenwash, and we suggest that significant further consideration is given to the name and structure of this label.

Understanding the label

We are concerned that the use of the term "Transition" in this product label may itself create confusion and mislead investors.

In the context of climate change, the Paris Agreement and net zero in the broadest sense, "transition" is routinely used to refer to the necessary decarbonisation of segments of the economy (globally and nationally) and the related policies adopted and steps taken by societies, governments, corporates and other actors.[22]

In the context of the EU taxonomy for sustainable activities (**EU Taxonomy**) and the proposed technical screening criteria (**TSC**) for climate change mitigation and adaptation, "transition" has a more specific meaning. The word "transitional" is used to refer to certain activities for which there is no technologically and economically feasible low carbon alternative which can nevertheless qualify as making a substantial contribution to the transition to a net zero economy if certain requirements are met.[23] If the UK Taxonomy follows the EU Taxonomy in this respect[24], "transitional" is likely to have a similar specific meaning in the UK domestic regulatory context.

Against this background, the "Sustainable-Transition" label could lead investors to think that:

a. the activities of companies in which a fund invests contribute to the transition to a net zero economy, when in fact they contribute to other environmental or social outcomes; and / or

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[21] Paragraph 3.35 of DP21/4.

[22] See, for one of many examples, the use of "transition" in the UK Government's Net Zero Strategy document 'Net Zero Strategy: Build Back Greener' (HM Government, October 2021).

[23] If they achieve best-in-sector greenhouse gas emissions performance (i.e. emissions are substantially lower than the sector or industry average), do not hamper the development of low carbon alternatives and do not lead to a lock-in of carbon intensive assets over their lifetime. See recital 41 and regulation 10(2) of the EU Taxonomy Regulation.

[24] The UK Government's sustainable investing roadmap suggests that the UK Taxonomy will draw on the EU Taxonomy with such adjustments as are necessary to create a suitable approach for the UK market – see page 22 of 'Greening Finance: A roadmap to sustainable investing' (HM Government, October 2021).

b. the fund invests in certain activities specifically classified as transitional under the EU or UK Taxonomies, when in fact the allocation to activities which are technically Taxonomy-aligned (including transitional activities) is low.

This adds to the broader point, mentioned in our general comments, that the product labels generally may be misunderstood by consumers / investors as relating to climate-related sustainability when they in fact accommodate contributions to a wide range of other social and environmental factors.

More generally, much more clarity is required in the next iteration of these rules regarding the sustainability characteristics, themes, objectives or outcomes towards which a fund in this category must "transition". In particular, will this label be reserved for funds seeking to support UK Taxonomy-aligned activities (which until a full suite of supporting guidance and screening criteria is produced may be limited to climate change or another subset of sustainability objectives), or will it also be available for funds seeking to improve sustainability metrics which fall outside the UK Taxonomy's technical criteria (such as, purely by way of example, reductions in carbon emissions or improved diversity across a market-weighted portfolio)?

Greenwashing

We are also concerned that this label may contribute to greenwashing if it is susceptible to abuse by funds that claim to be perpetually supporting transition towards some sustainability objective or other, but achieve little or no real progress over the life of the fund.

We note that the label has the weakest availability criteria of the "Sustainable" group of labels: funds in this category would have "*sustainable characteristics, themes or objectives*" but would have a "*low allocation to Taxonomy-aligned sustainable activities*" (in contrast to the "Sustainable-Aligned" category, which would have a high allocation), although this may be expected to increase over time because transitioning funds should "*pursue strategies that aim to influence underlying assets towards meeting sustainability criteria over time*".[25] A direct parallel can be drawn with funds classified under Article 8 of the EU SFDR (to which this label is intended to map) where the vague requirements of Article 8 have led to accusations that this category facilitates greenwash.[26]

Conclusions and Recommendations for Q8

We note that the Joint Research Committee (**JRC**) of the EU Commission has removed from its proposed EU Ecolabel criteria for retail financial products a criterion which would have accommodated investments in companies "transitioning" to a higher proportion of "green" revenues. This was on several grounds identified during stakeholder consultation including the insufficient stringency of the criterion and potential confusion with how transition is addressed in the EU Taxonomy itself.[27] We suggest that the FRC take steps to mitigate these concerns in the UK context.

Further work on this label will be required, but at this stage we suggest the FCA consider:

- how this label's name could be amended to avoid confusion with other common meanings of "transition";
- how disclosures which accompany this label can be designed to clarify to investors (in the case of each fund to which the label applies): (a) that this label does not necessarily imply a certain standard of climate performance (i.e. where it is based on other sustainability factors); (b) the sustainability factors to which the label does relate for a particular fund; and (c) the extent to which

[25] See page 17 of DP21/4.
[26] See 'SFDR: 'Vague' Article 8 definition increases risk of greenwashing' (ETF Stream, 9 August 2021).
[27] See page 66 of the 4th iteration of the JRC's technical report on the 'Development of EY Ecolabel criteria for Retail Financial Products' (JRC of the EU Commission, March 2021).

the label implies transition towards increased Taxonomy alignment (rather than other sustainability objectives);

- introducing a requirement for funds to set measurable targets progress towards sustainability objectives / Taxonomy-alignment over time (e.g. through a minimum percentage target requirement) in order to counteract greenwashing;
- precisely what the criteria for this label will be, including: (x) the degree of Taxonomy alignment required at the point the label is awarded; (y) the level of progress required for a fund to qualify as achieving "transition" (and the consequences for failure); and (z) whether transition must be "towards" Taxonomy-aligned criteria, rather than a wider pool of sustainability characteristics; and
- how, more generally, to avert greenwashing by establishing robust eligibility criteria and evidence of genuine sustainability characteristics of the fund (beyond the minimum criteria for this label suggested on page 17 of DP21/4, which will need to be developed further).

Additionally, in cases where a transitioning fund is promoting climate mitigation (including through portfolio-wide greenhouse gas emissions reductions), rather than this being a misconception caused by the label, we would suggest that additional criteria and disclosures should be required. These should: (a) require the fund to support robust Paris-Aligned phase-out plans for fossil fuels and / or emissions reduction plans consistent with a 1.5 degree pathway in order to qualify for the label; and (b) empower investors to assess whether the fund targets and achieves alignment with the objectives of the Paris Agreement and a 1.5 degree pathway. This is to ensure that weak climate commitments are not obscured by the award of a label that implies effective transition. We acknowledge, however, that this is a complex area and that the approach would need to be aligned with wider efforts to develop best practice and consistent methodologies for testing Paris alignment at corporate and investment portfolio levels.[28]

Q9: What are your views on potential criteria for 'Responsible' investment products?

We have several reservations about the inclusion of the "Responsible" investment label as currently framed in DP21/4. In its current form we believe this label may mislead consumers and support greenwashing and we question the value it adds to the labelling regime. Our concerns are as follows:

Our first and fundamental point is that we do not consider that the minimum criteria suggested by the FCA for this label (see page 18, and paragraphs 3.37 and 3.38 of DP21/4) should qualify an investment fund for a sustainable or responsible product label. This is because ESG integration, the consideration of the impact of material sustainability factors on financial risk and return and stewardship to support effective financial risk management are part and parcel of the legal and fiduciary duties applicable to all investment firms (including those "Not promoted as sustainable").[29]

This is consistent with the FCA's position, set out in its letter to the chairs of authorised funds[30], that funds that merely "*[integrate] ESG considerations into mainstream investment processes (with no material ESG orientation in the fund design/strategy)*" should not make prominent ESG claims in the fund's name, documentation or marketing. It is also consistent with the approach taken under EU SFDR, Article 6 of which requires disclosures regarding how "sustainability" risks are managed (or reasons why they are not

[28] Including, for example, the related portfolio alignment obligations which will be introduced UK occupational pension schemes, on which the Department of Work and Pensions is currently consulting: https://www.gov.uk/government/consultations/climate-and-investment-reporting-setting-expectations-and-empowering-savers/climate-and-investment-reporting-setting-expectations-and-empowering-savers-consultation-on-policy-regulations-and-guidance.

[29] See, for example, the executive summary at page 8 of 'Fiduciary duty in the 21st Century' (UNEP FI / PRI, September 2015).

[30] See footnote 16.

considered relevant) in the pre-contractual material for all funds, not just those marketed as sustainable. In our view this would be an appropriate requirement for the UK market, including for funds to which the "Not promoted as sustainable" label applies as it would increase transparency and help drive up standards for the integration of sustainability risks in mainstream investment decision-making.

To the extent the "Responsible" label creates the impression that a fund will apply a more responsible or sustainable approach than this (such as best-in-class stewardship aimed at particular sustainability outcomes) then it could confuse investors and entrench formal greenwashing. In our view this risk is high given widespread failures of stewardship identified in the asset management sector, including by funds that have aligned themselves with voluntary frameworks for responsible investment such as UN PRI.[31] Lessons can also be drawn from the accusations of greenwash levelled at the broad Article 8 classification adopted by funds under EU SFDR. To the extent the "Responsible" label is intended to provide a UK equivalent category to the "bottom half" of funds classified as Article 8 in the EU (i.e. those that claim to promote sustainability objectives but neither commit to make any "sustainable investments" nor consider their principal adverse impacts (**PAIs**) on society and the environment), this would suggest that this category will be particularly susceptible to greenwash.

Consumer misunderstanding and inadvertent greenwashing may also be compounded by confusion between the meaning of "responsible" and "sustainable", with products labelled as responsible misunderstood as having the features of a sustainable fund (when in reality their approach is limited to ESG integration).

For these reasons, we would support a reassessment of the inclusion of this label, and further consideration of the minimum ESG risk management requirements (and related disclosures) which should apply to all funds.

Q10: Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?

We accept that there may be products for which sustainability factors are less relevant and / or to which it is difficult to apply sustainability labels, though we are not in a position to give specific examples at this time.

However, as set out in our response to question 9, we do believe that the consideration of material sustainability risk is required by all managers to meet their legal and fiduciary duties (and we would suggest this is an absolute minimum of what these duties require). We therefore see a valuable role for an Article 6 style disclosure for all UK funds, including those that make no sustainability claims, explaining how the fund takes account of sustainability risks or giving reasons why such risks are not relevant to the particular fund.

As explained below, we also consider it crucial that the sustainability disclosures made under the SDR regime for all funds capture "double materiality", giving investors a clear picture of the impact of investment products on society and the environment (in addition to the financial risk posed to the product by social and environmental factors), regardless of whether the fund is promoted as sustainable.

[31] See for example: 'Investor stewardship: one hand on the wheel?' (Willis Towers Watson, 2019); 'Climate in the Boardroom: How Asset Manager Voting Shaped Corporate Climate Action in 2021' (Majority Action, 2021); and 'New data shows scant improvement in fund managers' voting on ESG resolutions' (ShareAction, December 2021).

Q11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

We have no comments in relation to this question.

Q12: What do you consider the role of derivatives, short-selling and securities lending to be in sustainable investing? Please explain your views.

We have no comments in relation to this question.

Q13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

We welcome the FCA's proposals to broaden the scope of entity and product level disclosure requirements for asset managers and FCA-regulated asset owners beyond climate to cover other sustainability matters and we support the streamlining of disclosures under TCFD and SDR. We are particularly encouraged by the FCA's commitment to ensure that sustainability reporting under SDR captures the impact investment firms and products have on the environment and society (in addition to the financial risks and opportunities posed by environment and society to the firm or product).[32] Our main concern is that the SDR regime should be designed to ensure that this "double materiality" is transparently captured and presented to investors.[33]

The potential limitations of a TCFD-based sustainability disclosure regime are that it becomes overly focussed on financial risk to the entity or product, rather than the impact of the entity or product on the environment and society[34], and that disclosures are overly focused on process (i.e. governance, strategy and risk management) rather than measurable impact and sustainability outcomes.

In order to overcome these limitations, the SDR should, in addition to mandatory disclosures covering sustainability governance, strategy and risk management, require the disclosure of mandatory sustainability metrics which capture the impact (at entity and product level) of investment activity on the environment and society. Given the risk, highlighted in our general comments, that the investment product labels are misinterpreted to signal climate-related sustainability, it is essential that the SDR disclosures include prominent metrics (including core TCFD metrics) that enable to investors to assess a product's emissions / climate impact over time, and the degree of alignment with a 1.5 degree pathway under the Paris Agreement.

A balance would need to be struck between comprehensiveness and the reporting burden on firms in scope of the new disclosure regime, but we would support an ambitious initial set of sustainability metrics with the potential to add additional metrics over time. In developing the sustainability metrics required to be disclosed under the SDR, the FCA could draw on (among other sources) the PAI indicators required to be disclosed under EU SFDR by fund management or advisory groups with, on average, 500 or more

[32] See paragraph 4.2 of DP21/4.
[33] Confusion between the "outside in" and "inside out" elements of double materiality is rife. See, for example, 'The ESG Mirage: MSCI, the largest ESG rating company, doesn't even try to measure the impact of a corporation on the world. It's all about whether the world might mess with the bottom line' (Bloomberg Businessweek, 10 December 2021) which illustrates this confusion in the context of ESG ratings provided by MSCI.
[34] See the comments regarding 'double materiality' at page 4 of 'Combatting Greenwashing: TCFD Reporting' (ShareAction, 10 December 2021).

employees in a given financial year[35], though we would support the mandatory disclosure of sustainability impacts by all FCA regulated firms, regardless of size. These indicators also benefit from some degree of familiarity in the market.[36]

Investment products to which a sustainable label is made available under the proposed labelling regime should be required to make additional disclosures about the nature of the product in order to substantiate their entitlement to the label. This should include the key features of the investment product such as its objective, binding investment strategy, sustainability features and the sustainability related metrics, KPIs and targets against which it will deliver and measure its sustainability objectives.[37] This additional layer of disclosure for labelled products will help ensure that labels are substantiated in practice by firms and products with binding sustainability features and adequate resources to deliver against them, in line with the FCA's general approach to sustainability and ESG related claims, as set out in its letter to the chairs of authorised funds.

Q14: What are your views on consumer-facing disclosures, including the content and any considerations on location, format (eg an 'ESG factsheet') and scope?

As set out in our response to question 1:

- we support the streamlined presentation of key sustainability information in an ESG factsheet or similar;
- consumers should, however, have access to the full suite of sustainability information disclosed under layer 2 SDR disclosures that they need in order to make informed investment decisions;
- disclosure systems should be designed to give consumers this optionality when they access information about a fund; and
- as far as possible, we support SDR disclosures being publicly available to stakeholders.

As explained in our response to question 13, we strongly support the prescription of a baseline set of sustainability metrics to enable consumers to support the sustainable performance of products over time (paragraph 4.8 of DP21/4).

Q15: What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?

Please see our response to question 13 for our views on the need for detailed mandatory sustainability metrics to be disclosed which capture the impact of an investment product (or the aggregate impact of its portfolio assets) on society and the environment. We agree with the suggestion in paragraph 4.17 that the PAI indicators under EU SFDR could be used as a starting point for the development of these metrics. The crucial point is that the "double materiality" of an investment product and relevant social and environmental factors is captured. In addition to being captured through granular metrics, this impact should be conveyed to consumers in any layer 1 fact sheet disclosures.

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[35] See Articles 4 and 7 of SFDR and the 18 mandatory metrics or "indicators" and 46 additional voluntary indicators for environmental and social impact set out in the draft Regulatory Technical Standards prepared by the European Supervisory Authorities for the content and presentation of disclosures under SFDR: See Annex I to the ESA's 'Final Report on draft Regulatory Technical Standards' (2 February 2021).

[36] Note that such measures would be intended to capture aggregate company impact for a given investment portfolio and would not necessarily capture additional investor impact which can be attributed to a given investment activity, with which impact investors will be concerned.

[37] See paragraph 4.6 of DP21/4 for overlap with the list of suggested consumer-facing disclosures proposed by the FCA.

In light of our general concern that the investment product labels may be interpreted to signal climate-related credentials when in fact they relate to other social or environmental characteristics, we would support particular emphasis on metrics that show: (a) the climate impact of an investment over time; and (b) the degree to which the product (and assets in its portfolio) are aligned with robust net zero aims and a 1.5 degree pathway under the Paris Agreement. We would support additional prescription in this area in addition to the information listed in paragraph 4.16 of DP21/4.

As stated in our response to question 13, products which achieve a sustainable label should be required to make additional detailed disclosures which explain the basis on which the fund qualified for the label.

Q16: What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?

We have no specific comments in relation to this question save that we consider disclosure of the impact of firms and their products on society and the environment to be crucial. The entity-level focus on strategy, governance and risk management, though important, should not detract from the focus on sustainability impacts.

We would also hope that a TCFD-style framework would provide a stronger foundation for entity-level reporting in contrast to the Article 6 disclosures required under SFDR, with many firms making “boilerplate” disclosures about their integration of ESG risk. The TCFD-style framework should be applied at entity level to require meaningful disclosures that will be decision-useful to investors.

Q17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.

This will undoubtedly be a complex exercise. Our only comment at this stage is that efforts to map UK disclosure rules to EU SFDR and align SDR disclosure requirements with other frameworks such as the ISSB should not be allowed to compromise the ambition of the UK labelling and SDR regime. In particular, the labels must be clear and robust to avoid misleading consumers and greenwashing, and SDR disclosures must capture “double materiality” and not purely financial risk faced by investment products. We have provided more detail regarding these concerns in our answers to other questions.

Q18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?

We have no specific comments in relation to this question at this stage.

Q19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?

We can see the value in some kind of third-party verification of sustainability disclosures and product labelling but this must be weighed against the burden this may place on some firms and products, and the endemic weaknesses seen in audit and assurance in other contexts. One option the FCA may wish to consider is including in the SDR regime a disclosure regarding whether sustainability metrics disclosed have been independently assured, by whom and to what standard – this would allow investors to factor in this information into their overall assessment, without being overly prescriptive.

In relation to investment labels, as set out in our general comments, we consider it essential that the FCA develop a concrete plan for monitoring and enforcing the award of labels. The FCA must therefore play a key role in ensuring high standards in labelling and disclosure, and must be adequately resourced to do so.

Q20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine-readable format to better enable data collection and analysis?

We have no comments in relation to this question.

5. Conclusion

Please do not hesitate to get in touch with Joanne Etherton or Robert Clarke if you have any queries in relation to this response.

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