

# Response to FCA CP22/20 Sustainable Disclosure Requirements (SDR) and investment labels

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## About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. The investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

## Executive summary

The IA welcomes the opportunity to respond to the FCA's Consultation Paper (CP) 22/20 on Sustainability Disclosure Requirements (SDR) and investment labels. Investment managers are committed to bringing clarity, transparency and consistency to the way industry describes and delivers sustainable and responsible investment products to clients. It is this commitment to clients and client outcomes that has dominated investment managers' thinking and work on all aspects of SDR and we are grateful for the inclusive and positive work undertaken to date by the FCA as part of this policy's development process.

We reiterate our support for a retail market labelling system and a clear disclosure regime that ensures that together, we raise standards and improve consumer confidence in this market. However, we are concerned that without modifications CP22/20 will not result in an approach that serves consumers effectively or facilitates the wider process of stewardship and capital allocation as part of the transition to a more sustainable future, considerate of net zero and positive social contributions. This, in turn, may have an adverse impact on broader UK competitiveness.

Our own analysis shows that the gap between the existing shape of the market and the fund universe envisaged in CP22/20 is simply too wide and the rules, as proposed, move beyond the

objective of better communication and disclosure towards a re-engineering of the way in which investment managers run sustainable investment portfolios. We also think that in implementation, there is a high probability that too many funds that are legitimately sustainable will fall outside the labels or between the Sustainable Focus and Sustainable Improvers labels. The IA's fund mapping demonstrates this issue in a number of ways:

- Our mapping showed that owing to data and methodological challenges, few funds have set thresholds (a requirement under Sustainable Focus).
- It further identified that mixed-asset funds or funds of funds and index trackers are particularly vulnerable to falling outside the scope of any label.
- Many funds invest in a blend of 'Improving' and 'Focus' assets and this is particularly prevalent among mixed-asset funds, which are commonly used by retail investors.
- It is not clear that funds pursuing a best-in-class approach across a broad range of industry sectors (not just sustainable solutions) and which are not using a 'primary channel' of stewardship to drive improvements would fit under either the Focus or the Improvers label. Many sustainable indices are constructed using a best-in-class approach.
- Most impact funds available to retail investors are investing in publicly-listed assets and would be unlikely to receive the Sustainable Impact label.
- Finally, many of the funds in the IA responsible investment fund data are 'ethical' funds or funds applying exclusions and 'responsible' funds. Such funds would not currently qualify for a label and we are concerned that the highly prescriptive marketing rules will make it difficult for investors to find these types of funds.

We are concerned that the net effect of this could limit consumer choice, complicate disclosure, and in effect, enforce a narrow methodological approach as to how funds can achieve sustainable objectives.

From the onset of the SDR and investment labels work, we sought answers to four key questions that in our view establish a reliable foundation for moving forward:

1. How can we ensure that the labels and associated disclosures build trust in the market and are clear and helpful to consumers and advisers?
2. How do the labelling proposals reflect the existing fund universe and do they serve the diverse ESG preferences of clients?
3. How do we build a system that is appropriately supported by data and methodologies?
4. How can we ensure that the new regime allows for the anticipated evolution of the market, including further relevant rules (e.g. ISSB standards)?

As we put forward the IA response to this consultation, we want to acknowledge that aspects of these questions remain open and we encourage the FCA to continue to consider how to make the new SDR and investment labels regime simpler and more adaptable and most importantly, useful to the consumer. We recognise that there is no 'right' answer at this stage that will satisfy simultaneously all investors, market participants and wider stakeholders. However, we do believe that with some modifications a foundation can be laid that delivers for customers today and can successfully evolve in the future.

Finally, we want to recognise the importance of globally-consistent and comparable standards for client outcomes. Many of our member firms conduct business on a cross-border basis and

fragmented approaches across different jurisdictions risk unnecessary complication and diseconomies of scale. Whilst there is currently limited interoperability between the proposed UK SDR and other prominent regimes (e.g. SFDR), we welcome the FCA's support for international sustainability disclosure baselines, including the work of the ISSB, and underline the importance of ensuring the UK's regime is as compatible with other initiatives internationally as far as possible and where it is in the best interest of the investor. A more pragmatic approach to some aspects of the SDR proposals will facilitate this.

***Below, we outline the key suggested changes that could make a positive difference to the effectiveness of the new SDR and investment labels framework:***

**1. Adopt a pragmatic approach to agency and influence and move away from specific language on channels for investor contribution**

The consultation paper commentary is very specific in its suggestion that a sustainable investment fund should identify primary and secondary channels for investor contribution by which the product plausibly achieves a positive outcome for environmental or social sustainability.

We recommend that the FCA moves away from this language around primary and secondary channels. In reality, investment managers aim to meet client demand across different asset classes by using a variety of channels across their portfolio. Furthermore, investment managers and investee companies may have different approaches to reaching the same outcome. Limiting the way investment managers are able to manage these relationships could be detrimental to the objectives of the fund and good outcomes.

The issue of identified channels is a particular problem in the Sustainable Improvers category. Whilst we are supportive of the inclusion of a category focusing on investing in securities that improve their sustainability characteristics over time, this category should be approached in a more pragmatic way. Managers must be allowed to construct a portfolio that can demonstrate improving characteristics over time, without being required to rely on demonstrable agency (through stewardship or other methods). This can be achieved by moving away from the focus on the primary channel of stewardship, and for fund managers to decide the weight given to a stewardship or asset selection approach held within the strategy rather than distinguishing between primary and secondary channels. Those firms that wish to communicate their stewardship activity and outcomes would, of course, be able to do so as part of their overall proposition. This appears to be the direction taken in the proposed draft rules but not reflected in the commentary in the CP.

**2. Introduce more inclusive and less prohibitive naming and marketing rules**

Product names are a critical first step in communicating with clients some of the product's features and so we are supportive of the principle of the naming rule. However, it is our view that the list of prohibited terms for funds that do not receive labels is too extensive. A particular concern for our members is the inclusion of terms like 'responsible', which are used extensively and do indicate to consumers that the fund is considering sustainability issues beyond ESG integration. **We ask that 'responsible investing' should fall outside the scope of prohibited terms for naming.** Fundamentally we do not agree with the implication that using

sustainability-related terms in the marketing of unlabelled products would necessarily constitute greenwashing.

**We have even stronger reservations about the marketing rules.** The marketing rules are overly prohibitive on the use of certain terms which are commonly used across investment strategies and are not limited to specific sustainable portfolios. The current suggestion to restrict these terms (which, in itself, is not a finite list of terms) would severely limit the ability of IA members to communicate effectively and clearly to clients. The adoption of a label is only notionally optional: the significant restrictions on the use of certain core sustainability-related terminology in marketing materials for funds without a label or sustainability-related objective makes it difficult to see how such funds could communicate their consideration of these factors and continue to operate under their existing approaches.

This is a particular concern given that a significant number of funds which have been sold entirely legitimately to satisfied customers on the basis of a given strategy related to responsible and/or sustainable investment, will likely find it very difficult to gain a label. **We ask that the FCA reconsiders the marketing rules and designs them to be less prohibitive on the use of terms which are used across investment strategies and are not limited to specific sustainable portfolios.**

**3. Accommodate funds that invest in a blend of Improving and Focus assets within the Sustainable Focus label**

Under the current proposal, funds that select a mix of assets with the intention to deliver measurable improvements *and* to invest in assets that meet a 'credible standard' of sustainability would not meet the requirements for either the Sustainable Focus or Sustainable Improvers label. This is a significant issue for many mixed-asset and funds of funds and would prevent funds pursuing legitimate sustainable investment strategies from receiving a label due to the proposed qualifying criteria. We agree that allowing funds to hold more than one label could be confusing to investors, so we propose that these blended funds should be accommodated within the Sustainable Focus label. Funds investing in improving companies are ultimately moving them along the trajectory to meeting a credible standard of sustainability and so these funds should, over time, increase the proportion of assets that meet the standards required by the Sustainable Focus label.

**4. Incorporate new sustainability-related fund information into existing product disclosures**

It is important to our members that clients have all the information they need to make informed decisions about their investments, ensuring they align with their sustainability preferences. However, the suggestion that the industry creates an additional document / template consisting of regulated disclosures raises concerns that the information will either not be read or be too complicated for a retail client who will be required to read two overlapping documents rather than have one factsheet explaining the fund's investment approach in a holistic way. The FCA acknowledges that it has over-ruled advice from its consultative group on this point, which includes a wide range of stakeholders.

Our members suggest incorporating sustainability related information relating to a fund into existing product disclosures. This is in effect the direction taken in the FCA's own consumer testing, which looked only at the advantages of a single factsheet alongside a KIID document.

Furthermore, SDR requirements need to be considered alongside the Consumer Duty obligations as well as the FCA's Future Disclosure Framework Discussion Paper and HMT's recent CP on UK retail disclosures. All of these aim to move away from prescriptive requirements, particularly in an age of digital communication.

**5. Recognise current data and methodological limitations and allow firms to use internal frameworks as a credible standard for environmental and social sustainability**

In the Sustainable Focus category, and in the absence of a standard methodology for determining a sustainable asset, firms should be allowed to use internal proprietary frameworks / scorecards to determine a 'credible standard of environmental and / or social sustainability' and / or a 'specified environmental and / or social sustainability theme'. This should be allowed without the need for verification by an external third-party (unless the firm deems it appropriate) providing that the firm has effectively outlined a credible methodology, which is required under the KPIs for disclosure.

Furthermore, the FCA should specify if it intends that the threshold should be applied at portfolio level (proportion of assets) or whether a look-through approach is also acceptable (e.g. proportion of revenue aligned to sustainable economic activity). For example, funds seeking taxonomy alignment would likely be using the look-through approach.

**6. Adopt a more pragmatic approach to Impact**

Funds with an Impact label are unlikely to form part of a retail client's portfolio under the current proposals. This is due to the requirement to deploy 'new capital' and prove financial additionality, which are difficult to demonstrate in public market investments. This, in turn, will restrict impact funds to investing in private markets and primary issuances only, both of which are generally not available to retail clients. The concept of additionality should be defined instead as 'contribution' and not be limited to being financial only. This would allow a more realistic set of criteria, while still maintaining high standards with respect to authenticity of objectives and transparency of delivery.

There is also an unintended consequence that this approach may be contrary to the UK government's proposal to generate investment in new infrastructure and public sector developments from private investors which could include retail consumers.

**7. Recognition of importance of cross-border distribution**

Although difficult to achieve, the IA has long been calling for the global harmonisation of standards in the sustainable and responsible investment space. In particular, UK investors currently benefit significantly from access to a wide range of investment funds, both UK and EU-domiciled funds, which account for 44% of the funds available to UK retail investors. With the UK and EU now moving in a clearly different direction in an area that is of critical importance for investors, both retail and institutional, **there needs to be clarity about the FCA's approach to overseas funds as soon as possible.** Effective interoperability or equivalence across cross-border markets should be a guiding principle. The danger – as also seen with the Consumer Duty – is that UK regulatory divergence works against a competitive and dynamic product market, and to the disadvantage of customers.

## CHAPTER 3 - OVERVIEW, SCOPE AND TIMINGS

### Q1: Do you agree with the proposed scope of firms, products and distributors under our regime? If not, what alternative scope would you prefer, and why?

The FCA's final proposals on SDR and investment labels are extensive in their scope and application and will require significant resource from members and the sustainable finance industry - at a time of heavy regulatory change - to ensure they are appropriately implemented and meet their objective to raise trust and improve transparency.

It should be further noted that firms already have a requirement under the Consumer Duty's cross-cutting rules and outcomes to ensure that appropriate and sufficiently detailed information is made available to the end consumer and distributors are given the information they need to ensure they are able to meet the needs of the target market. This includes requirements that product manufacturers must provide sufficient information to institutional clients where the retail consumer is the ultimate customer.

Below we outline our detailed comments on all in-scope entities and products.

#### Overseas Funds Regime

Many IA member firms are global in nature and need urgent clarity from the FCA as to how it plans for the SDR regime to be applied to overseas funds.

In addition, a significant portion of UK investors' fund investments are in non-UK UCITS funds and there are growing concerns that without the ability for non-UK funds to opt-into the regime, investment options for retail clients (including pension products and mixed-asset products) would be significantly impaired.

We understand that it is difficult for all regimes to be identical, but the SDR regime needs to provide for equivalence/interoperability in order for investors to understand how categories compare. Contradictory requirements will result in separate fund vehicles being created in each jurisdiction, which ultimately results in higher costs for investors and, all things being held equal, would also mean smaller FUM per fund as FUM would need to be spread across the appropriate vehicle/label. There is also the risk that managers will simply choose not to set up fund vehicles in the UK given the relatively small size of the market.

If the regime is indeed extended to overseas funds, there will also need to be clarity around those funds that use ESG or sustainability-related names in the EU but that do not qualify for a label under SDR (e.g. an SFDR Article 8 fund with 50% sustainable investment commitment that uses 'sustainable' in its name but does not qualify as a Sustainable Focus fund in the UK). Clarity is needed on how this would impact the names of those funds, and to what extent those funds would be able to describe their sustainability or ESG characteristics without breaching SDR marketing/greenwashing rules. Similarly, as per the new ESMA draft guidelines on fund names, a fund could use an ESG-related term as long as 80% of its investments are used to meet environmental or social characteristics. The same fund in the UK may not qualify for a label, so would not be able to use those same ESG-related terms in its name or even to explain its strategy in marketing materials.

## **Firms**

With regards to firms, we would support as little divergence as possible in the scope of entities to be covered by the SDR regime, the FCA rules on TCFD implementation, and the EU's SFDR. A top-level approach of consistency of scope across all regimes would be the optimal outcome. The same point applies to products in scope.

IOSCO's recommendations may be particularly useful to consider, as they reflect a general consensus amongst international regulators on best practice for sustainability-related disclosures. IOSCO's recommendation that entity-level disclosures should be consistent with the TCFD recommendations, in particular, aligns with the FCA's policy intent and the wider international direction of travel on climate disclosures.

We do, however, note that SDR is being developed before UK TCFD disclosure requirements have had time to properly bed in. This could create a situation whereby a firm commences TCFD reporting and is then required to essentially repeat the exercise and amend these disclosures for SDR.

## **Products**

We note that in the short term the more targeted proposals in this CP – on labelling and classification, disclosure, naming and marketing and distribution – are directed at authorised investment funds and unauthorised alternative investment funds, including investment trusts (primarily those marketed to retail investors in the UK) and the firms that manage or distribute those products. However, the IA would like to seek clarification on whether discretionary portfolios which are offered to retail clients and constructed using segregated mandates, where the mandate invests directly in securities rather than through a fund structure, are in the scope of the CP.

We would highlight that setting the bar of 90% for portfolio management services is a very high hurdle and out of step with the 70% threshold set for the Sustainable Focus label. If portfolio management services have to reach 90% of the value of all constituent products in which they invest and align these products to one label in order to receive a label, then this is likely to prohibit the majority of portfolio management services from obtaining a label. Most model portfolios, mixed-asset funds and funds of funds are looking to provide diversified rather than concentrated portfolios and there could be concentration risk in channelling portfolio flows into a small set of products, for example in the case of the Impact label.

Furthermore, whilst the CP is focused on supporting retail consumers making informed choices, our members would like to understand the FCA's intention to expand the requirements to portfolio management services aimed at institutional clients.

## **Distributors**

We support the proposed scope of the CP to cover firms that are distributors of in scope products to retail investors (including platforms and advisers). They play an integral role in the investment value chain and the vast majority of retail investors make fund choices through platforms or on an advised basis, rather than having a direct relationship with the fund manager.

However, on distributor obligations regarding overseas funds, it is unclear whether the proposals are suggesting that distributors have to determine whether an overseas fund would meet the



proposed labelling requirements, and if so, which label. If that is the case, we strongly disagree with this proposal, not least because it would be challenging for distributors to determine if overseas domiciled funds meet the label criteria. We would stress that one third of the responsible investment funds in IA data are domiciled overseas. We provide further views on this point in our answer to question 24.

### **Advisers**

Lastly, given that the majority of all fund sales to UK retail investors are subject to advice, we also feel that the FCA should have considered the advice process and suitability alongside its proposals for sustainable labels. We would urge the FCA not to leave this review for too long. It will be integral to ensuring that the labelling and disclosure system functions effectively and that retail investors are being advised on sustainable products that have a suitable risk and return profile alongside appropriate sustainability characteristics.

In the absence of rules for financial advisers, pending the FCA's review, advisers may decide that clients with sustainability preferences should only be recommended funds that receive a label. This could mean that long-established funds with ethical or responsible investment strategies are not selected. The restrictions imposed by the naming and marketing rules would also make it harder to find funds without a label, further limiting the likelihood that they would be considered by advisers. This could restrict consumer choice, particularly as diversified sustainable mixed-asset funds and lower cost funds tracking sustainable indices may not meet the label criteria as currently written.

### **Q2: Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?**

The CP outlines (Table 1, section 3.7), amongst other things, that labelling, consumer facing disclosure, pre-contractual disclosure and naming and marketing rules will come in to force twelve months after the day of the Policy Statement publication.

Given the importance of the SDR regime to the investment management industry, the multi-faceted nature of the proposals, and the on-going implementation of other new regulatory requirements (e.g. Consumer Duty, TCFD entity and product level reporting), twelve months is a very short timeframe. We therefore urge the FCA not to rush with the implementation but create a clear progressive timeline, which allows industry to meet the requirements of all these significant and inter-related initiatives.

Regarding the immediate application of the anti-greenwashing rule on publication of the Policy Statement, we provide detailed views under question 20.

Please see below for some further points that outline specific challenges with the proposed implementation timeline:

- The rules require an assessment of sustainable investment which should be based on a credible standard. These credible standards, whether proprietary or provided by a third party, rely on ESG data and disclosures which are currently inadequate.



- Funds will need sufficient information from investee companies or assets to ensure that they are achieving the sustainable objective or improving their performance against the sustainable objective. This will require better disclosures from the underlying assets in the portfolio. Even with the work of the ISSB to support a baseline in global sustainable disclosures due in Q1 2023, there will remain significant gaps. If the ISSB keeps to this timeline, it will then need to be adopted in individual jurisdictions and there will be a lag before companies report against these standards. It is very unlikely that companies will be required to report against ISSB by the time that this labelling regime is implemented. Therefore, there is a significant risk that investors continue to have insufficient information to meet the requirements of the fund labelling regime and so the FCA should have a pragmatic view on how to evidence progress against KPIs and that this will improve as an industry over time as more data becomes available to demonstrate progress on outcomes. The IA would encourage the FCA to continue to work with government towards mandatory disclosures by corporates on a range of sustainability characteristics and global adoption of the ISSB standards.
- The one-year implementation timescale will disproportionately impact smaller firms with fewer resources compared to larger investment managers. If smaller fund managers decide to make adjustments to funds to meet the label criteria, feedback from members is that the absence of a direct supervisor makes the process more challenging.
- The update of a fund's investment objectives in its prospectus in order to qualify for the SDR labels will require an application to the FCA. For SFDR in the EU, national competent authorities adopted fast-track approval processes which, while welcomed, also increase misclassification risk. We note that a credible standard, as per the proposals, would involve independent assessment to strengthen assurance of products that would meet the Sustainable Focus criteria. It would be useful to understand the FCA's anticipated plans and timescales for managing this within the implementation timeframe.
- Given the limited number of funds that would currently align to a label, it is likely that the FCA will receive large numbers of applications for modifications to existing funds as well as applications for new funds. It may be challenging for firms and the FCA to complete this process in the twelve months proposed between final rules and the inception of the regime.

**Q3: Do you agree with the proposed cost-benefit analysis set out in Annex 2. If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage.**

It is our members view that the costs in reality are likely to be significantly higher than estimated by the FCA. We have outlined below several key areas which need further consideration.

**Number of firms/funds impacted by the proposals**

The cost-benefit analysis (CBA) suggests that only 25 firms will be covered by the proposals relating specifically to sustainable investment labels which we believe underestimates the population of UK firms which currently run and promote a UK-based sustainable investment fund. Furthermore, the CBA implies that only 450 funds will be affected by the naming and marketing proposals. We believe this needs further exploration. Whilst many funds will not use sustainability related terms in their fund names, they will potentially incorporate these terms into their fund documentation and marketing in order to provide a comprehensive overview for the benefit of a retail client of how the

fund operates. Such terms include 'ESG integration', 'investing for impact', 'investing responsibly' and 'governance'. The potential cost of reviewing all existing fund documentation to ensure these terms are not used for marketing purposes will be comprehensive. If funds are changing their investment objectives, policies or names this will require funds to be re-authorised as a significant change event and they will need to contact all investors notifying them of the change, with approval potentially required. The FCA will need to provide further clarity on its proposed naming and marketing rules before the true cost of the proposal can be assessed (see our answers to questions 21 and 22 for areas on which we are seeking clarity).

### **Consumer facing product level disclosures**

The requirement to produce consumer facing product level disclosures with prescribed fields for all retail funds, regardless of whether they have sustainability characteristics, will lead to all firms with retail clients incurring costs (as these are typically costs charged to the fund). This is also against a backdrop of an overall review of the UK consumer disclosure regime for investment products where further changes, not least with the PRIIPs regime, will be inevitable. It will also mean significant development work for distributors. Platforms will effectively be required to ensure that investors access this new document alongside the KID/KIID. This means that they will have to upgrade their systems to facilitate this for all UK domiciled products. The publication of such disclosures in effect becomes a regulated document which will lead to significant costs related to legal and compliance oversight.

### **Notices on overseas domiciled funds**

Another additional cost not considered in the CBA is the work required to put prominent notices on overseas domiciled funds that are marketed as sustainable but would not be eligible for a label. Distributors will bear a cost burden here, but it is highly likely that investment firms will have to help distributors make a sensible judgment on whether the notice should be applied, if our interpretation of the proposals is correct (more on this in our answer to question 24). This would incur product, legal and compliance costs for overseas domiciled funds. This is likely to be disproportionate for an interim approach ahead of the FCA's approach to overseas funds.

### **Funds which don't meet the criteria for a label**

There are also costs to firms who already have responsible or sustainable labelled fund names which will not meet the criteria. Not only might these funds have to be renamed, potentially eroding consumer confidence in both the firms and the FCA (who approved the fund names and objectives), but the suite of fund documentation including prospectuses, KIIDs, factsheets etc. will have to be rewritten and the FCA will need to approve these changes.

### **Divergence from SFDR and SEC approach**

More generally, there will also be additional resources and costs caused by the SDR approach differing quite significantly from, for example, the EU's SFDR and incoming SEC approach.

### **Third-party verification**

If, as we understand it, it is the FCA's intention that firms have to use third party verification, the FCA has not considered the costs to firms of using third-party verification if they are applying proprietary methodologies to determine the 70% threshold for the Sustainability Focus label. By compelling firms to use what is likely to be a small group of external providers, this is forcing firms to incur additional data costs that will be increasingly difficult to avoid passing on to investors. It will also penalise smaller investment management firms less able to incur rising data costs and this will

ultimately mean less competition, in particular from new entrants and boutiques, and will lead to poorer investor choice. It is worth noting that data costs seem to be constant, so one fund manager with £100bn AUM does not pay ten times more for the same ESG/sustainable data than a manager with £10bn AUM. Therefore the cost to small and medium sized firms is proportionally higher.

### **Value for money**

An additional consideration is around the cost of providing the underlying services to funds within a value for money framework. We agree with this but the cost needs to be considered. As the services and governance for labelled funds would be additional to the existing management structure of the current ranges these should be factored into the input costs of manufacture and servicing of funds. Additionally, as they refer to these funds alone, the services should not be 'shared' across the range and cross-subsidisation should not occur. This could therefore result in higher OCFs for labelled funds versus non-labelled funds, which might be considered a barrier to entry for investors and may dissuade investors (both retail and institutional) from pursuing a sustainable investment profile within their portfolios.

### **'Unexpected investments'**

In section 5.38 of the CP, the FCA states that for 'unexpected investments', where firms do not know this information, the FCA encourages them to conduct consumer testing to better understand the types of holdings their consumers would or would not expect the product to invest in. The CBA makes no reference to the cost of this consumer testing.

Overall, given the CBA underestimates the number of firms and funds impacted by its proposals and the various omissions stated above, we think there is merit in the FCA issuing a revised CBA on the basis of its final proposals, working with industry to get a more accurate reflection of the actual costs. We would also like to stress the importance of providing clear guidance on assessment criteria, transparency on how the FCA will ensure consistent application of labels at the outset and continued support to investment managers with SDR interpretations, in order to avoid further additional unforeseen costs being incurred by firms.

## **CHAPTER 4 – CLASSIFICATION AND LABELLING**

**Q4: Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why.**

### **Sustainable investment**

Our understanding is that the FCA sees the approach to sustainable investment as one that contributes to positive sustainability outcomes for the environment and/or society and firms can achieve this through asset selection, portfolio construction and investor stewardship. As far as we can see, there are at least three locations in the CP that help to define what the FCA understands as a sustainable investment product:

- Chapter 2, section 2.2, Box 1: Market for sustainable investment products – ‘Sustainable investment products are structured around or pursue sustainability related characteristics, themes or outcomes, while providing a financial return to investors.’
- Chapter 4, Section 4.5: ‘In our view, one of the key attributes of a sustainable investment product is an explicit environmental and/or social objective (‘sustainability objective’), that is part of the investment objectives (i.e., sitting alongside the product’s financial return objective) and is expressed in specific and measurable terms.’
- In the appendix glossary: ‘sustainability characteristics – environmental, social or governance characteristics.’

However, overall, the paper does not specifically define what is a sustainable investment – indeed each label takes a different approach to the definition. ‘Sustainable Focus’ implies a sustainable investment is an investment which is already environmentally or socially sustainable based on a credible standard or theme supported by an investment manager’s capital allocation. A sustainable investment in the Improvers category is one that is on a transitional path to improving a sustainability characteristic with support from investment managers’ engagement policies. A sustainable investment in an impact fund is one that offers a solution or addresses a market failure in underserved markets, with investment managers providing ‘typically’ new capital.

### **Sustainable objective**

The IA is supportive of the need to incorporate a sustainability objective alongside a financial return objective in order for firms to receive a sustainable investment label. This will distinguish sustainable investment products from products purely focused on financial objectives. Based on the IA mapping of member firms’ funds within our responsible and sustainable investment data, we estimate that around one third of funds currently incorporate a sustainable investment objective alongside a financial return objective. However, the requirement to set credible, rigorous and evidence based KPIs aligned with the sustainable investment product’s sustainability objective, and monitor these on an ongoing basis, could limit the variability of sustainability objectives to those where data is readily available. Currently these are all likely to be in the climate space with carbon-based metrics. This is because the measurement of progress of sustainability objectives beyond climate-based targets may prove exceptionally difficult, particularly in products which focus on social characteristics where there are very few frameworks currently in operation and progress could be open to significant amounts of subjectivity. Third party data providers in this area are

creating data points based on proxies and subjective opinions which will create significant diversity of opinion with regard to progress.

### **Channels**

The FCA has identified a number of channels by which a positive sustainability outcome can be achieved: via capital allocation, active stewardship and influencing asset prices and the cost of capital. In both public and private markets, we would support the FCA's suggestion that these are the three main channels or mechanisms by which an investor may plausibly contribute to positive outcomes for the environment and/or society. In section 4.8, the FCA raises concerns that very few firms attempt to describe a causal link between the firm's investment objective and the positive real world sustainability outcomes of a product. Whilst we support the need for a *plausible* link as identified in the CP, as the FCA is aware it is very challenging to identify a *causal* link between a firm's activities and direct outcomes in a company's behaviour or cost of capital changes. A change in company behaviour could be due to numerous factors, including regulation, company decisions, NGO pressure and of course, the stewardship activities of other investors. As a result, some members are concerned that given the challenges outlined, the Sustainable Improvers category may not be used. Likewise, a change in the cost of capital could be due to factors including government monetary policy or a change in assessment of the risk of a company's peer or sector in which it operates due to the examples outlined previously.

With regards to the FCA's emphasis in the CP commentary on identifying the primary and secondary channel by which a product may plausibly achieve a positive outcome, we strongly disagree. We also note a difference between the commentary in the CP and the drafting of the rules, which are more ambiguous. As framed overall in the CP, this approach is inflexible and erroneously restricts the manner in which positive outcomes might be achieved. The primary channel, for example in the Improvers category, is identified as stewardship. Whilst this may be the case in some equity portfolios, this would not necessarily be as applicable in other asset classes such as real estate, fixed income, private assets or sovereign bonds. Using a primary and secondary channel approach appears to limit sovereign investments to the Sustainable Focus category – while we recognise that there is on-going industry led work to identify the gaps in stewardship resourcing in different assets classes, at present it would be near impossible to link investment management engagement with a sovereign state's sustainability outcomes. There may be some scope to prove that a sovereign debt fund is providing new capital, but it will be difficult to link this to a real-world change by a sovereign nation. The fact that stewardship is a primary channel for investor contribution may also disproportionately benefit larger firms with larger resource and larger ownership of companies. We support the notion that stewardship (proposed as primary) and asset selection (proposed as secondary) should work in parallel and that it should be at the discretion of the fund manager to determine how these approaches are deployed within the investment strategy.

We ask the FCA to reconsider the approach of articulating the concept of a primary and secondary channel. Having set the sustainability objective, it should be for fund managers to determine the weight given to a stewardship or an asset selection approach held within the strategy rather than distinguishing between primary and secondary channels. Funds should be able to use capital allocation as their central mechanism to drive improvement alongside funds that choose stewardship to achieve this aim.

In addition, prescribing a primary and secondary channel approach, especially for an Improvers fund is not suitable nor reflective of the dynamic nature of the sustainability characteristics of the

underlying securities that will comprise an Improvers fund. For example, where a fund with majority Improver assets has been successful, through investor stewardship, in affecting improvements in the sustainability characteristics of underlying securities, stewardship may no longer be the primary channel of influence. At this point if the fund hasn't achieved 70% of assets meeting a credible sustainability standard, the fund can no longer be an Improver nor would it qualify as a Focus fund. The prescriptive channels, therefore, would result in such a fund not qualifying for a label at all, even though it has been successful in achieving its sustainability objective. Members also note that there needs to be an end goal to improvements once a fund has met its sustainability objective otherwise firms will just buy and sell investments to keep the Improvers label which could be detrimental to the credibility of the standards and label. There is a further risk that the Improvers category could become the new Article 8 under SFDR which has become a catch-all 'category'.

**Q5: Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?**

The findings of the IA's consumer research, conducted in March 2022, clearly indicated that investors broadly welcomed the concept of labels, preferring a simple framework with clear distinctions between the labels. We therefore reiterate our support for a retail market labelling system which provides clarity to clients and builds trust in the market for sustainable and responsible investment products.

In the IA confidential position paper on 'Operationalising DP 21/4: Sustainability Disclosure Requirements and investment labels', which we submitted to the FCA in May 2022, we outlined our vision for an effective labelling system, based on intentionality and the nature of the investment process. More generally, from the onset of the SDR and investment labels work, we sought answers to five key questions that in our view establish a reliable foundation for a labelling that is simple, effective and adaptable. We use these key questions again to demonstrate where we agree and where we have reservations with the proposed approach to labelling and classification.

**1. Can the labelling proposals reflect the existing fund universe and do the proposed labels serve the diverse ESG preferences of clients around the world?**

The label system cannot accommodate the existing universe. From our initial mapping of UK domiciled funds with sustainability characteristics, we estimate that around one third of funds have sustainable investment objectives. Use of thresholds is not widespread: just under a quarter of the funds analysed are using a threshold of greater than 70%. There is also limited reference to stewardship in investment objectives or policies – just 14% of funds refer to stewardship, although a further 6% reference stewardship in the prospectus or a separate document. This means that most firms will have to update their investment objectives and policies in order to receive a label.

Therefore, the FCA's current approach does not fully reflect the existing sustainable investment product universe and we are concerned that there are funds legitimately pursuing sustainable investment strategies that do not easily fit into the sustainable label categories. This may preclude them from receiving an appropriate label. Furthermore, many asset managers will be replicating 'global' strategies that they use in other jurisdictions when selling their sustainable fund ranges into the UK. In many cases it won't be feasible for UK-marketed funds to diverge from the 'global'

strategy and to make changes to their investment process to align with the specific criteria of the FCA's labels, even if the funds clearly meet the spirit of what the FCA is trying to achieve.

However, there is also a recognition that the FCA is aiming to raise the standards of funds that can use ESG and sustainable investment credentials and that the minimum threshold is a sustainable investment objective – therefore it is likely that we will see movement to meet the FCA's criteria. We would caution the FCA that if there is a significant scale of market movement taking place over the twelve month implementation period, then it should consider the risks to market stability in the UK if the regime causes a significant and quick change in funds' investment strategies. The universe of assets that will be eligible under the Sustainable Focus and Sustainable Impact categories for certain asset classes, such as fixed income, could be narrow. This may lead to firms compromising on the liquidity profile of the assets in order to meet the labelling requirements. Since retail products typically require daily liquidity, this can increase liquidity risk for investors, working against the FCA's objectives in protecting the retail investor and general policymakers' objective in addressing overall liquidity.

### ***Index trackers***

The FCA provides an example of an index tracker that meets the criteria for the Sustainable Improvers label, whilst acknowledging that index tracking funds would be unlikely to achieve a Sustainable Focus or Sustainable Impact label. However, it would still seem very difficult for index trackers to meet the primary channel requirements of stewardship for this label as most are constructed on a capital allocation approach driven by the constituents of the chosen index. Index trackers may struggle to meet the stewardship KPIs due to the limited potential escalation. Whilst ETFs tracking more customised indices might be able to introduce escalation policies such as divestment, it is not clear that this is feasible for the majority. UK domiciled index trackers (excluding ETFs) make up 11% of the FUM of responsible investment funds in IA data. Furthermore, it is not clear from the FCA's proposal whether funds tracking an index that aims to have a certain ESG score improvement compared with the parent index can qualify as Sustainable Improvers. This approach applies to a number of index tracking funds.

### ***Sustainable Leaders (best-in-class)***

There are a number of large funds in IA data investing in the most sustainable companies across a broad range of industry sectors and geographies. These funds are not thematic and are not purely investing in 'sustainable solutions' or in industries that are leading examples of sustainability. Based on the FCA's definitions, it is not clear that these funds would fit into the Sustainable Focus category and they would also struggle to meet the FCA's requirement for stewardship as the primary channel for the Improvers label. Whilst stewardship remains an important component, these funds are primarily constructed around capital allocation decisions. To accommodate these funds, which we believe are pursuing legitimate sustainable investment strategies, we would argue that it is for the fund manager to decide the weight given to a stewardship or an asset selection approach held within the strategy so that funds can pursue diverse approaches.

Furthermore, the requirement for KPIs to be absolute rather than relative will also make it difficult for a best-in-class strategy, as well as those strategies based on ESG scoring methodology, to obtain a label. The premise of 'best-in-class' is that one is leading but only relative to others in the industry.

### ***Mixed asset funds***



Mixed asset funds make up one quarter of the UK domiciled responsible investment FUM in IA data. Mixed asset funds invest in a mixture of equities and bonds and typically aim to be diversified. We have concerns that it is more challenging for mixed asset funds to meet the label criteria. Mixed asset funds can be directly invested, structured as a 'fund of funds', or can be a combination of both. There is also an expanding group of mixed asset funds that are investing in a range of sustainable index trackers and ETFs.

For mixed asset funds that make direct investments, assets which may be held in a sustainable strategy can include:

- Equities – of sustainable companies and/or companies whose products and services contribute to real world change
- Corporate debt – of sustainable companies and/or companies whose products and services contribute to real world change
- Sovereign debt – bonds whose proceeds are used in projects or initiatives that contribute to real world change (e.g. green, social and sustainability bonds)

An important feature of a number of mixed asset funds is their flexible investment style, which allows significant scope to alter the proposition invested in different asset types, including cash, in response to or anticipation of expected market conditions. This means that typically these funds would not have a static allocation to one sustainable asset type.

The Sustainable Impact label, as it is currently written refers to 'its (the investor's) contribution to a positive environmental and/or social sustainability outcome through financial as well as other types of investor additionality.' Based on the requirement to demonstrate investor additionality, the equities, corporate debt and sovereign debt asset types listed above (including green bonds where investor additionality can only be demonstrated by the bond's originator) would not qualify as 'impact' investments thereby disallowing mixed asset funds to qualify for the Sustainable Impact label.

Funds that allocate flexibly (and don't have a substantial minimum threshold for allocating to equities) may not be eligible for the Sustainable Improvers label, with a primary channel for sustainability outcomes being investor stewardship, as outlined in the response to question 6.

The Sustainable Focus label would therefore appear to be the most appropriate label, subject to credible standards being used by the manager for asset selection. However, this would require clarity on whether one 'credible standard' must be applied or whether different methodologies may underpin the 'credible standard.' Different investment types, such as sovereign investments, encompass different sustainability attributes which necessitate the ability to employ different methodologies as part of the credible standard. Consideration should also be given to investments in cash, which is an important and sometimes sizable allocation in a mixed asset fund when a cautious positioning stance is being sought. The treatment of cash should depend on its purpose within the fund, i.e. whether it is being used for liquidity purposes, which should not be included within the core 70% or to enable tactical asset allocation, which would support the investment strategy of the fund.

Furthermore, many mixed asset funds use fund of funds structures and it is not clear from the proposals that these funds would also be subject to the 90% rule in order to receive a label. Our

initial conversations with members managing sustainable mixed-asset funds suggest that most of these funds are not investing across one label category. We understand that under the current proposals, a mixed-asset fund may invest in a number of underlying funds, all with sustainable investment labels but if they do not have the same label, the mixed-asset fund would not receive a label, although the fund of funds could be named and marketed as sustainable. We believe consumers would find this confusing and that the FCA should come up with a sensible solution to address these challenges. For example, the FCA could allow the firm to choose the most appropriate label for the fund of funds based on the investment strategy.

### ***Sustainable impact funds investing in public markets***

The requirement to show additionality through the deployment of ‘new capital’ means that it is very unlikely that any impact funds investing in public markets will receive a label. We strongly believe that impact investing can apply to public markets and that there are other ways to demonstrate what the FCA refers to as ‘additionality’ but the IA refers to as ‘contribution’. ‘Additionality’ should not necessarily be a requirement for an impact fund and the Global Impact Investing Network (GIIN)<sup>1</sup> definition – the leading global definition of impact investing – does not require that impact funds demonstrate additionality. Most funds investing in private markets are not available to retail investors and restricting this category to a very small number of products therefore makes the label less relevant to them. Whilst investment trusts are popular with more sophisticated retail investors able to navigate premiums and discounts, we feel that restricting this category means that there is little choice available to retail investors. The LTAF would provide an alternative structure but we are waiting for the outcome of the FCA consultation [CP22/14](#) on the LTAF being marketable to retail investors before it could become an accessible product for the retail market.

### ***A fund with a mix of Focus, Impact and Improvers***

It is not clear from the proposals whether a fund (not fund of funds or mixed assets) which has a mix of ‘focus’ and ‘improver’ assets, which is very common in the market, would get a label. For example, in fixed income, in order to achieve the diversification desired by investors, it is common to have funds that are a mix of Focus, Impact and Improvers. For example, one fund could have:

- 25% of its assets in green bonds or other assets that fit the Sustainable Impact category;
- 25% of its assets into decarbonising credit, which will fit into Sustainable Improvers category; and
- 25% of its assets into climate solution assets, which will fit into Sustainable Focus category.

Together they make up more than 70% of assets into sustainable categories. However, currently the proposals in the CP would not permit this fund to have a sustainability label, which members find concerning. The naming and marketing rules will then further affect how these funds are presented. The reason why these funds are mixed between these asset types is to meet investors’ diversification needs. Fixed income funds that solely fit into either Sustainable Focus, Impact or Improvers categories will have high issuer concentration which brings with it high credit risk. It is important to allow for funds that are still sustainable, but allow for greater diversification to manage credit risk.

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<sup>1</sup> <https://thegiin.org/impact-investing/>

**2. How can we ensure that the labels and associated disclosures build trust in the market and are clear and helpful to consumers and advisers?**

The intention of the FCA's approach to disclosure requirements for sustainable investment labelled products appears broadly proportionate. However, there are elements – such as those related to unexpected investments, the need to provide consumer facing disclosures for all products including those without a label and the format and regulatory standing of the disclosures – which will need further examination. We expand on our concerns later on in our response. A number of concepts in the paper will be challenging to explain to a retail audience.

**3. How do we build a system that is appropriately supported by data and methodologies to show how funds are delivering?**

There is not yet a clear quantitative methodology to determine a sustainable asset. The EU taxonomy is unfinished and there is no UK taxonomy as of yet. Even when a UK taxonomy is in place, metrics will have an environmental focus. This makes it difficult to set thresholds.

Even with agreement around methodologies, there would need to be a better roadmap to data availability given the industry's dependency on third party data and especially on corporate reporting. For funds to provide data on how they are delivering against the sustainable objective, it will be imperative that they have underlying information from investee companies or assets, which is why it is important that the ISSB standards are adopted globally on a timely basis.

Also, we would caution against introducing a verification process that causes firms to rely on a small number of data providers, which could increase costs.

**4. What is the level of interoperability with other international regimes?**

As stated previously, our members are generally supportive of the need to 'raise the bar'. However, the lack of interoperability, particularly between the FCA's approach and the SFDR and the proposed SEC rules, will present a challenge to global investment managers that run strategies across different jurisdictions. Outside of the EU, we would encourage the FCA to work with other regulators, for example, those developing labelling regimes in APAC and the US, in order to ensure global harmonisation where possible.

**5. How can we ensure that the new regime allows for the anticipated evolution of the market, including further relevant rules?**

We support the FCA's proposals to carry out a post-implementation review after three years to see how the labelling regime has bedded in. We are also supportive of the FCA's proposal to assess the usefulness of the labels and product-level information to consumers through the FCA's Financial Lives Survey and by engaging with consumer groups. Building in mechanisms to review and measure success are critical and acting on the findings of these reviews will help to ensure that the system continues to be fit for purpose for investors.

We would however, also welcome further guidance from the FCA on how it plans to incorporate new standards as they develop and any impact this may have on funds which have already received sustainable labels.

**Q6: Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on:**

- a. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?**
- b. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?**
- c. Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?**

A key point we want to acknowledge upfront is that stewardship is a vital part of the investment process and a unique mechanism to deliver changes in behaviour of investee companies and assets. It is our fundamental view that stewardship is a baseline expectation across all activities and all sustainable fund strategies, rather than a distinguishing factor for one category of funds (one label). Below, we outline in some detail how stewardship operates, how it is normally used by investment managers, but also what are its limitations.

#### ***Industry Purpose and stewardship***

The investment management industry’s purpose is to deliver long term returns to clients aligned with their investment objectives. Investment managers’ stewardship activities will be conducted to be consistent with this objective. Stewardship is normally used by managers to address financially material risks and opportunities that could impact a company’s long-term value. Such risks and opportunities relate to a broad range of issues, company strategy, quality and diversity of the management and board, the impact of climate change on the business strategy, or how the company promotes employee voice. These issues increasingly include sustainability concerns and the impact of investee companies’ activities on the environment and society and how in turn events in society, the environment and the economy impact the value of the company. Stewardship plays a role in helping to mitigate the various risks and realising the opportunities.

The integration of stewardship and consideration of a wide range of risks and opportunities, including environmental, social and governance (ESG) factors in the investment process leads to better investment outcomes for clients. The assessment of these factors informs investment decision making and stewardship activities.

In aggregate and over the long-term, the explicit integration of all material risks into the investment process should also result in positive impacts for society, the environment and the economy. This wider impact can be accelerated where clients explicitly state their preferences and mandate their managers to achieve positive impact for the environment and society through their investment objectives.

#### ***Limitations of Stewardship***

Investors are not responsible for the management of the companies they invest in. The board of a company is responsible for governance and oversight of the strategy while the Executive Directors run the company. All directors of the company are ultimately responsible for fulfilling their

Directors' Duties to shareholders and taking account of their impact on other stakeholders such as employees, communities, the environment and suppliers. Non-Executive Directors provide independent oversight of whether the company is being run in the interest of stakeholders and all shareholders. In the UK, this is done through a unitary board structure.

Boards are accountable to their shareholders, and it is the responsibility of those shareholders to hold the board to account for its actions and the way the company is managed, particularly where there is a risk to long-term value. Ultimately, it is the responsibility of the Board and company management to listen and respond to these concerns, where appropriate. Shareholders have certain rights and obligations to manage their investments responsibly and will use these to address potential risks or opportunities they see that could impact the long-term value of their clients' assets.

Even the best stewardship practices will not lead to a perfect market with no corporate failures or provide specific sustainability outcomes. It is important that stewardship is not seen as a silver bullet in preventing failure or delivering specific outcomes; investing involves risk and without it, returns are unlikely to be delivered. What investment managers can do is manage risk in order to generate sustainable value on behalf of clients.

Investment managers seek to encourage companies to change their behaviours where they believe there is a risk to long-term value, but ultimately it is the responsibility of the board to listen and respond to their concerns, where appropriate. Stewardship can help a company to improve its prospects if the underlying business is viable and if the company is receptive to constructive engagement with investors. Where sustained stewardship efforts are not effective, it may be the right course for some investment approaches to reduce exposure to the risks posed by the company in order to protect clients and end investors by exiting the investment, while other investment approaches such as indexing, are limited in their ability to avoid exposure to these risks unless the index has a clear mandate to do so.

Stewardship, and the broad range of activities it entails, can therefore play a central role in delivering on both clients' investment and sustainability objectives. IA members welcome the prominent position that stewardship takes in the labelling framework, across all three sustainability labels. In particular, members welcome that the FCA has adopted a baseline requirement that in order to qualify for any of the three labels, firms must maintain an active investor stewardship strategy and resources in a manner that is consistent with the sustainable investment product's sustainability objective. Members recognise that the market for stewardship beyond listed equities is evolving rapidly – we note, for example, our recently produced guidance 'Improving Fixed Income Stewardship' to help the market to develop best practice in stewardship in fixed income. While there are still some operational and implementation challenges, IA members support that stewardship should become a minimum expectation across all activities as part of all sustainable fund strategies, rather than being a distinguishing feature of some sustainable funds.

### ***Stewardship within the SDR & investment labels proposals***

It is our members' view the proposals appear to be written from the standpoint of equity investors. We therefore include some observations on stewardship in other asset classes:

- Fixed income - Stewardship in fixed income is not as developed as that in equity investment and occurs less frequently. Investors in the corporate fixed income market have

fewer rights compared to equity investors: they do not have the right to vote at the company's AGM, usually only having voting rights on changes to the terms of their bonds. Furthermore, most fixed income investors have in-house methodologies for prioritising engagement (e.g. materiality, emissions trends etc.) which would need to be compatible with the new labels to allow for tracking of performance over time. Fixed income investors are increasingly combining fixed income stewardship with their existing equity stewardship activities, whether formally or informally.

- Sovereign/government bonds – With respect to sovereign debt, stewardship activities are currently focused at the pre-investment stage in due diligence and through monitoring. While firms have been known to conduct engagement via collaborative initiatives and annual letters, and there can be opportunity for engagement if a country's debt needs restructuring, access to central banks through debt ownership doesn't necessarily provide access to or engagement with government departments responsible for financing sustainability agendas. Stewardship practices around sovereigns are in the process of development, but members note that setting specific macro criteria (e.g. investor participation in consultation responses and meetings with policy makers) could lead to more resources being focused in this area.
- Real estate - Following the recent introduction of the Stewardship Code, the appropriate standards are still evolving so those funds investing in real estate can demonstrate their stewardship credentials. Engagement here would involve considering the whole life cycle of assets and the intervention of the asset managers at the acquisition, operational and disposal stages. This should include how asset managers engage with occupiers, local communities, tenants and how they invest in making physical changes to their assets and the operational management of the assets.
- Mixed-asset funds – As per our answer to question 5, these funds may invest in a number of underlying funds, all with sustainable investment labels but if they do not have the same label, the mixed-asset fund would not receive a label. Under the mixed-asset fund umbrella there are also funds that have an absolute return objective, dynamic asset allocation (including to cash investments) and extensive use of derivatives. Under the proposed rules, it looks impossible for these types of funds to get a label. By way of example, at the end of December 2022, one of our member's asset allocation for their core strategy was 15% in equities, 65% in sovereign fixed income and the remainder in cash, commodities and derivatives. Thus only 15% of the fund was invested with corporate issuers on which the SDR proposals are focused. No label, coupled with the naming and marketing restrictions, would put such funds at a significant competitive disadvantage and potentially unable to effectively describe their approach to sustainable investment. We believe consumers would find this confusing and a solution needs to be found. Mixed-asset products are widely used by direct investors who are not advised and they provide investment solutions for investors not confident in building their own portfolios.

As a reflection of this complexity, our members would welcome further guidance from the FCA on how it would consider various stewardship requirements being met in non-equity asset classes. Firms would also welcome additional 'worked through' examples (including suggested KPIs) for each sustainable investment label incorporating different product profiles. For example, how stewardship would work for index funds, mixed-asset fund of funds or model portfolios (which have to rely on the stewardship conducted by the underlying asset managers).

Finally, in addition to our response to question 3 (on CBA), we note that it is not possible to have influence over all companies – e.g. those with a controlling shareholder; companies with dual-class share structures; where a company has a large and fragmented shareholder base; or where there is a significant element of sovereign control. Even where none of these structural issues are present, some companies are simply unwilling to engage with investors and do not have governance systems which provide investors with access to the Board.

Please see below for specific comments on each proposed label.

**a. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?**

*FCA CP22/20 Para 4.28 – ‘These products aim to invest in assets that a reasonable investor would regard as being environmentally and/or socially sustainable.’*

Our members are broadly supportive of the label’s intention.

The CP suggests that the secondary channel to achieve sustainability outcomes is linked to stewardship and that this stewardship must be based on ‘continuous improvement’. Given these firms are already meeting a high and credible standard of sustainability, this may not be achievable, for example a best-in-class green energy fund would likely struggle to achieve continuous improvement in the environmental sustainability of the product’s assets and so we would question the addition of this language unless it is pertaining to assets not already meeting the standard being used to assess sustainability.

An area that our members believe needs significant clarification and further careful consideration is in relation to the need for assets to meet a ‘credible standard of environmental and / or social sustainability’ or ‘align with a specified environmental and /or social sustainability theme’. Clarity is needed on what the FCA considers to be ‘credible standard’. The requirement is that it must be ‘robust, independently assessed, evidence-based and transparent’. It would be helpful to understand whether the FCA believes only third-party data and rating providers could provide a credible standard or specified environmental theme or whether proprietary systems are sufficient. Our members have strong reservations that the proposals will potentially mean that ESG data and ratings providers, who are currently not regulated, will play an even more prominent role within the sustainable finance market. Members have used internal proprietary systems that have been developed and refined over a number of years and would suggest that providing that they undertake a thorough assurance process, these should be allowed to act as a credible standard.

As also mentioned in our answer to question 3, there are also significant concerns about the possible costs to members if they are required to use third-party verification in order to provide a credible standard. This is particularly pertinent when different methodologies are employed in different funds. It will be increasingly difficult for firms to avoid passing these costs on to investors. It will also penalise smaller investment management firms less able to incur rising data costs and this will ultimately mean less competition, in particular from new entrants and boutiques, and will lead to poorer investor choice.



The need for the credible standard to be an absolute standard rather than a relative or risk-based standard is at odds with many firms' approach to stock selection of leading sustainable companies. This approach aims to provide capital to those firms outperforming their peer group to enable them to continue to do so. It would appear to imply that best-in-class funds, which are prevalent in the UK sustainable investment market, would not fit in this category. The primary driver of these funds is capital allocation rather than stewardship and engagement and so they are unlikely to fit into the Sustainable Improvers category under the current proposals.

Furthermore, given the evolution of sustainable practices and technologies, an absolute threshold is likely to require frequent change whereas relative standards are more dynamic. Take, for example, an absolute threshold to determine whether a company is a low carbon emitter; as companies adopt policies and new technologies to reduce carbon emissions, the pre-existing absolute threshold becomes less compelling.

Looking at UK-listed companies, one member firm has highlighted to us that there are only a very small number that could potentially be included in a fund in this category. This could lead to a significant investment flow moving offshore to find companies that meet this 'credible standard'. Again, this is a potential unintended consequence when the UK government is keen to reinstate the UK as a primary market for listing and investing and as a centre of sustainable finance.

Whilst we are not against setting the threshold for the Sustainable Focus label at 70%, we would benefit from a greater understanding of the assumptions and the methodology behind setting the threshold at 70%. For example, has the FCA done an assessment of the percentage of available UK / European equities that would meet its 'credible standard' of sustainability and would therefore be eligible in a Focus fund to justify setting the threshold at 70%?

Finally, we would like to express confusion around a possible inconsistency in Rule 3.2.6. At present, the Sustainable Focus category is split into two sub-categories: 'meet a credible standard of environmental and/or social sustainability' or 'align with a specified environmental and/or social sustainability theme'. Clearly, it is only in relation to sub-category (a) that a reference is made to a 'credible standard'. Some members would contend that both (a) and (b) should be held to the same standard to ensure that Sustainable Focus products are sufficiently robust.

#### ***A special note on Implementation Costs for Sustainable Focus***

Following on from our response for question 3 (CBA), the requirements of the labels for third party assessment of internal approaches or rigorous and evidence based KPIs are likely to lead to increased costs, particularly as the proposal appears to direct investment managers towards the services of ESG data and rating providers or require additional resource to deliver on fund specific stewardship requirements. The average cost of a sustainable investment fund is currently in line with the average in the market, however, there is considerable risk that by adopting the approach the FCA has suggested, the increased costs of these funds will be passed on to retail investors. This is likely to dissuade retail investors from investing in sustainable funds and ultimately could have an impact on government policy to meet long term climate and sustainability objectives. A more economical alternative would be for firms to create, and disclose information on, an internal governance processes which ensures robust challenge and consistent application of 'credible standard' applied to funds with a Sustainable Focus label.

**b. Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?**

*FCA CP22/20 Para 4.32 – ‘Products in this category aim to invest in assets that, while not objectively environmentally or socially sustainable at present, have the potential to deliver measurable improvements in their environmental and/or social sustainability over time, including in response to the stewardship influence of the firm.’*

There are mixed views within our membership as to the applicability of a label category which focuses predominately on the role of stewardship to improve the performance of companies in a portfolio. Whilst the market for stewardship in other asset classes is evolving rapidly, members recognise that there are still some practical implementation challenges that exist. The majority of members support the broad approach, but highlight a number of issues which need to be considered in greater detail before the label could work in practice. We discuss these below.

There are also a number of members who do not believe that the proposed criteria to Sustainable Improvers is appropriate for the fund labelling regime. They consider that stewardship should not be a defining feature in the labelling regime. Instead, it is an important factor to help to deliver sustainability outcomes across the whole fund regime which is generally conducted at the firm rather than at a fund level. Members also note that the FCA needs to give further consideration to what it defines as stewardship under the new Rules and Handbook, and the extent to which this draws upon the existing definition within the FRC’s Stewardship Code.

Members find that it would be difficult to demonstrate the outcomes achieved from these stewardship activities to prove the impact that their stewardship has had. This in turn could lead to ‘engagement washing’. To this end, some members argue that provided the fund makes progress towards its sustainability objective, under a principles-based approach, it should be for the fund to set out the method or process for achieving that progress. Seeking to specify in advance the primary method that fund managers should use appears overly-prescriptive and runs against the grain of an intentionality-led approach. We further recognise that some aspects of the qualifying criteria may be more difficult to achieve for index funds (which may be unable to utilise divestment as an escalation measure).

We would urge the FCA to consider the following as it refines its approach:

- **Stewardship as a primary channel for investor contribution:** The Improver category rests on the premise that stewardship will be the primary investor contribution to the sustainability objective and investment decisions will be the secondary contribution. In reality, a majority of members consider that these two factors work in parallel and each channel is a reasonable and legitimate means of achieving sustainability outcomes. A key component of achieving investor stewardship will be the research and selection of companies which are underperforming on an ESG issue or approach, which with investor stewardship could improve their performance and meet the investment objective of the fund. The selection of individual assets will work hand-in-hand with the investor stewardship with the fund being more likely to select companies that are more likely to improve over time.

- Equally, we recognise that firms may choose to invest in companies that decide to proactively improve themselves (e.g. new company management or a Board that steers the company in a different direction), in which case capital allocation will be the primary driver in meeting the sustainability objective, with stewardship helping to maintain the company's sustainability performance. As a result, there is a need for these two strategies to work together.
- **Attributing causality to stewardship activities and more sustainable outcomes:** The Sustainable Improvers category will require funds to provide KPIs on the extent to which the improvements in the sustainability of a product's assets have been achieved over time, including through investor stewardship.
  - The most recent revisions to the Stewardship Code have focused on requiring signatories to report annually on their stewardship activities and outcomes of that activity. This includes a focus on engagement with the assets they invest in, collaboration and escalation (including their voting records) with issuers and others to achieve changes in corporate behaviour and enhance the value of their investments. This greater transparency enables clients to see if those investing on their behalf are doing so in accordance with their needs. As a result, signatories to the Code are already reporting on the stewardship activities and outcomes achieved. However, the industry has found it difficult to provide a causality link between individual engagement or stewardship activities and changes in company behaviour (the change in company behaviour might be due to a mixture of things including a firm's engagement, other shareholders as part of a collective approach, regulation, company decisions, NGO pressure, etc.) It is not clear how the FCA expects asset managers to demonstrate that their stewardship activities have led to a particular change in company behaviour.
  - Members have differing experiences where they have emphasised their role in changes to corporate behaviour. Some companies like to be highlighted as responsive to their shareholder views and attitudes. Others have found companies object to claims or the implication that they changed their behaviour in response to shareholder requests, insisting that they planned on making the change irrespective of their shareholder's views.
  - Members welcome the acknowledgement from the FCA at the IA's webinar that causality in respect of stewardship activities and outcomes is hard to prove and that instead evidencing stewardship actions are *correlated* with sustainability outcomes could be a reasonable way to meet the stewardship-related KPIs. The industry is supportive of the FCA's efforts to align the labelling regime with the Stewardship Code's focus on reporting on stewardship activities and the outcomes of those activities. However, there is a concern from some members that a greater focus on stewardship activities could lead to an increase in the stewardship activities - such as the number of letters or meetings that firms undertake - rather than the outcomes they achieve.
  - The Stewardship Code notes that clearly reporting on outcomes is a key component of good reporting, and that organisations should report on how effective they have been in achieving their desired outcomes. As part of this, the most recent review of reporting against the Code found that reporting outcomes should be supported by

a mix of quantitative and qualitative measures including internal metrics, reviews, client feedback and case studies. The latter has helped provide clients with some comfort on the way firms have articulated their journey in trying to achieve stewardship outcomes. We would suggest that elements of this approach could be utilised by the FCA with respect to demonstrating how funds under the Sustainable Improvers label achieve their stewardship outcomes.

- Members note that the increased focus on how a firm's individual activities contribute to more sustainable outcomes risks funds pursuing individual activist behaviour, rather than stewardship that is conducted collaboratively with other investors. Collaborative approaches taken with due regard to Market Abuse Regulations (MAR) and competition law obligations, such as through the Investor Forum, have a record of delivering successful outcomes. Increasing diversity within the boardroom serves as a useful example, whereby a co-ordinated effort across investors, corporates and regulators led to desired improvements. A narrow focus on individual activities and outcomes could weaken the positive developments that have already been made as well as paint a misleading impression of what stewardship is and how it is conducted in the UK market.
- **Composition of funds is not static and changes over time:** Under the Improvers label, as the sustainability profile of the stock improves, the fund may sell out and buy another company which is at the start of its sustainability journey. Not only does this make it difficult to demonstrate improvement, but it would need to be addressed so that the KPIs appropriately reflect the contribution achieved by those companies which have subsequently been sold. The disclosures from companies on ESG issues are likely to be reflected in a sustainability objective which is typically made on an annual basis. Therefore, how the fund can capture progress in company performance outside of this annual reporting period will need to be considered so that KPIs appropriately reflect the progress made, particularly to reflect portfolio turnover.
- **How much engagement is expected?** It is unclear whether the FCA expects stewardship activities to be undertaken at the portfolio level or whether a minimum level of engagement is required with every company within the portfolio. A requirement for engagement with every company would be very resource intensive and not practicable, especially in large, diversified portfolios. Managers should have the flexibility to decide where their engagement resources are best placed to deliver on the fund's sustainability objective.
  - There is a risk that an increased focus on engagement could result in an acceleration of automated requests to companies, which will lead to a decrease in the quality of stewardship, with it becoming a mechanical, tick box process. Some members note that firms will undertake engagement based on material risks flagged under their proprietary ESG systems, and that undertaking engagement with every portfolio company is an unrealistic expectation. It would end up creating barriers to entry for smaller firms with less resource, which could also have the impact of preventing them from applying for a label. More generally, these proposals could require fund specific stewardship resources to meet the specific requirements of the fund, which is currently resourced at a firm level across all funds. This would have impacts on the cost of the fund, with some members

questioning if there are enough appropriately experienced staff within the industry to meet the increased volume of engagement required. Members have also been keen to stress that the FCA is separating out engagement in order to meet the sustainable objective from engagement that takes place on issues which are material to long-term value creation. Most firms will undertake engagement for the latter reasons and it is currently unclear how this will be captured under the proposed KPIs.

- As a possible solution, some members have suggested that the sustainable investment objective for the Improvers label (including the contribution of stewardship activities and outcomes) should be set at the portfolio level. As an example, a target of 10% reduction in carbon emissions would be applied and measured across the entire portfolio of companies, rather than necessitating engagement with every portfolio company. In this instance, firms would need to articulate how stewardship has helped to meet the investment objective at the aggregate level across the entire portfolio. This will allow stewardship activities to be focused on companies where most progress is needed or likely to be achieved.
- **Engagement in other asset classes:** The focus on stewardship and corresponding requirements under the Sustainable Improvers label will be met most easily by listed equities. The Stewardship Code has only recently focused on extending its scope to cover a broader range of asset classes beyond listed equities. There are important differences in asset classes outside of listed equity that firms must consider when determining their approach to stewardship. This includes access to management, size of holdings, ownership rights, liquidity, time horizon and the direct or indirect nature of the investment. For example, fixed income investors may have different levels of access to management (being more likely to engage with the CFO or treasurer) in comparison to equity holders who are more likely to have access to the executives, Chair or non-executive directors of a company. Furthermore, in most circumstances, bondholders cannot use voting as an escalation strategy in the same way that equity holders can. This may make it difficult to demonstrate the necessary improvements in the sustainability profile of transitioning companies, and consequently harder to meet the sustainability objective. While the IA has recently published guidance 'Improving Fixed Income Stewardship' to help the market to develop best practice in stewardship in fixed income, stewardship across other asset classes is still nascent, and the FCA needs to work alongside the FRC to help support market-led developments.
- **Stewardship in index funds:** The CP notes in 4.37 that index trackers may qualify for a Sustainable Improvers label where they track tilted benchmarks and where the firm engages proactively with the assets. In these cases, the onus is on the firm to demonstrate that the index providers' methodology for index construction aligns with the sustainable investment product's stated sustainability objective and its target environmental and/or social sustainability profile. While some targeted stewardship activities could result in changes to certain measurable metrics (which in turn could be factored into index rebalancing), index funds are limited in their ability to exercise the full range of stewardship tools, particularly escalation measures such as divestment. Typically, given the size of these portfolios, engagement is only likely to cover a fraction of the portfolio relative to other funds. This could make it difficult for index funds to demonstrate the requisite improvements to assets against the KPIs. Members further note that the FCA should clarify

whether index funds that aim to have a certain ESG score improvement compared to the parent index can qualify as Improvers.

- Furthermore, for index funds it is difficult to translate how firmwide stewardship activities are aligned with and achieve fund-level objectives. For example, third party index funds do not align with stewardship activities directly. At a minimum, some members propose that the FCA would need to adapt its requirements for index funds to allow for stewardship activities to be consistent with the investment return objectives of an index rather than determinants of sustainability outcomes. A better solution, however, would be to offer a choice of channels for investor contribution to cater to different types of investors.
- **Tensions between investors/ investee companies:** In a recent publication from Tulchan Communications<sup>2</sup>, some Chairs and Boards have expressed a concern that investors are increasingly engaging on issues that the Board or company consider are not always financially material or central to the long-term success of the company. While the views expressed in the report are not unanimously supported by all companies or investors, there is a risk that they could be exacerbated under the Improvers label, particularly where fund managers are incentivised to seek changes in corporate behaviour on issues that some companies or boards may not, legitimately, consider to be material to the business in order to fulfil their sustainability objective. Some Boards are already concerned that engagement is becoming a mechanical and ‘box-ticking’ exercise as a result of being driven by regulation and this adds to those tensions. Where investors are incentivised to increase engagement in order to meet their KPIs and sustainability objectives, this further has the potential of blurring the distinction between the role of boards as stewards of the company and investors in holding them to account.

There is a further disconnect because investors have stressed the need for disclosures made by corporates to be financially material and linked to enterprise value under ISSB but this doesn't seem to match with the approach of SDR, where engagement is taking place in order to meet KPIs and the sustainability objective. Where firms have to report on information that extends beyond what the investee companies consider to be financially material, there is a risk that this may not be readily available in the annual reports/accounts and they may therefore have to rely on third party data providers. Furthermore, while the focus on financial materiality may be helpful for delivering sustainability objectives linked to climate, this is unlikely to be the case for broader environmental or social objectives where the basis for delivery of the KPIs will link to disclosures that focus on ‘double’ materiality. The paper also assumes that we can unbundle the underlying motivations in what drives an engagement. In some cases, stewardship will be conducted for both financially material and also sustainability purposes.

**c. Sustainable Impact: whether ‘impact’ is the right term for this category or whether should we consider others such as ‘solutions’; and the extent to which financial additionality should be a key feature?**

*FCA CP22/20 Para 4.38 – ‘These products aim to achieve a positive, measurable contribution to real world sustainability outcomes. While sustainable investment products in the other two categories*

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<sup>2</sup> [https://www.tulchangroup.com/media/Tulchan-Stewardship-Report\\_November-2022.pdf](https://www.tulchangroup.com/media/Tulchan-Stewardship-Report_November-2022.pdf)



*would set objectives that target a particular sustainability profile for their assets, a firm seeking to use the sustainable impact label would commit to deliver and report on its (the investor's) contribution to a positive environmental and/or social sustainability outcome through financial as well as other types of investor additionality.'*

As the category is defined, we believe that 'impact' is the right term and one that is beginning to increase in familiarity amongst retail clients. We do not feel 'sustainable solutions' is an appropriate term as we believe this could create a significant and erroneous overlap with the Sustainable Focus category.

The UK-based investment management industry is global in nature and has been a strong proponent of international coordination and the harmonisation of sustainable finance rules. Fragmented approaches across different jurisdictions – including for example, gold-plating at a national level – run the risk of not treating clients consistently and fairly. In this context, we have supported the GIIN definition of impact investing, that 'impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return'. More recently, we have supported the GIIN draft guidance on impact investing in listed equities<sup>3</sup> which we believe could be used consistently across jurisdictions to define impact investing in public markets, and in particular, equity markets. The GIIN definition and supporting documents do not make reference to 'financial additionality'.

Varied regulatory approaches to entity and product level sustainability practices and disclosures across jurisdictions, combined with the lack of standardised definitions of sustainability terminology in products and investment approaches could lead to confusion and complication in the sustainable investment market, as well as risk greenwashing. A common set of global standards and terminologies across all regions would help address this issue and therefore we would propose that the FCA make some adaptations to the definition of impact investing as set out in the proposal to align with GIIN, including its draft guidance on impact investing in listed equities.

The IA and its members are concerned that the FCA is introducing a different and much more restrictive approach to defining impact investing and one that is firmly planted in private and primary markets. This is due in particular to the requirement of 'financial as well as other types of investor additionality' as well as reference to the fact that impact investing will require 'typically new capital'. Impact investing should not be limited to 'new capital' or private markets given the large scale of investment required to achieve global environmental and social objectives. Impact investing makes up less than 10% of private market investments and even if the entire \$600bn p.a. private equity market converted to impact investing, it would still leave a significant funding gap<sup>4</sup>.

We advocate for impact investing in public secondary markets as these markets play an important and complementary role in the impact investment ecosystem, offering solutions and scale that private markets cannot and allowing retail investors to participate in funds that support tangible progress on environmental and social goals alongside financial returns. As such, we do not support the DP21/4 stakeholder feedback views that financial additionality should be a key feature of impact investing. In light of this and given that there are huge challenges in demonstrating financial

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<sup>3</sup> [https://thegiin.org/assets/Draft%20for%20Public%20Consultation\\_July.pdf](https://thegiin.org/assets/Draft%20for%20Public%20Consultation_July.pdf)

<sup>4</sup> Bain & Company Global Private Equity Report 2020 and IFC Global Impact Investing Market 2020



additionality in public markets, we see the FCA's use of financial additionality as an unnecessary and limiting requirement.

As expanded on in our answer to question 9, the IA proposes the use of the term 'contribution' instead of 'additionality' given the limitations of the latter and notes that this is a term commonly used in the impact investing space instead of 'additionality'. Furthermore, this should not be limited to 'financial' contribution. Investor contribution can be shown through other means, including via stewardship, as discussed below. The requirement for it to be 'financial' would be erroneously restrictive. If the FCA does decide to use the term 'additionality', we would strongly suggest that the wording is revised to 'to financial *or* other types of investor additionality'.

**Q7: Do you agree with our proposal to only introduce labels for sustainable investment products (i.e. to not require a label for 'non-sustainable' investment products)? If not, what alternative do you suggest and why?**

We are supportive of the FCA reducing the number of labels: a five-stage labelling system could prove too complex and difficult for consumers to understand and this was borne out by the IA's investor research. In addition, we are supportive of the labels being designed to accommodate different asset classes (which the proposals currently don't) and to meet different consumer preferences.

Within our extensive consumer research and as discussed in more detail in the IA's confidential position paper - Operationalising DP21/4: Sustainability Disclosure Requirements and investment labels – we determined that labelling a fund based on something that it is not doing is confusing to retail clients. Investors felt that it was counter-intuitive to label a fund that had 'no sustainable goals' and negative language was found to be off-putting. Investors preferred a simple, clear label framework. Investors also found it very difficult to make sense of the descriptor for the 'No Sustainable Goals' label, which was initially based on an FCA proposal to combine 'No ESG' with 'ESG integration' and therefore we are supportive of only introducing labels for sustainable investment products. This is providing that the label categories are refined in line with our previous comments and that amendments are made to the naming and marketing proposals so that funds pursuing well-established strategies such as exclusions, positive tilts and other responsible investment approaches are able to market these approaches without a sustainable label. Furthermore, any proposed requirements for financial advisers relating to product suitability should not lead to a situation wherein only products availing of the sustainable labels will be recommended. This will be a result of adopting a very narrow definition of ESG preferences to only cover products contributing to positive sustainability outcomes.

We would also request greater clarity on how firms can demonstrate the 'ESG aspects' of funds which don't qualify for a label, without triggering any breach of the proposed anti-greenwashing rule.

The majority of our members support the labels being mutually exclusive and without hierarchy, although we would note that mutually exclusive labels present challenges for funds of funds and portfolio management services that are investing across a range of sustainable investment strategies. As we noted in our response to DP21/4, we had concerns that the original approach

could appear to suggest to customers that there was a clear gradient of continuum from responsible investment through to impact which would (erroneously) imply that one approach was better or 'more sustainable' than the others. The current proposal from the FCA however incorporates a distinct approach with different characteristics based on a firm's intentionality.

Presenting the labels as a hierarchy could mislead investors. As noted, our consumer research found that investors did think in terms of a hierarchy of sustainable approaches and they typically associated a hierarchy with environmental characteristics. This led them to assume that each label was underpinned by metrics. The sustainable labels will include funds investing to achieve social and environmental objectives and not all labels will be subject to quantitative metrics.

**Q8: Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider:**

As noted, our members are supportive of the objectives the FCA is trying to achieve with the CP, including the development of a qualifying criteria that all firms must meet before using a sustainable investment label. The ambition to raise the bar through the requirement of a sustainability objective and rigorous criteria in order to raise trust in the market and limit greenwashing is welcome. Indeed, the IA along with the pan EU trade body, EFAMA, are working towards ensuring minimum standards under the SFDR so consumers can have confidence that the funds in which they are invested support their own sustainable interests and objectives.

- **whether the criteria strike the right balance between principles and prescription**

The IA and its members welcome the approach the FCA has taken in building from, and remaining consistent with, existing and relevant expectations and requirements, including those set out in the Guiding Principles and the UK Stewardship Code. However, the implementing guidance is very prescriptive and this, in turn, could limit innovation, the diversity of the UK investment products market and ultimately lead to poorer outcomes for consumers. Furthermore, our members have concerns regarding the highly prescriptive nature of the label requirements. These requirements would effectively dictate the way in which investment managers should manage and operate sustainable investment funds. Firms manage money on behalf of clients in line with their mandates and investment objectives and policies. Whilst managing money takes many forms, we do not believe that firms today manage sustainable funds according to a primary and secondary channel for achieving a sustainability outcome, instead using stewardship and capital allocation either in parallel, or applying the weight depending on the fund strategy. Introducing primary and secondary channels for achieving a sustainable outcome is highly prescriptive and we believe that fund managers should have discretion in how they deploy stewardship and asset selection. In our response to question 6.b, we also offer a view on the proposed stewardship KPIs under the Sustainable Improver label as another example of where the criteria is too prescriptive.

- **the different components to the criteria (including the implementing guidance in Appendix 2)**

## 1) Sustainability objective

IA data would suggest that only a third of sustainable investment products domiciled in the UK currently incorporate a sustainable objective. Morningstar data also estimates that EU domiciled Article 9 funds (those with a sustainable investment objective) account for 3.6% of total funds available for sale. Whilst the data suggest that a small proportion of the fund universe currently has a sustainable investment objective, it also indicates that the incorporation of a sustainable investment objective as a minimum criterion for the SDR labels will 'raise the bar'. We are supportive that sustainable investment funds should seek to have a dual financial and sustainable objective to which they have to align their investment policy and strategy and provide supportive KPIs.

Appendix 2, Non-Handbook Guidance: implementing guidance 1c (on sustainable objectives) suggests that firms need to detail any 'trade-offs or adverse environmental or social impacts, including a clear articulation of any financial trade-offs that may arise'. Our members would welcome examples of when the FCA considers that such a trade-off occurs. Whilst the Sustainable Impact label is clear firms should avoid unintended negative environmental or social impacts, this principle has not been explicitly stated in the requirements for other labels. If such a trade-off occurs, clarity is needed from the FCA on how it believes investment managers should consider this with regard to their chosen sustainability objective. There also does not appear to be an option to invest in sustainable companies with a return maximisation strategy (i.e., with no trade off). There is a risk that sustainable funds may well underperform non-sustainable funds under these rules which is not supportive of market growth or clients.

Separately, we note that a requirement for a firm to describe the 'time horizon over which the sustainability objective is expected to be attained' is not easily achieved outside of emissions-related objectives. There are also questions as to what happens at the end of the time horizon and whether a fund might need to be repositioned in order to re-align with its sustainable investment objective or to determine a new strategy.

Finally, we note that funds with a secondary sustainability objective would qualify for the Sustainable Improvers label, provided the conditions in which the financial objective would be prioritised are clearly communicated. A secondary sustainability objective equates to taking an 'all reasonable endeavours approach'. That is, it relates to doing everything a fund manager can to run the fund sustainably except subordinating commercial interests. A secondary sustainability objective acts as a robust accountability mechanism for managers to explain why they have not achieved an objective where this is the case. We therefore feel that funds with a secondary sustainability objective should be eligible for inclusion in the Sustainable Focus label.

## 2) Investment policy and strategy

The proposals require a number of additional disclosures in precontractual materials. These are quite extensive and prescriptive and could have the unintended consequence of firms having to update prospectuses more regularly with the attendant notice to investors and approval from the FCA. It might be more reasonable to allow firms to make more detailed disclosures on how they pursue their investment strategy in other fund documents, as a change in strategy does not necessarily stem from a change in fund objective or policy. This would also allow the framework to grow more easily as the market develops.

We also note that HMT and the FCA is reviewing the fund disclosure framework and the FCA has already identified in DP22/6 that the 2017 Asset Management Market Study found that *'under 3% of retail investors read regulated pre-contractual fund disclosure documents. This indicates that the existing retail investment disclosure framework is not supporting good consumer outcomes.'*

Mandating that such prescriptive requirements are added to the product's precontractual disclosures (as outlined in section 5, chapter 5) would not help firms to produce good outcomes for consumers if the investor does not read the pre-contractual disclosures anyway.

With regard to points 7 (f), (g) and (h) in the draft implementing guidance we would appreciate clarification from the FCA on whether funds that do not use derivatives, short selling or securities-lending have to disclose under these three points . Or is it the FCA's expectation that firms should disclose that the fund doesn't engage in these activities? It seems overly burdensome to have to explain something a fund doesn't do, particularly as such disclosures would be worded in such a way that the average consumer would find difficult to understand.

### 3) KPIs

While the principle of measuring progress against both a financial return objective and a sustainable objective is appropriate, the type of data and measurement available for sustainability characteristics is limited due to a lack of appropriate data or issues around quality. Whilst KPIs measuring an environmental objective may be sufficient, those measuring, for example, progress against a UN SDG, are more limited. The risk is that investment firms adapt their sustainability objective to something that is easier to measure rather than something that may support the transition to a more socially and environmentally sustainable economy. This in turn is likely to lead to many funds following very similar strategies. Encouraging funds to follow similar, easier to manage KPIs will therefore reduce the offering of funds for retail investors and will also make it even more difficult for funds of funds to obtain the correct level of diversification.

KPIs also measure a point in time and as long-term investors, members are likely to see volatility in metrics. This is particularly pertinent when measuring progress against social sustainability characteristics given the subjective nature of what progress may look like. Investment managers are likely to rely on third party data providers and, as pointed out in our response to CP 21/18, there are issues with visibility of methodology and quality of data. We believe this may limit the ability for investment managers to report against 11a – c unless the ESG data and rating providers are specifically requested to provide this information.

Accepting the need to have KPIs for accountability, given that the fund's KPIs may change over time, defining the KPIs in the prospectus may potentially limit the longevity of the documentation and add to further expense for firms, distributors and the FCA in terms of resource in the updating, authorisation and re-publication of documents. It would therefore be useful to see detailed examples for each sustainable investment label across asset classes in terms of expectations around associated KPIs.

In relation to KPIs for real estate assets, we understand that a submission has been made to the FCA on ESG metrics for real estate by real-estate related associations including the Association of Real Estate Funds (AREF). This forms part of an ongoing engagement by the associations with the FCA to address the unique challenges with sustainability reporting for real estate assets.

#### 4) Resources and governance

We have no comments on this point.

#### 5) Investor stewardship

We support the principle on stewardship that requires the firm to maintain a stewardship strategy and resources consistent with meeting the sustainable objective. We would expect that firms that want to use stewardship to achieve a sustainable objective will be making considerable disclosures already which set out their approach to stewardship as part of their Stewardship Report produced to be signatories to the UK Stewardship Code.

The FCA also notes that where stewardship plays a significant role in an investment policy and strategy for a sustainable investment product, the firm must specify credible, rigorous and evidence based KPIs that relate to the contribution of stewardship activities and outcomes to the achievement of the product's sustainability objective. Alongside this, a firm also has to monitor its stewardship performance against any KPIs. To be able to deliver these KPIs, investment managers will require the assets which they invest in to provide sustainability disclosures under the ISSB and the UK Transition Plan Taskforce Sector- Neutral Framework.

As we set out more fully in our response to question 9, the industry has found it difficult, for valid reasons, to demonstrate whether their own stewardship activities have led to corporate changes in behaviour and therefore more sustainable outcomes. Whilst the fund will be able to demonstrate the stewardship activities and the outcomes that have been achieved, they are unable to provide a causality link between their engagement and stewardship activities and the changes in company behaviour. For this reason, we believe that the emphasis should be on a plausible link rather than a causal link. Members recognise that it can be difficult to separate their contribution out from other factors including engagement with other shareholders, regulation, collective engagement with other investors, the boards own decision making and lobbying from NGOs/ civil society.

- **whether they sufficiently delineate the different label categories, and;**

The FCA's proposal clearly sets out three delineating categories of sustainable investment labels:

1. One focused on sustainable assets (Sustainable Focus);
2. One focused on assets in the process of transition (Sustainable Improvers); and
3. One focused on investing for real world change (Sustainable Impact) - although in the way it is described we would argue it would be of limited value to retail consumers due to the private and potentially illiquid nature of underlying investments being allowed within a UK UCITS / NURS fund.

We believe that there is reasonable delineation between the categories but that delineation doesn't stop the proposals unintentionally leading to different asset classes intending to follow similar strategies from falling within a different category due to the underlying criteria, in particular, the difference in primary and secondary channels of achieving the sustainability outcome. A fixed income impact fund investing in public market securities may find itself in the Sustainable Focus

category due to the inability to prove financial additionality. In addition, a fixed income fund investing to support transition may not be able to produce the necessary stewardship related KPIs to sit in the Improvers category and may end up in the Sustainable Focus category. Similarly, real estate funds' primary channel of investing for sustainability outcomes is generally capital allocation so the way they aim to support transition may mean they fall in the Impact or indeed Focus category.

- **whether terms such as 'assets' are understood in this context?**

'Assets' may be familiar terminology used in the investment management industry but we would propose that the term, by its nature, is broad in meaning and we would suggest that the FCA refer to 'assets' as 'investments'. This is supported by our investor research conducted in 2019 on fund communication – consumers more readily understand the term 'investment' and 'asset allocation' is a term that requires explanation, for example: 'Dividing the money invested in the fund across different investments ('assets'), e.g. in different geographic areas or by industry sectors such as oil and gas or financial companies.'

#### **Q9: Do you agree with the category-specific criteria for:**

- **The 'Sustainable focus' category, including the 70% threshold?**

The principle behind introducing a label which supports capital flowing towards firms that are already sustainable, or that provide goods and services that support a more sustainable future is a welcome one. Firms that have proved they are on this pathway should be encouraged and supported.

Under the SFDR, the ESAs have sought clarification from the European Commission on whether sustainability needs to be in relation to the company's products/services or whether sustainably run companies can qualify as 'sustainable investments'. Our view is that the investment manager should have the discretion to choose, as long as they can credibly outline their methodology and investment approach. Similarly, in relation to sustainability characteristics, the FCA proposal is not clear as to whether this can be in relation to 'internal' (i.e. sustainably run businesses) vs. 'external' (i.e. businesses with sustainable products and services) sustainability.

Although our members are broadly supportive of the threshold being set at 70%, provided there is greater clarity around how it should be calculated, further explanation from the FCA is needed on how they arrived at 70% as the appropriate threshold.

Furthermore, the threshold set for portfolio management services is inconsistent at 90%, which would be confusing for investors who are unlikely to understand the reasons behind the different percentages. While not clear from the CP, we understand from engagement with the FCA that it does not mean that 90% of the underlying assets invested in have to meet one sustainable criteria, rather that nine out of ten funds in a portfolio must be sustainable and in one label category. However, we believe that this threshold is still set too high as it does not consider that portfolio management services are typically diversified across different approaches. We would therefore propose that there is greater alignment with the 70% threshold, if the FCA requires a predominant

threshold. We would also request that the requirement for the funds to be aligned with one label is removed entirely. As long as the portfolio management service is investing 70% of the total value of products in funds of any label category, we believe that it should be free to choose the most appropriate label. This reflects the current market practice, which focuses on diversification rather than picking homogeneous funds. We provide further views on this under question 10.

A mixed-asset fund manager may on occasion, due to market conditions, have a significant proportion of cash within their fund, particularly mixed asset funds taking a flexible investment approach. As we note above, the treatment of cash should depend on its purpose within the fund, i.e. whether it is being used for liquidity purposes, which should not be included within the core 70% or to enable tactical asset allocation, which would support the investment strategy of the fund. However, certain EU national competent authorities do consider cash, for example CSSF in Luxembourg requires a minimum 80% of sustainable investments in SFDR Article 9 funds which means they accept a maximum 20% in cash. Ultimately consideration needs to be given to the treatment of cash within the thresholds which should differ depending on what the cash is being used for, i.e. for liquidity purposes or to support trading.

Our members would welcome further clarity on how they are expected to calculate the 70%, for example, is the 70% calculated at the portfolio level (e.g. 70% of assets must achieve a credible standard of sustainability) or could other metrics be used to determine an asset weighted basis or a pass/fail approach. For example, in the case of mixed-asset funds investing in other collectives, collectives are a distinct category of eligible security under COLL therefore firms' assessment of whether the assets of a mixed-asset fund are meeting the 70% test might stop at the underlying fund level (i.e. is the underlying fund considered to be a 'sustainable investment'). This interpretation would be consistent with other regulations, for example firms are not required to monitor derivative positions held within the underlying funds. What is unclear, is whether the application of this test might require firms to look through to the underlying holdings in the underlying funds. Early clarification on this point will be important to avoid future re-categorisations due to a lack of clarity.

- **The 'Sustainable improvers' category? Is the role of the firm in promoting positive change appropriately reflected in the criteria?**

For Principle 1 (sustainability objective) and Principle 2 (investment policy and strategy), we believe it is appropriate that the fund has to set out how investor stewardship will support the investment objective and encourage portfolio assets to be more sustainable over time.

On Principle 3 (KPIs), the Sustainable Improvers label has the longest list of KPIs to meet (page 45 of the CP). This is likely a reflection of the fact that products in this category may be broadly invested across sectors with transitioning sustainability profiles.

At the IA's webinar with the FCA post CP publication, members welcomed that the FCA sought input from the industry to help ensure these KPIs are structured in a way that seeks to develop reporting which demonstrates the stewardship improvements delivered by individual funds. Some members noted that the KPIs are similar to disclosures the FRC currently requires as part of its reporting against the Stewardship Code, particularly on engagement-related reporting.



As noted in our response to question 6b, it is not clear whether the FCA requires engagement with individual portfolio companies to be disclosed under the suggested KPIs. Under the first bullet of the category specific criteria for Sustainable Improvers (p44) members note that further clarity is needed as to whether it is acceptable to have different targets for each company (and whether they should be at the portfolio level), if the KPIs need to be uniform across the portfolio, and if engagement impact should be described in aggregate. In this regard the FCA could provide further guidance on what would qualify as a KPI (for example, will it be a standard indicator known to the industry such as Potential Adverse Impacts as required under SFDR?) and whether holding level targets should be provided (which some members note could be both onerous and difficult to report).

Additionally, in order to meet bullets 3 and 5 of the category specific criteria, some members noted that in practice naming an investee company and attributing positive engagement outcomes as part of existing stewardship reporting has led to negative consequences, with tensions between investee companies and investors increasing as a result of Boards feeling that they are being directed to take specific actions or the investor is taking credit for the Board's actions. Where companies are named, they may argue that they had planned to take a specific action irrespective of the outcomes of investor stewardship. This will not help firms to demonstrate that their own activities have led to meeting the sustainable objective.

In addition, some members noted that they prefer to have consent from investee companies to publish case studies on engagement reporting and outcomes. Where this is the case, there is a risk that reporting will be 'glossed over', with companies only allowing investors to publish information that is favourable to them. In order to mitigate against this, some members noted that engagement which is targeted at the portfolio rather than specific company level could help to prevent the risk of naming and potentially shaming individual companies, particularly where the outcomes of engagement have not led to positive change. Some members also commented that reporting on engagement outcomes anonymously, and then providing a list of companies at the end of their stewardship report has helped to provide a true account of engagement reporting whilst maintaining company anonymity.

With regards to bullet 7 of the category specific criteria, members noted that the FCA needs to give further thought to the timing and duration of engagement. Engagement may take place over a number of years to deliver a positive result, it cannot be expected that stewardship will deliver specific improvements over an annual period. The engagement will often use multiple routes including other stewardship mechanisms, such as voting, to get the desired results. The KPIs should reflect the fact that stewardship outcomes might only be achieved over multi-year periods. In addition, engagement goals are not uniform and in some instances, it may be the case that firms have to change or pivot away from existing KPIs depending on the company's response and willingness to engage or market developments. This represents the evolving nature of engagement and the ongoing dialogue that is required with investee companies in order to effect change. It is not clear how this will be measured or reported on against the suggested KPIs. Members would also welcome further guidance on whether proprietary ratings systems can be used here, with changes in scoring reflecting an improvement or deterioration in the sustainability profile of individual assets. The FCA might further consider guidance on portfolio rotation where assets have fulfilled their sustainability potential and how this might overlap with the Focus label.

Annex D, ESG Sourcebook Draft rule 3.2.7R(2b) stipulates that the KPIs must include ‘the long-term sustainability profile of a sustainability product’s assets, as projected over a period of more than one year’. While there are methodologies available for climate-related sustainability objectives (for example using scenario analysis), such forward-looking methodologies don’t exist for many other sustainability factors like environmental or social sustainability.

Appendix 2 (non-Handbook Guidance) provides a suggested list of metrics that might be used to help fulfil the KPIs. While members are grateful for this additional guidance, some have queried whether it is overly prescriptive and whether the FCA intends to review and update it on a periodic basis. We would note the following points on those metrics within the non-Handbook guidance:

- **20a - number and types of engagement relevant to products sustainability objective.** Members are keen to stress that engagement should not just become a numbers game in terms of being able to conduct a certain level of engagement without any clear link to outcomes. There should be alignment with the FRC’s Guide to Effective Engagement Reporting: (a) explain issues that led to engagement; (b) state objectives for engagement; (c) use representative examples (e.g. by geography or sector); (d) be specific about activities in reporting year; (e) give the rationale for the chosen engagement approach; (f) explain the organisation’s role and contribution in collaborative engagement; (g) explain reasons for escalations; (h) explain the outcomes of the engagement and identify next steps.
- **20b - engagement across asset classes.** As we have noted previously, this will depend on the ability of the Improvers label to be applicable for different asset classes. However, the risk (as set out at Q6b) is that it misunderstands the nature of engagement by ascribing change to a single firm alone, encouraging firms to make claims that cannot be properly substantiated. While the FCA has suggested that correlation rather than causation might suffice for such disclosures, this needs to be reflected in the draft rules and guidance.
- **20c - metrics for voting outcomes relevant to the sustainability product’s sustainability objective.** There may not be specific resolutions tabled on some of the issues that firms are keen to engage on in order to demonstrate improvement against the sustainability objective. In this case, firms may need to utilise existing votes (e.g. the ability to vote against the re-election of directors, or voting against the remuneration structures within an organisation). As noted, voting also cannot be used as an escalation measure for some asset classes outside of listed equities. This could make it difficult to demonstrate improvements under the Improvers label.
- **20d - focus on collaborative engagement.** As we have noted, while firms are expected to report on this as part of their Stewardship Reports, there are considerable difficulties in attributing how a firm’s own engagement (especially as part of a collective engagement) has led to better stewardship outcomes. As per reporting under the Stewardship Code, simply listing a collaborative engagement is not going to provide helpful context to clients. A mix of quantitative and qualitative data on the approach to the engagement would be helpful, supplemented with case studies on collaboration with other investors, the fund’s contribution to the escalation and how its activity contributed to achieving change at the issuer level.
- **20e on escalation measures (including divestment).** As we previously note, divestment is unlikely to apply to index funds.

**20f engagement with policymakers, NGOs etc relevant to products sustainability objective.** Under the Code, signatories should explain the role they have played in any relevant industry initiatives and the extent to which they have contributed. Instead of just providing a list of initiatives that the firm has been involved in, it should demonstrate its contribution to driving the initiative forward and how this contributed to achieving change at the issuer level. Again, this could be demonstrated well through a case study.

- **The ‘Sustainable impact’ category, including expectations around the measurement of the product's environmental or social impact?**

We largely support the category-specific criteria for the Sustainable Impact label outlined on pages 41-44 of the consultation paper, although we have a number of concerns regarding the criteria laid out on pages 36-38.

We support the wording that ‘the sustainability objective must be to achieve a predefined, positive, measurable real-world environmental and/or social outcome’, which is based on the definition of impact investing formed by the Global Impact Investing Network. As mentioned previously, the UK investment management industry is global in nature and the IA is a strong proponent of international coordination and the harmonisation of sustainable finance rules. Fragmented approaches across different jurisdictions – including for example, gold-plating at a national level – run the risk of not treating clients consistently and fairly. A common set of global standards and terminologies across all regions would help address this issue and therefore we support the use of the GIIN definition as outlined above.

Impact investing should be clearly distinguished from other types of sustainable investment and our members agree with the FCA’s suggestion that a sustainable objective for an impact fund should aim to achieve a pre-defined, positive, measurable real-world outcome based on a theory of change linked to an environmental and / or social outcome. However, we note that some members are of the view that flexibility should be provided where a fund manager should be able to determine whether theory of change is at a product level or underlying holding level, as in some cases a fund manager may not have a single overarching problem or strategy but instead have designed a theory of change specific to each individual holding.

In particular, we support robust methods to measure and demonstrate that the investor (and investee) have made a significant contribution towards the impact objective and that there should be appropriate escalation plans if targets are not met.

As it stands, the proposed criteria for an impact label would limit the category to a very small number of funds, which generally would not be available to retail investors due to the private and illiquid nature of the underlying investments.

Impact investing that is restricted to private markets is firstly, unlikely to help provide solutions to environmental or societal problems due to the inherent limitations of private equity and secondly, is unlikely to be offered to retail clients due to the risky and illiquid nature of the underlying investments being unsuitable to most retail clients bar high net worth individuals. This therefore limits choices for consumers to align with their own sustainability objectives.

We differ in opinion to the FCA as to the assets that can be used to achieve ‘impact’ and have concerns regarding the limitation of this category to funds that primarily invest in ‘new capital’ via private or primary markets, both of which are typically inaccessible to retail clients. As noted above, our members support international coherence in relation to sustainable finance regulation and terminologies and believe it would be best for the category to align with the definition of impact investing provided by GIIN who are considered a global standard setter for impact. GIIN supports the concept of impact investing in listed equities in the secondary market and the majority of our members would suggest that the FCA seek to align with this approach. We note that the GIIN definition does not make reference to ‘additionality’, financial or otherwise, instead using the term ‘contribution’ in its draft guidance on impact investing in listed equities.

A requirement for ‘additionality’ in the impact investing label would create severe and misguided limitations on investors’ ability to gain this label. Additionality is most clearly demonstrated in respect to financial additionality, which in listed equities is likely to restrict impact investing to IPO’s and secondary capital raises. In fixed income, this is likely to be limited to primary debt issuance rather than refinancing. The IA strongly supports reference to ‘contribution’ instead of ‘additionality’ given the limitations of the latter and notes that this is a term commonly used in the impact investing space instead of ‘additionality’. This contribution should exist at both investor and investee level.

At investor level, this would predominantly exist via capital allocation and engagement with the investee company towards a fund’s impact objective. The investor's contribution via capital allocation is the added value of the investor in identifying those companies and business models that are mostly likely to drive material and sustainable impact and allocating capital accordingly. Strategies that solely focus on impact companies create a new market for them, not just driven by financial considerations. This means ‘patient capital’ for these companies in challenging times and ‘fair value’ or ‘ESG premium’ for companies which can be monetised for acquisitions or to protect them from being targets. The investor’s contribution via engagement towards the investee’s company towards a fund’s impact objective is outlined in answers to other questions in the consultation.

At the investee level, contribution may come, as suggested in the FCA’s proposal, through serving underserved stakeholders or through the production of products and services that contribute to social and environmental solutions and / or progress.

We note within the FCA’s description of sustainable impact investing there is no minimum proportion of assets which must align with the label. We would welcome clarification on whether the FCA has an expectation as to the proportion of investments that would need to align.

The impact investing label is the only label to incorporate an element of the SFDR concept of ‘do no significant harm’ by requesting firms avoid ‘unintended negative environmental or social impacts’ when selecting assets that align with their theory of change. We therefore would welcome further guidance as to how firms must demonstrate they have considered this trade-off. As noted previously, the implementing guidance mentions that for all funds with sustainable investment objectives, firms must consider trade-offs or adverse environmental or social impacts including a clear articulation of any financial trade-offs that may arise in pursuing sustainability objectives, and therefore clarification on the differential between the requests would be welcome.

**Q10: Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?**

We support the need for firms to have to display and use the relevant graphic when using an FCA label – this will raise awareness of the labels and will underpin consumer understanding of the labelling regime, helping to build trust in the sustainable investment market.

Our members are also supportive of the FCA's approach to not introducing a mandatory requirement for firms to seek independent verification of their labelling at this stage. Firms' internal product design, product governance, disclosure and compliance procedures should be robust in ensuring appropriate classification and labelling. A requirement for firms to seek independent verification would significantly increase the costs and burden on firms, potentially disadvantaging smaller firms. A mandatory requirement would also go against the principles-based approach of the labelling proposal. The IA remains fully supportive of the FCA's role in challenging firms' claims during regulatory engagement, for example, at the gateway when authorising new funds and on an ongoing basis through supervisory dialogue.

Our members would however like the FCA to provide further transparency on the authorisation and verification process to demonstrate how consistency will be applied throughout this process and indeed the subsequent monitoring process. In addition, even though label standards could potentially be broadly interpreted, we request clarity as to how the FCA will manage any post-authorisation changes to labels in a way that does not create market confusion (for example, suggesting reclassification of similar funds using a staged approach across managers). This is important to serve the consumer, or we risk consumer confusion and disillusion with the regime.

**90% threshold for portfolio management services**

Lastly, it is under this section of the CP, in section 4.69, that the FCA is proposing that with respect to portfolio management agreement or arrangement, 90% of the total value of the products in which it invests must meet the qualifying criteria for the same label in order for it to use the label. As outlined in our response to questions 1, 4 and 9, if portfolio management services have to reach 90% of the value of all constituent products in which they invest and align these products to one label in order to receive a label, then this is likely to prohibit the majority of portfolio management services from obtaining a label. Most model portfolios, mixed-asset funds and funds of funds are looking to provide diversified rather than concentrated portfolios and there could be concentration risk in channelling portfolio flows into a small set of products, for example in the case of the Impact label. The 90% threshold does not allow flexibility to construct a portfolio which can hold moderate levels of cash or sovereign bonds, which is a key requirement to help investment managers to diversify returns and manage risk. In 2022, we saw the worst returns for gilts since the 1700s and the worst returns for equities since the 1960s. Under such circumstances, fund managers should be able to hold reasonable levels of cash, mandate permitting, and to hold government bonds. Forcing fund managers to place at least 90% of a scheme's assets into a very narrow pool of assets (i.e. all underlying products that meet only one label) will hamper returns, increase volatility and lead to worse client outcomes. It will also prompt excessive and unnecessary turnover as mixed-asset funds look to move towards a specific SDR label.

The proposals would also favour large fund managers who run fettered funds of funds. These fund managers will be able to change the mandates of the underlying funds that they access, whilst smaller investment houses will not have this option. The mixed-asset sustainable market has evolved so that there are many boutique investment managers that are able to provide high quality products. The proposed FCA regulations will give large managers an unfair advantage and lead to worse outcomes for end clients. As we propose in our answer to question 9, we would propose the 90% is aligned with the 70% threshold as proposed for the Sustainable Focus category. We would also request that the requirement for the funds to be aligned with one label is removed entirely. As long as the portfolio management service is investing 70% of the total value of products in any labelled funds of any label category, we believe that it should be free to choose the most appropriate label. This reflects the current market practice, which focuses on diversification rather than picking homogeneous funds.

## **CHAPTER 5 - DISCLOSURES**

### **Q11: Do you agree with our proposed approach to disclosures, including the tiered structure and the division of information to be disclosed in the consumer-facing and detailed disclosures as set out in Figure 7?**

The IA has extensive experience over the years of helping members with effective disclosure so that industry communicates with clarity to help the end investor make informed investment decisions. A key lesson is that there is no single 'right' approach to the disclosure of information across a range of investment products – it is an ever-evolving space, not least due to changing customer expectations and the day-to-day experience of accessing information online which has transformed in the past decade. There are a number of overarching key points we made in the 2021 IA-Eversheds Sutherland joint guidance<sup>5</sup> on the FCA Guiding Principles that are relevant to this work:

- A framework for support not prescription: there are no right answers in how communication should be developed, and the disclosure of sustainable information should lead to a more informed end investor without reducing that choice for the investor or constraining the investment manager in how that fund is run.
- Balance between concision and simplicity: there is clearly a challenge in striking the right balance between being succinct in fund disclosure documentation and avoiding jargon or technical terms that are designed to describe a concept in a concise manner.
- Responsibility throughout the distribution chain: clear disclosure and good customer information is a responsibility throughout the retail distribution chain, particular platforms and advisers given their role in the retail sales process. Many firms are producing literature for the same products across multiple jurisdictions which raises issues of how to ensure consistency while recognising that different jurisdictions have different norms and expectations, particularly around disclosure of sustainability-related features of a product.

The IA fully supports the need for the industry to deliver information to investors on the sustainability-related features of investment products to retail investors in an accessible way. We are ready and willing to work with wider industry stakeholders and regulators to ensure that happens. However, sequencing is key. We provide views on the CP proposals against a backdrop of developing ISSB corporate sustainability disclosure standards and the FCA currently seeking views in DP22/6 on the design and delivery of a new UK retail disclosure regime to replace the PRIIPs and UCITS disclosure frameworks which follows from HMT's proposals to maintain retail disclosure requirements within FCA rules and to revoke PRIIPs. We strongly urge the FCA to consider the overall impact the forthcoming widespread changes will have in its totality rather than each piece in isolation at both industry level and through the distribution chain to end investors.

Regarding the specific proposals in the CP, the IA supports the FCA's proposal for a tiered approach incorporating product labels and enabling investors to choose the level of granularity of information that they wish to see. Such a structure takes into consideration that different audience types may have different information needs and levels of understanding.

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<sup>5</sup> <https://www.theia.org/sites/default/files/2021-09/IA%20Eversheds%20Sutherland%20Guidance%20on%20FCA%20Guiding%20principles%20on%20ESG%20sustainable%20fund%20design%2C%20delivery%2C%20disclosure%2020210920.pdf>



Having a more layered approach to fund communication chimes with the consumer testing the IA carried out in 2018 in response to the Asset Management Market Study. At the time, we learned that experienced, self-directed investors who use a broad range of funds and other investments within their portfolios, want sufficient detail on holdings and active positions to allow them to compare funds. They want information layered in a way that means they can dip into it as and when desired.

Notwithstanding that different information and level of disclosure may be required by different audiences, it will be important not to exclude a group of clients from an information set or in which information available to institutional investors is only, for example, available to retail investors on request.

There is also an additional concern from some members that having two different and separate disclosure regimes (consumer facing and institutional) would require further resourcing and incur further costs for firms for potentially limited benefit to institutional investors.

We therefore encourage the FCA to carefully consider how the different levels of disclosure align, interact and could interchange, and how the information could be provided to all audiences, preferably in a digital format. Clarity is also needed, as soon as possible, on what obligations will be placed on non-UK domiciled funds marketing in the UK to provide these disclosures. As already noted, around one third of funds available to UK retail investors are domiciled overseas.

**Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?**

We broadly support an approach which builds on the TCFD disclosure requirements with the objective of evolving these requirements in line with the development of a global baseline in sustainable investment disclosures. However, there have been concerns raised by a small number of members about the suitability of TCFD disclosures as the foundation for SDR disclosures – these concerns are elaborated below.

Separately, as noted above, the IA is a long-term proponent of international standards and frameworks in sustainable investment and therefore we support the intention of the FCA to adapt the proposals as the ISSB standards develop.

However, we note the concern of some members that it may be confusing and misleading for retail investors if the TCFD report is used to report on sustainability factors. Sustainability is more than just climate risk and where firms believe it appropriate, and to avoid double reporting, they should be allowed to signpost in a sustainability disclosure to the TCFD-aligned report.

In addition, it has been suggested that whilst at fund level, TCFD-style disclosures are suitable, this is not necessarily the case at entity level. Just as TCFD is aimed at climate financial risk faced by investment institutions and not necessarily climate impact in the real world, for sustainability risks, the ISSB standards are intended to measure material sustainability risks to the company, and not the impact of sustainability risks in the real world (double materiality). Therefore, an entity level

report on sustainability risks is unlikely to be the best format for reporting on longer-term real world sustainability outcomes. Further to this, while the focus on financial materiality under the ISSB standards will help to deliver some sustainability objectives (e.g. related to climate) a lack of focus on broader environmental and social objectives, (e.g. ecological boundaries, social safeguards, and UN Sustainable Development Goals) will be difficult to deliver in the absence of reporting standards that embrace a double materiality approach.

**Q13: Do you agree with our proposals for consumer facing disclosures, including location, scope, content and frequency of disclosure and updates? If not, what alternatives do you suggest and why?**

While we fully support the need for fund managers to be transparent and open about their investment strategies, we disagree with the form of disclosure which the FCA has prescribed for customers. This runs counter both to available evidence on effective communication and the broader principles-based regulatory direction of travel as set out in the Consumer Duty.

**A Single Factsheet for Clarity and Engagement**

In line with the feedback from a range of different stakeholders, we disagree with the FCA's proposal that an additional document should be created outlining whether the fund has a sustainable label, sustainable goals, metrics and approaches, and unexpected investments. There are a number of inter-connected challenges with this proposal.

Firstly, where a fund has a sustainable label, the objectives are likely to be an integral part of the overall fund design delivery, and therefore need to be explained as such. Creating the requirement for what is in effect an additional regulated factsheet alongside existing material which includes a general factsheet does not provide for a coherent approach to investment communication. Moreover, another document should not be introduced while the FCA is currently seeking feedback on how it can design and deliver new disclosure rules which meet the needs of the UK market and support investors to make informed decisions.

Second, this issue of coherence is even more important given what we know about customer behaviour. As already noted in our response to question 8, as part of analysis included in the Asset Management Market Study, the FCA found that under 3% of consumers look at fund documents. The industry recognises the challenges of effective communication and would like to work with regulators to address the challenge, especially in the context of the growing expectation that this should be in a digital format rather than a traditional PDF on screen. Given this reality, it is not clear how the FCA believes consumers will engage with an additional, sustainability-focused disclosure document.

Third, the proposed rules around document revision (Annex D, ESG 4.1.3), which require 60 days prior notice, are disproportionate and out of alignment with wider communication norms. Firms should not be required to write to clients regarding updates in areas such as performance information. Existing fund rules would already cover notification regarding significant change events.

Our position therefore is that sustainability-related information should be included in existing consumer facing disclosures such as the KIID and fund factsheet and adapted for wider digital communication. As stated in our response to DP21/4, this view aligns with consumer testing carried out by other trade bodies that suggests consumers want all relevant information in one place. We also think that the view aligns with the FCA's own behavioural testing, as outlined in Occasional Paper 62, which showed the value of the factsheet compared to just a KIID. Critically, it does not support the idea of two factsheets.

While the proposed level of disclosure can be hyperlinked in a prospectus, the IA would advocate for a statement within the investment objectives on a fund factsheet/KIID which details to the customer, in non-financial or scientific jargon, the sustainability attributes, strategies and stewardship policies which the manager is employing for the product.

### **Targeted disclosures depending on use of labels**

We also disagree with the proposals that non-labelled funds need to make disclosures as per section 5.31 in the CP. By requiring funds without a label to produce the separate consumer facing document, that is almost the same as requiring non-sustainable products to label themselves 'non-sustainable'. We understand that the proposal to include all products in the disclosure requirements (not just those adhering to a label) was driven by consumer testing, however, we call on the FCA to create rules whereby consumer facing disclosure is limited to those that are adhering to the labelling regime. The majority of funds will not receive a label and will be compelled to put 'not applicable' against these categories. This is not useful information for the investor and will come at a cost for firms to produce these documents for all products and require technological developments by investment platforms to share these documents alongside the KIID.

### **Content – unexpected investments**

The requirement to include unexpected holdings in disclosure should not be needed if the labelling and disclosure regime works as expected. Furthermore, different managers will define 'unexpected investments' in different ways – for example, active managers look to utilise engagement to improve companies over time, therefore it is unclear how 'unexpected' should be defined. It is also not clear if improving companies should be considered unexpected. The level of improvement/change will vary depending on the starting point of the company and the sector. There are formal governance and risk management processes which would act as a safeguard against portfolio management teams retaining investment in companies which are showing no improvement.

Given there is no one definition of sustainable investment, the requirement to 'provide a summary of the types of holdings that the firm would reasonably expect consumers of the product to find 'surprising' (i.e. inconsistent with the sustainability objective)' appears unachievable. Consumers will have their own viewpoint as to what is unexpected, but this is likely to be subjective in the context of that consumer's sustainability ethos. This approach will lead to inconsistencies in the market and potentially diminish the trust and understanding of consumers. This disclosure would be especially challenging for the Improvers category where all investments could be classified as unexpected depending on the viewpoint of the consumer. The IA proposes that a more pragmatic approach would be for investment managers to show what is held in portfolios – at the sector (which is already being provided) or thematic level, not individual stock level – and let consumers decide whether there is anything 'surprising' held. Alternatively, there could be a uniform set of

activities and firms would have to confirm if a product has exposure to those activities, which would aid comparability.

**Q14: Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?**

As noted in our answer to question 13 on an additional document, we have reservations regarding the likely benefit of distributing additional documentation to consumers who already do not read the current literature available to them. However, we are supportive of working with other industry stakeholders to consider the development of a template, or at least, have a consistency in approach that retail investors would find useful. We note, however, that some members have expressed scepticism as to how this might work in practice given the differentiation in product, strategy and client amongst investment managers. If a template did emerge, it would be important for its use not to be made mandatory to allow for innovation and different business models and strategies to develop which might not be well suited to a template.

While it is not consumer facing disclosure, we do have extensive experience, through FinDatEx (Financial Data Exchange) of working as part of the pan-European industry to develop data specifications for the transmission of, *inter alia*, relevant ESG and sustainability related information between participants in the distribution chain. FinDatEx is a joint structure established by European asset management, insurance and banking associations in order to coordinate, organise and carry out standardisation work to facilitate the exchange of data between stakeholders in application of European financial markets legislation, such as MiFID II, PRIIPs, Solvency 2 and SFDR (see [findatex.eu](http://findatex.eu) for more information).

**Q15: Do you agree with our proposals for pre-contractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on the scope, format, location, content and frequency of disclosure and updates.**

The FCA's proposals for pre-contractual disclosures seem proportionate and we agree that sustainability-related features should be disclosed in pre-contractual documents and that all products with sustainable investment labels should make pre-contractual disclosures associated with the qualifying criteria. It is also sensible that where products have sustainability-related features but do not qualify for a label or have chosen not to adopt a label that they should outline these features in pre-contractual disclosures as per section 5.47 of the CP. However, for this to be applied in practice and uniformly, clarity from the FCA is needed on what is meant by 'sustainability-related features'. Clarity is also needed on how industry should interpret the specification 'in a manner proportionate to the sustainability profile of the product.' Also, it's not clear how the requirement in section 5.47 interacts with the marketing requirements which prohibit the use of such language where the labels are not being used.

There are likely to be significant one-off changes made to pre-contractual disclosures in order to prepare for the introduction of the labels and the proposed SDR regime. Many funds will have

approaches such as ESG integration embedded into their investment strategies without being in scope for a label.

As per the requirement in section 5.51 of the CP, some members do not consider that creating a dedicated section of the fund prospectus would help to make sustainability-related disclosures more accessible and given that very few investors read the prospectus, this would also require an overhaul of the prospectus template, which may not be proportionate to the aims being achieved. Our preference would be to include the disclosures within the entry for each fund, or an annex at the end (as is done for SFDR and seems less intrusive).

We agree with the FCA's view that the pre-contractual disclosure requirements should not be applicable to products that do not qualify for a label or adopt sustainability related policies or strategies. We also support the FCA's position that pre-contractual disclosures should not apply to portfolio management services.

The timeline of one year to coincide with introducing new disclosure requirements for consumer facing documents provides consistency. We also see the merit in making the change process required for pre-contractual disclosures consistent with consumer facing disclosures.

**Q16: Do you agree with our proposals for ongoing sustainability related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.**

We support the FCA's proposals to build on the requirements set out in the TCFD product report for the Sustainability Product Report B. This is more proportionate than introducing a wholly new set of requirements. It is helpful to disclose how the fund is performing against the stated sustainability objective and to measure its progress, but we would question how accessible these reports will be to investors, who are routinely shown not to read multiple documents, however useful. Many investors do not even read the KIID.

We have reservations over the FCA's longer term aim to require that all products produce a report showing a baseline of sustainability metrics. Whilst firms should be allowed the flexibility to disclose these metrics if they wish, for many firms, this is a far more complex exercise than climate disclosures and will add a substantial cost burden through additional data requirements and the development of credible methodologies. This information is highly unlikely to be considered by investors and it is unclear that this data would be used by advisers who first and foremost must consider the risk and return profile of the fund in order to determine suitability. It would be useful to ask advisers how likely they would be to use these metrics in their suitability process.

Whilst we believe there is merit in building on the FCA's proposed TCFD-aligned disclosure requirements by widening the scope beyond climate to other sustainability-related information, we have concerns regarding extending the requirement to produce sustainability product reports to all products, regardless of whether the product uses a label. It will be important for the FCA to first understand how TCFD product-level reports are being used by consumers before widening the

scope of sustainability product reports. We believe there is a review clause in TCFD requirements, so it is worth ensuring that the above is considered as part of that review.

While we fully support transparency, in terms of disclosing metrics where data gaps or methodological challenges are so severe that they cannot be addressed by proxies or assumptions, we would question the usefulness of disclosing an explanation of the proportion of data that has been verified, reported, estimated or is unavailable, given that this is unlikely to lead to material decisions being made over whether to select the fund. We feel that it is enough to provide the contextual information around the metrics used.

**Q17: Do you agree with our proposals for an ‘on demand’ regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?**

The proposals for an ‘on-demand’ regime are based on the existing TCFD rules. These rules require an on-demand TCFD product report to be provided when requested. DWP rules and statutory guidance require pension schemes to obtain emissions data and calculate TCFD metrics, and pre-date the FCA rules for on-demand information. We formed a joint working group with members of the PLSA, ABI and IA to develop an industry standard for providing the information required by pension schemes. This standard (the [Carbon Emissions Template](#)) provides all the data required by pension schemes to fulfil their own TCFD obligations but is not consistent with the FCA’s specification of an on-demand TCFD product report. In particular, the FCA specification includes information that cannot be used by pension schemes (scenario analysis, historical calculations), and provides insufficient granularity where pension schemes are required not to aggregate beyond a level which remains meaningful (in practice, corporate and sovereign emissions are reported separately as are public and private corporate emissions). We would recommend ensuring that firms can comply with the ‘on-demand’ reporting obligation by providing the information pension schemes require rather than a full TCFD product report.

In addition, we would observe that despite the FCA’s proposal that the client could only request the disclosure once a year, receiving multiple ad hoc requests from clients could be difficult to manage. It might therefore be more reasonable to specify that clients requesting access to these disclosures can receive them on a set date annually. That date would be at the discretion of the portfolio management service or unlisted AIF.

**Q18: Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.**

We are broadly supportive of the FCA’s approach to build on the current requirements for TCFD entity-level disclosures, a reporting approach that is familiar to in-scope firms. We also consider it helpful to introduce a phased approach for the entity-level disclosure requirements meaning that smaller firms have more time to prepare entity-level reports.

Whilst harmonisation between SFDR entity requirements might be attractive for firms that are already reporting on this basis, we agree with the FCA's proposal not to adopt requirements to report Principal Adverse Impacts. Aligning the disclosure requirements with the TCFD's four recommendations on sustainability related risks and opportunities is a sensible starting point but we would highlight that it will be far more complex to report against sustainability metrics than climate metrics. The FCA acknowledges that the entity level report disclosures will need to evolve over time.

The proposal makes reference to the ISSB's general sustainability-related disclosure requirements but acknowledges that these standards have not yet been finalised or adopted in the UK. The sequencing of data reporting and the adoption of international standards will be critical in determining a reasonable timeline to report on a wider set of metrics.

However, a small number of members have expressed concerns that TCFD-style disclosures are not suitable at entity level, as outlined in our answer to question 12 that an entity-level report on sustainability risks might not be the best format for reporting on longer-term real world sustainability outcomes.

**Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?**

The FCA intends to build on the TCFD entity level disclosure requirements which will be familiar reporting for many in-scope firms. There is a large degree of consistency with the ISSB's S1 standard as this draws heavily from the TCFD recommendations.

We agree that firms may want to look at how corporates are reporting against the governance, strategy, risk management and metrics and targets pillars under the S1 framework as a way of understanding the types of information that would be decision-useful to clients and consumers (in the same way that corporates have to consider whether their disclosures will help investors in assessing enterprise value). While we believe that this is a helpful starting point, a line-by-line approach that is expected of corporates under the proposed ISSB framework will not necessarily be helpful to end clients in understanding the approach that the fund takes to contributing to positive environmental or societal outcomes and could make it more difficult for consumers to navigate an already complex landscape.

We note that the CP is also considering whether firms should refer to SASB standards in order to help determine which sector-specific information to disclose. We note that investors have already integrated the SASB framework into their investment processes and developed proprietary internal analysis systems to assess the sustainability criteria of their portfolio companies. However, we would reiterate that the level of detail captured by preparers under the SASB framework is unlikely to help provide decision-useful information to clients to help them select products that meet their needs and preferences, or assess the performance of the fund and how it seeks to achieve its sustainability objective.



## **CHAPTER 6 - NAMING AND MARKETING**

### **Q20: Do you agree with our proposed general ‘anti-greenwashing’ rule? If not, what alternative do you suggest and why?**

Our members have been strong proponents of the FCA’s Guiding Principles on design, delivery, and disclosure of ESG and sustainable investment funds. The principles are an important part of the UK regulatory architecture to help ensure good customer outcomes and a well-functioning fund market with the consumer at the core. Therefore, our members are broadly supportive of the decision to introduce an ‘anti-greenwashing’ rule to ensure that the naming and marketing of financial products and services in the UK is clear, fair and not misleading, and consistent with the sustainability profile of the product or service, i.e. proportionate and not exaggerated. However, we note that this would be met in any case by current rules without the need for a new specific rule to this effect.

We have some concerns about the trade-off between the need to present clear and easily understood disclosures about a fund’s investment process and policy (which will likely refer to ‘ESG integration’, a commitment to ‘net zero’ and advocacy around strong ‘governance’ for investee companies) and the marketing requirement to not mislead clients by using banned terminology. We would therefore strongly urge the FCA to provide clarity on what it means by providing ‘factual information’ and when this type of reporting could be construed as marketing.

With regards to timing, while we agree firms should already be ensuring the information they communicate to clients is clear, fair and not misleading, section 1.19 of the CP states that the anti-greenwashing rule would come in to effect upon publication of the Policy Statement. Given the anti-greenwashing rule will also apply to the naming and marketing of financial products (as per section 6.9) and given the proposals on naming and marketing rules, the timing of the anti-greenwashing rule should be aligned to the implementation of the SDR regime as a whole. There are already very clear rules in COBS 4 on communications to retail clients and guidance on financial promotions. There is a risk that by introducing the anti-greenwashing rule sooner than naming and marketing rules not yet in force, asset managers will not have completed changes to their funds and existing disclosures, and this could cause issues with under-disclosing or not making disclosures in alignment with the new rules. We would welcome clarity from the FCA that requirements implemented by the details of SDR and investment labels coming into force are not erroneously introduced a year earlier with members being held up to the higher standard. There are some reports from members that the authorisations process is already considering factors as outlined in the CP as part of this process.

Clarity is also needed on how the anti-greenwashing rule will work for overseas funds that are not subject to the labelling regime.

### **Q21: Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?**

Product names are a critical first step in communicating with clients some of the product's features and so we are supportive of the principle of the naming rule. For example, it could be confusing to investors to see a fund named an impact fund without a Sustainable Impact label.

However, we believe supplementing existing rules on undesirable or misleading names (COLL 6.9.6) and the FCA's ESG Guiding Principles with the general anti-greenwashing rule for all FCA-regulated firms should be sufficient to achieve the same policy outcomes. We understand the FCA wishes for the sustainable labels regime in the UK to set a high bar and we would argue this is in keeping with the approach taken by existing sustainable labels on the continent, for example, the ISR label in France or the FNG label in German-speaking Europe. As such, there is no need for the FCA's proposals to take a prohibitive approach to sustainability terminology in relation to unlabelled products. Those existing French and German sustainable labels have worked well, and facilitated consumer choice, precisely by maintaining a high bar for investors without prohibiting firms from communicating the sustainability credentials of unlabelled products.

The list of prohibited terms for funds that do not receive labels is too extensive especially given the 'catch-all' provision under ESG 3.3.2(2)(h), which begs the question of who will decide which synonyms are caught under this category. Our members do have serious concerns regarding the inclusion of terms like 'responsible' which are used extensively and by funds that are pursuing strategies that go beyond ESG integration but would not reach the bar to receive a sustainable fund label. While ESG integration may be understood by some in the industry to be synonymous with responsible investment, our recent research with retail investors showed that a relatively high percentage of investors see 'responsible investing' as an umbrella term for a broad range of sustainable and responsible investing approaches (ranging from exclusions to investing in line with your ethics but also encompassing considering risks related to the environment, society and governance before investing in a company).

Restricting the use of the term 'responsible' in marketing to funds that receive a sustainable label would imply that responsible investment has a narrower scope, which does not align with retail investor understanding. We therefore ask that 'responsible' is specifically excluded from the list of prohibited terms.

We also note that the naming rule may have the unintended consequence of making it harder for consumers to differentiate between products, e.g. two UK equity index funds, where one applies extensive exclusionary screens/tilting and the other doesn't.

We note that 'ethical' is not included in the list as identified by the FCA and query whether this is an intentional omission because the FCA does see a distinction between ethical and sustainable approaches. We would welcome clarification from the FCA on this point.

**Q22: Do you agree with the proposed marketing rule? If not, what alternative do you suggest and why?**

As noted above, we believe supplementing existing rules on undesirable or misleading names (COLL 6.9.6) and FCA's ESG Guiding Principles with the general anti-greenwashing rule for all FCA-regulated firms should be sufficient to achieve the same policy outcomes. We also believe that prohibiting marketing materials from using sustainability terminology risks firms' compliance with

existing FCA rules requiring financial promotions to be “fair, clear and not misleading”. For example, [COBS 4.5.5](#) outlines that “when communicating information, a firm should consider whether omission of any relevant fact will result in the information being insufficient, unclear, unfair or misleading.” We believe that not including any information relating to sustainability in marketing materials for products for which sustainability considerations have a material impact on investment approach (but for one reason or another don’t qualify for an FCA label) risks falling foul of this rule.

If the FCA proceeds with a prohibition, our preference is for this to be limited to product names and not to be extended to marketing materials. The proposed marketing rules appear to have extensive implications across a significant number of funds, even those which do not hold themselves out to be sustainable.

We would welcome clarity on what the FCA means by ‘marketing’ and examples of what would and would not cross the line between factual information (as per section 6.15) and marketing. For example, it is not clear whether answering a distributor due diligence questionnaire would count as marketing. Within the consultation paper, the ‘carve-out’ for factual references is not as clear as laid out in the rules. This could put our members at significant risk of breaching the anti-greenwashing rules unintentionally.

In relation to specific terms, we highlight our response to question 21 and the terms that are used frequently across fund names but note that terms such as ‘governance’ would be used broadly by all investment funds, particularly active funds which are likely to want to invest in well-governed companies. Similarly, the word ‘impact’ is used extensively across fund literature – it is a generic term and can be used in funds which do not have sustainability characteristics to explain the ‘impact’ of their strategy. We would advocate that ‘impact’ along with ‘governance’ and ‘responsible’ be removed from the list of prohibited terms given the generic nature of these terms coupled with the need to make disclosures in ‘plain English’. We also note the risk that the FCA’s list of prohibited terms is not exhaustive and yet must be complied with.

It is also unclear whether the term ‘ESG integration’ would be acceptable in marketing materials and pre-contractual disclosure documents in an unlabelled fund that does consider ESG aspects as part of the investment process. ESG integration can be used for risk management purposes, not just in relation to sustainability.

The concerns on the marketing rules are best illustrated using an example: a product may have an objective to generate material positive sustainability impact, and not do significant harm. To do this, it could exclude tobacco, fossil fuels, or weapons, while also requiring a company’s products and services to create positive impact relative to one or more of the UN Sustainable Development Goals. However, the product may not qualify for one of the investment labels on a technicality (for example, it may have a mix of sustainable and transitioning assets which means it doesn’t fit neatly in either the Improvers or Focus categories, or because the credible standard against which sustainability is measured is proprietary, and has not yet been independently assessed). In this example, the product manager/distributor would not be able to explain the sustainable aspects of the product in marketing materials, despite the fact that sustainability features are a key consideration in the investment strategy and will have a material impact on investment outcomes. While these factors can be described in disclosure documents, we believe the reality of how investors consume information about products they are considering investing in creates a significant risk of the issues described above emerging.

### ***Interaction with Net Zero agenda***

The UK's net zero target is established in law with a basis in the Climate Change Act 2008, as amended in 2019. The Chancellor has recommended that the FCA should have regard to the Government's commitment to achieve a net zero economy by 2050 under this legislation when considering how to advance its objectives and discharge its functions. This target will affect the whole economy and companies operating in every sector will need to align themselves with the transition to net zero, regardless of how they choose to market themselves.

In essence, this transition is expected to be central to the way the UK economy develops over the coming decades, reflected through changes in the policy and regulatory environment and driven by competition and demand. To encourage this transition and ensure high standards and integrity, the Government has introduced a range of measures – often aligned with international standards – to enhance information flows. These measures have included mandatory TCFD-aligned disclosures across the economy, support for the ISSB, and the development of recommendations for “gold standard” transition plans. The FCA has been involved in the development of these measures and its ESG Strategy includes a specific key action on this – ‘to encourage effective investor stewardship of net zero and sustainability, including through investor engagement, voting and responsiveness to clients’ and consumers’ preferences and objectives.’

This approach favours transparency by requiring and improving disclosure and has been supported by investment managers who require high-quality information at all points on the investment chain. The FCA's proposed approach to marketing rules would appear to be counter to this broad approach by restricting reference to ‘transition’, ‘net zero’ and ‘Paris-aligned’ in fund marketing to a small group of funds with a sustainable label.

As noted above, we fully support that it is not acceptable for funds to make unverifiable or meaningless sustainability claims in marketing material. However, by restricting firms to disclosing factual information in pre-contractual disclosures, the FCA would implicitly be prohibiting the inclusion of factual information on net zero and other sustainability issues in marketing material. This approach casts a veil over the economic transformation which we expect to take place between now and 2050. It is not clear how a lack of transparency, or even a lack of acknowledgment of the economic reality, has proper regard to the Government's commitment to achieve a net zero economy by 2050 or serves the best interests of consumers.

It is proper to prohibit inaccurate or false claims about sustainability activity within marketing material and it is understandable that the FCA would want to prevent firms from using marketing to give a misleading impression of their sustainability credentials through excessive focus on sustainability issues which are not central to the portfolio or how it is managed. However, in the absence of a clear definition of what constitutes marketing activity there is the potential to introduce a chilling effect on – among other things – online content, research and thought leadership reports which consider net zero. If this transition is to be achieved, it will need to involve the whole economy including the wider investment management industry.

While climate change and net zero are the most prominent example of this issue, there are likely to be shifts in the treatment of a range of environmental, social and governance factors in the economy. Often these shifts will be initiated by policymakers. Efforts to prevent greenwashing should be careful not to detach investment managers from discussing and supporting these shifts.

Separately, as noted above, we would also add that the marketing rules could have the unintended consequence of not identifying to end-consumers that funds may employ ESG tilts in addition to financial objectives, therefore misleading end-consumers into thinking that these funds pursue a purely financial objective.

***ESMA consultation on naming and marketing***

In addition to our commentary in question 21 on the French and German approaches to labelling, we also note that ESMA launched a consultation in November 2022 on more focused guidelines for the use of ESG or sustainability-related terms in funds' names. This more balanced approach (in the sense that ESMA has not restricted the use of ESG terms in marketing) would be a suitable alternative to the proposed marketing rule and would provide a greater degree of coherence in international standards. Please note we are not advocating at this time an adoption of the 80%/50% tests as ESMA has proposed as we have not had a chance to discuss the ESMA proposals with members.

**Q23: Are there additional approaches to marketing not covered by our proposals that could lead to greenwashing if unaddressed?**

At this stage we have no comments to make.

## **CHAPTER 7 - DISTRIBUTORS**

### **Q24: Do you agree with our proposals for distributors? If not, what alternatives do you suggest and why?**

Most fund managers are disintermediated from direct relationships with investors because investors buy funds through investment platforms or they go through an advice process where an adviser helps them to choose a suitable investment portfolio. Distributors therefore have a critical role to play in ensuring that investors can access the sustainable labels and associated disclosures and it is right that they are captured in the scope of these rules.

Whilst the FCA has considered the role of distributors in the CP, it has chosen to leave financial advice suitability requirements to a future consultation. We find it difficult to see how the products can be considered separate from the advice process. While the SDR rules are being developed, advisers will not stop advising clients on their sustainability preferences. We will therefore operate in a vacuum that has the potential for significant unintended consequences. The majority of our members would welcome the FCA committing to a timetable to conduct the advice/suitability review as soon as possible. It will also be crucial for the FCA to do more to help the adviser community understand how it intends the label regime to work which shouldn't wait until the SDR rules are final. We do not want to be in a position where advisers are discounting legitimate responsible and ethical products that do not meet the label criteria if a customer wants to invest sustainably (given the adviser also has to consider financial goals and capacity for loss). Assessing the suitability of a fund based on a client's sustainability preferences is an integral part of the investment process and the majority of UK retail investors are advised. The labels should aid the suitability process and we would welcome further clarity from the FCA on proposals for suitability rules. We do not believe that it would be a good outcome for investors if advisers take the view that funds without a sustainable label are automatically unsuitable for investors with sustainability preferences.

We agree that distributors should have an obligation to ensure that labels are prominently displayed, and platforms (both adviser and direct) should ensure that labels are searchable, making it easy to find and compare funds in the different label categories.

As we have noted in various sections in this response, we do not think it is proportionate to create a new consumer facing disclosure document outlining sustainability characteristics. We believe that this information should be included in existing documents – either the KIID or the factsheet. Providing access to an additional document for all funds would also be a significant development cost for platforms. If it is mandatory, a hyperlink is unlikely to suffice and most platforms use pop-ups and require investors to tick that they have read the document.

#### **Distributors and overseas funds**

Section 7.12 in the CP and the corresponding draft rule in Annex D ESG Sourcebook 3.1.15R(2) is proposing that where an overseas product uses sustainability-related terms in its name and marketing, distributors need to put a notice on that product, alerting retail investors that '*this product is based overseas and is not subject to FCA sustainable investment labelling and disclosure requirements.*' It is not clear whether the FCA is expecting distributors to determine whether an overseas fund would meet the proposed labelling requirements. If that is the case, then we would strongly urge the FCA to reconsider as, in practice, it would require, on the part of distributors, an

intimate knowledge of the investment strategy and fund holdings to make this assessment effectively which surely is the sole responsibility of the product manufacturer. Distributors will not want to be responsible for making those judgements.

Furthermore, the above requirement in section 7.12 is also in relation to the marketing of overseas products. While we could support the requirement for the notice to be on funds that include prohibited sustainability-related terms in their name, in the absence of a clearer definition of what constitutes marketing material, we feel it is onerous to expect distributors to be aware of every piece of UK overseas fund providers' marketing material content and suggest this requirement be restricted to overseas fund name only. Overall however, we feel it might be prudent to wait until there is clarity on how SDR will apply to overseas funds in general rather than applying this temporary solution.

Separately, there are also consequent jurisdictional issues that arise in respect of the importing of overseas funds into the UK market where members act as the distributor of funds. If different jurisdictions adopt vastly different reporting standards, this could lead to a plethora of gold-plating requirements and make cross border investment business far more expensive to undertake.



## **CHAPTER 8 – NEXT STEPS (OTHER)**

**Q25: What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?**

Pension products would encounter similar problems to those outlined above in acquiring a specific label. This would be exacerbated by the diversified nature of pension products. For purposes of diversification, these products will likely invest in a range of asset classes and funds, some of which will be sustainable, with the latter group potentially having different labels<sup>6</sup>. Where that is the case, under the FCA's current proposals they would be unlikely to be able to apply a single label to their products given the mutually exclusive nature of the labels. Pension funds are also likely to use index trackers, which for reasons outlined above, may face significant challenges in obtaining a label.

The challenge of applying a label at product level is then made even more complex by the fact that pension products' asset allocation usually changes over time (with the typical approach being to reduce investment risk as the investor gets closer to retirement). As a result, the sustainability characteristics of the pension portfolio may change over time, meaning that any product-level label would need to reflect any such changes. As a result of these two factors, the current proposals imply that there is a possibility of there being no 'sustainable' pension products in the market, which we do not believe would be an optimal outcome.

That being the case, a different approach will be needed in order to apply a label at the product level. Applying a qualifying threshold for the proportion of sustainable assets needed to qualify for a label seems a reasonable approach, which also has the advantage of addressing changes in asset allocation over time, if the assessment is made on a periodic basis (e.g. annually).

However, the label will require more thought, given the ability of pension products to invest in underlying sustainable funds with different labels. Rather than adding additional labels at product level, one approach may be to allow pension products to display multiple fund-level labels, as long as the overall portfolio meets the threshold level. This should also allow for changes in asset allocation to be captured in the labelling as the labels could vary over time if shifting asset allocation demands it.

As to the appropriate threshold for gaining a label (or labels if investing in multiple different types of sustainable fund), any number is arbitrary, but in this case our view is that the best option would be to align with the 70% threshold at fund level, i.e. for a pension product it becomes 70% at the portfolio level, with the threshold test needing to be met on a periodic basis, e.g. annual in order to account for changes in asset allocation and associated sustainability characteristics over time.

Separately, without an overseas fund regime, members could also see significant pressure from UK pension clients seeking labels who may be unable to invest in products distributed into the UK given these funds would not be able to support clients' labelling requirements. There is also a risk of potential pressure from pension clients to classify funds within similar categories to help support

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<sup>6</sup> Pension schemes are likely to invest in a mixture of funds, some of which will be sustainable funds, some non-sustainable. An added complexity is that some of these funds might be offshore and so not in scope of the FCA's labelling rules initially.

labelling unless the FCA allows for a mix of labels to be incorporated into pension products seeking labels.

**Q26: Do you consider the proposed naming and marketing rules set out in Chapter 6 to be appropriate for pension products (subject to a potentially lower threshold of constituent funds qualifying for a label). If not, why? What would be an appropriate threshold for the naming and marketing exemption to apply?**

The issues outlined above in relation to the naming and marketing rules for retail funds regarding the limitations to referring to restricted terms within their marketing publications would equally apply to pension products.

**Q27: Are there challenges or practical considerations that we should take into account in developing a coherent regime for pension products, irrespective of whether they are offered by providers subject to our or DWP's requirements?**

There should be consistency between the regimes applied by the FCA and DWP towards the parts of the pensions market they regulate. This is particularly important with respect to the workplace DC pensions market, where trust and contract-based products are substitutable as far as the end investor is concerned. Many people will have pension entitlements in both types of scheme, further strengthening the need for consistency in the regime between trust and contract-based schemes, to ensure retail customers receive the benefits of a consistent labelling and disclosure regime across all DC pension products.

We are supportive of the approach taken by the FCA with respect to the sequencing of the SDR regime, with requirements for asset managers being consulted on ahead of those for pension schemes. We recommend that this sequencing is maintained when it comes to the timing of final rules being in force. This should allow for a more realistic approach to disclosures by pension schemes in time, recognising that the quality of their SDR disclosures and labels is dependent on the underlying data availability at fund or asset level. This is in contrast to the experience with TCFD reporting, where, as we have previously discussed in our response to the FCA's consultation in that area<sup>7</sup>, the fact that disclosure requirements were put on pension schemes before any rules on asset managers were in force, meant that the quality of disclosures would inevitably be limited in the initial rounds of reporting by the challenges with data availability.

Finally, we highlight the need to distinguish between DB and DC schemes as far as labelling of the pension scheme's portfolio is concerned: a label in DC schemes makes sense because the investment risk is borne by the scheme member, who has the ability to choose investments in line with their own sustainability preferences. This is not the case for DB schemes, where the risk is borne by the scheme sponsor and where members have no role in choosing the scheme's investment strategy. In this case, it is important that DB trustees have access to the information arising from the fund and asset level labelling and sustainability reporting, in order that they can

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<sup>7</sup> IA response to CP21/17. Available to download at <https://www.theia.org/sites/default/files/2021-09/IA%20Final%20Response%20FCA%20CP21-17.pdf>

choose investments in line with their sustainability preferences and beliefs. They can also use this information to make their own portfolio-level sustainability reports. However, we do not think there is the need for a member-facing portfolio level label in this case because the information would not be decision-useful; members do not make any investment decisions. We recognise that this is a matter for the DWP rather than the FCA, but we highlight it here for clarity and consistency.

**Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers i.e. do you foresee any challenges or concerns in making consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports?**

Pension providers would need to provide a look-through of their underlying funds data and therefore will heavily rely on the availability of data/disclosures from the underlying asset managers. We would anticipate the need for technological developments to aggregate the data needed to provide satisfactory consumer facing disclosures.

However, ultimately we believe this question is better answered by pension providers, thinking about how they communicate with their customers, although we note that a number of the points we make about retail-customer facing disclosures in our answers to the questions in Chapter 5 will also be relevant for pension providers.

**Q29: Do you agree that the approach under our TCFD-aligned product-level disclosure rules should not apply to products qualifying for a sustainable investment label and accompanying disclosures? Would it be appropriate to introduce this approach for disclosure of a baseline of sustainability-related metrics for all products in time?**

Yes, we agree with the approach set out here because the SDR disclosures for now do not require the calculation of specific prescribed metrics in the manner of TCFD. This means the disclosures should be relatively less complex for pension providers to implement and so the basis for a de minimis threshold/representative investment profile across multiple strategies is less clear. We agree that it would be worth reviewing this position if the FCA were in future to require the calculation and disclosure of specific sustainability-related metrics on a prescribed basis.

**Q30: What other considerations or practical challenges should we take into account when expanding the labelling and disclosures regime to pension products?**

We think the main factors are the ones set out in our response to question 27. In addition, we would suggest that, were sustainable investment products in future required to calculate specific sustainability metrics in the same way that TCFD does, then a proportionate approach should be taken to the calculation of such metrics, reflecting likely issues in data availability and quality, as well as the evolution of sustainability metrics in the future. These same issues were catered for in TCFD through the inclusion of an 'as far as able' provision and we would recommend the same approach be taken for the future introduction of any sustainability metrics.

**Q31: Would the proposals set out in Chapters 4-7 of this CP be appropriate for other investment products marketed to retail investors such as IBIPs and ETPs. In your response, please include the type of product, challenges with the proposals, and suggest an alternative approach.**

The IA urges the FCA to work to include both IBIPs and ETPs within the regime. The UK unit-linked market is over £1 trillion in size, over 20% larger than the retail market by most estimations. Investors in unit-linked funds tend to be pension savers – they should have the same right to disclosures on the sustainability of their investments as other investors including those domiciled overseas through the overseas funds regime.

Since many unit-linked funds simply ‘wrap’ existing authorised funds, the sustainability characteristics of these products will often mirror those of the underlying wrapped funds and should be able to rely on the SDR disclosures of these underlying funds. Therefore, we do not believe that it would be especially challenging to extend the SDR regime to these products. It would have the benefit of ensuring that customers have consistent access to the sustainability characteristics of the full range of investment products across the retail market.

Once the final rules are in place for SDR we encourage the regulator to include these products within the disclosure and labelling regime and also be subject to the same naming conventions under the proposed marketing rules.