CLIENT ALERT

UK Consultation on Sustainability Disclosure Requirements and Investment Labels[1]

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Background

In October 2021, the UK Government published 'Greening Finance: A roadmap to Sustainable Investing'. That roadmap set out the FCA's[2] plans to introduce disclosure rules for asset managers, certain FCA regulated asset owners, listed issuers and financial advisers, as well as a labelling and classification system for investment products.

In line with the UK Government's commitment to introduce mandatory TCFD[3]-aligned disclosure requirements the FCA has already implemented climate-related disclosure rules for listed issuers and UK authorised asset managers and asset owners which are aligned with TCFD.

As part of the FCA's commitment to the roadmap, the FCA published a discussion paper in 2021 seeking feedback on a potential approach to classifying and labelling investment products based on sustainability characteristics to help consumers, i.e. retail investors, navigate the market for sustainable investment products.

The proposals apply to UK asset managers and portfolio managers in respect of UK authorised and unauthorised funds and investment trusts. There is a general 'anti-greenwashing' rule that will apply to all FCA regulated firms.

The FCA's new proposals build on that discussion paper and set out draft rules. We provide a summary below.

[1] FCA CP22/20 https://www.fca.org.uk/publication/consultation/cp22-20.pdf.

[2] The Financial Conduct Authority ('FCA') is the UK regulator of investment firms, asset managers and others.

[3] Task Force on Climate Related Financial Disclosures.

Overview of proposals

Sustainable investment labels. The FCA is proposing three different classifications of sustainable investment products as set out in the table below.

Sustainable focus	**Sustainable improvers**	**Sustainable impact**
Products with this label must have an objective to invest in assets that meet a credible standard of environmental and/or social sustainability, or that align with a specified environmental and/or social sustainability theme.	Products with this label must have an intention 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. This could include investment in assets in the process of becoming more sustainable. The firm must provide clear and measurable targets in the form of KPIs[4] for improvements in the sustainability profile of assets.	Products with this label must aim to achieve a pre-defined positive, measurable environmental and/or social impact.

A firm is not required to apply a sustainable investment label to their product but if it does choose to apply such a label, it will have to ensure that the product meets qualifying criteria to be set by the FCA for the relevant label. The criteria are designed to ensure that the three categories are mutually exclusive. The FCA intends that such criteria are clear and objective and set a high bar. The FCA does not regard consideration of ESG[5] risks, opportunities and impacts as enough to be a sustainable investment strategy on its own, it considers that is more aligned generally with a firm acting in accordance with its fiduciary duty and general risk management. Likewise, the FCA does not consider an exclusion or negative screening on its own as a strategy to contribute to a positive sustainability outcome and so would not qualify for a sustainable investment label.

The criteria are set out in detail in the draft rules but comprise the following overarching principles covering (1) a sustainability objective expressed in specific and measurable terms with a plausible and credible link to positive

[4] Key Performance Indicators.

[5] Environmental, Social and Governance.

environmental and/or social outcomes; (2) an investment policy and strategy aligned with its objective; (3) rigorous, credible and evidenced-based KPIs, which, in due course, may be informed by standards being developed by the ISSB[6] or other guides such as produced by ICMA[7] and the Climate Financial Risk Forum; (4) resources and governance; and (5) investor stewardship; and a number of key ('cross-cutting') considerations associated with each of these overarching principles. In addition, there are certain category-specific key considerations for each label.

For example, for a fund to use the sustainable focus label, at least 70% of its assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme. The standard must be robust, independently assessed, evidence-based and transparent. For the time being, the FCA is not being prescriptive as to how a firm will demonstrate that credible standard of sustainability. In the future, this may be linked to the UK Green Taxonomy (once developed) or other standards that may emerge.

The FCA says there is no hierarchy between the proposed categories; they are designed to deliver a different profile of investment objectives and assets. In each case, a sustainable investment product must have an explicit environmental and/or social objective which is expressed in specific and measurable terms (alongside any financial/risk return objective).

Where a firm chooses to use one of the labels and meets the relevant criteria, it must notify the FCA that it will use the label within one month. This is merely a notification requirement, the FCA will not 'approve' the use of such a label and a firm must not give investors the impression that the label has been approved for use by the FCA.

Any product which does not use one of these labels must comply with the naming and marketing rules (described below).

Disclosures

The FCA makes clear that the proposed disclosure requirements are a starting point and they may add more detail to the requirements over time—for example as international reporting standards such as the ISSB develop sustainability disclosure standards.

Consumer facing disclosures – this must be a short standalone document for products with or without a sustainable investment label. For products which do not have a sustainable investment label, they must be identified in this document as 'no sustainable label'. There is no prescribed format or template but the document must not exceed two pages of A4 and be presented in a clear and accessible way (for example, on a website). The FCA sets out prescribed topics that the disclosure must cover, including the sustainability objective, its strategy to achieve the objective, other types of investments that may be made outside that strategy and an explanation as to why they might be held, relevant metrics to be used and links to any other disclosures.

[6] International Sustainability Standards Board.

[7] International Capital Markets Association.

Distributors will have responsibilities to ensure that retail investors are provided with this disclosure.

Detailed product level disclosures – these disclosures are intended to provide institutional investors and consumers seeking more information with greater transparency on a product's sustainability objective, strategy and progress towards meeting that objective as well as ongoing performance metrics and contextual information. The FCA has included in the consultation paper guidance as to the content of the disclosures.

- Pre contractual disclosures (e.g. in the fund prospectus), covering details relating to the objective, the investment policy and strategy and the firm's stewardship strategy and resources. Initially, this will only apply to full scope UK AIFMs[8] with products using a sustainability label or with sustainability-related features.

- Sustainability product report – for products that have a sustainable investment label and products without such a label but where the product has sustainability-related features. The report should include details of the products performance against the specified KPIs.

- Entity-level disclosures – a report covering how firms are managing sustainability-related risks and opportunities. This should reflect disclosures based on the TCFD recommendations and must include a statement signed by senior management of the firm confirming the accuracy of the disclosures. Given the TCFD's focus is on climate change, a firm may take account of other international standards for other sustainability elements such as ISSB or SASB[9] sector-specific standards.

The entity-level reports will only apply to the largest UK asset managers (those with £50 billion or more of AUM) from 24 months after the rules come into effect and, for UK asset managers with between £5 billion and 50 billion, 36 months after the rules come into effect.

Naming and marketing

Where an investment product does not qualify for a sustainable investment label, the FCA wants to ensure that a product is not named in a way which could suggest it is sustainable. Accordingly, the FCA is proposing to introduce restrictions around the naming and marketing of products for retail investors.

The first element of this proposal is an 'anti-greenwashing' rule that will apply to all FCA-regulated firms (not just asset managers). Whilst UK firms are already required to ensure that their communications are 'fair, clear and not misleading', there will be a specific rule to link this directly to any sustainability claims—such claims must be proportionate to the sustainability profile of the product.

[8] Alternative investment fund managers.

[9] Sustainability Accounting Standards Board.

The second element proposes a prohibition of terms such as (but not limited to) 'ESG' (or 'environmental', 'social' or 'governance'), 'climate', 'impact', 'sustainable' or 'sustainability', 'responsible', 'green', 'SDG' (sustainable development goals), 'Paris-aligned' or 'net zero' in their product names and in their marketing to retail investors. 'Sustainable Focus' or 'Sustainable Improvers' products shall be prohibited from using the term 'impact' in their naming and marketing. These restrictions will not apply, at least initially, to products only marketed to institutional investors.

Where a distributor is involved in marketing an overseas (i.e. non-UK) product to retail investors in the UK which includes prohibited sustainability-related terms, they will be required to place a notice on the product stating 'This product is based overseas and is not subject to FCA sustainable investment labelling and disclosure requirements.' This is intended to be a temporary approach until the FCA consults on and brings into effect rules relating to overseas products.

Comparison to the EU SFDR[10] and the proposals of the US SEC

The FCA acknowledges that many UK firms are subject to the EU SFDR and will have products that are classified under that regime. The FCA has done a mapping exercise of the UK sustainable investment labels against those in the SFDR. It has also done this against the proposed categories of funds under the SEC[11] proposals.

Given the more detailed qualifying criteria being specified by the FCA for use of sustainable investment labels, it is possible that products which a firm may have classified as article 8 or 9 under SFDR may or may not qualify for a sustainable investment label in the UK. Likewise, a fund which might be categorized as 'Integration', ESG-focused' or Impact' under SEC proposals may not be able to use a sustainable investment label in the UK unless it meets the UK qualifying criteria.

The FCA points out some differences between the disclosure regimes in the EU and that being proposed in the UK. In part, these differences stem from the UK building on the TCFD approach and wanting to be in line with international standards more generally, such as those being developed by the ISSB. Whilst some disclosures are consistent with the EU SFDR, there will be differences. For example, the FCA is not at this stage proposing to require disclosure of principal adverse impacts at the entity level. To reduce the burden on firms they will be able to make their entity level disclosures in a group or affiliate report that includes other sustainability disclosures provided the correct disclosures are included and the cross references are clear.

Unlike the EU SFDR, the FCA is not mandating a prescribed form of template for pre-contractual disclosures and the FCA disclosures do not mirror the EU SFDR's 'Do No Significant Harm' approach for the time being. The FCA will require more

[10] EU Regulation on sustainability-related disclosures in the financial services sector (2019/2088/EU).

[11] The US Securities and Exchange Commission.

granular information to be included in pre-contractual disclosures than under the SFDR, particularly in relation to the investment policy and strategy to provide greater transparency on the firm's asset selection processes and criteria.

Timing and Next Steps

The FCA aims to finalise its rules by the end of June 2023. The general anti-greenwashing rule, which will apply to all UK regulated firms, will come into effect immediately on those rules being published.

The rules relating to the labelling and naming of investment products, consumer-facing disclosures and the more detailed pre-contractual disclosure requirements are expected to apply from 12 months after the rules have been finalized—on the current timetable this would be from July 2024. The rules relating to performance reporting on products will apply 24 months from finalization of the rules—i.e July 2025. The entity-level rules will apply either from July 2025 for large UK asset managers and from July 2026 for those with AUM of between £5 and £50 billion.

The FCA has set out a number of areas where it is considering how to bring other products within the scope of the regime; for example, pension- and insurance-based investment products marketed to retail investors and overseas investment products marketed in the UK. The FCA will consider how to update their product disclosure requirements by reference to the UK Green Taxonomy once it is developed and build on sustainability-related metrics for all products and entity-level disclosures as ISSB sustainability disclosure standards develop.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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