What is SDR?

SDR - the FCA's new 'Sustainability Disclosure Requirements and investment labels' policy statement (PS23/16) was published on 28 November. Julia Dreblow outlines what these changes mean for advisers and clients

The largely principles-based rules aim to address sustainable investment-related market imperfections, mostly relating to the mismatch between client expectations and what funds actually do. These rules differentiate between funds that place significant emphasis on environmental and/or social sustainability issues and opportunities - and funds that integrate them into their processes. Both are covered by the rules, but only the former will be able to adopt sustainability labels – subject to certain requirements, including the need to set out and evidence their positive sustainability aims and intended outcomes.

The rules largely focus on improving communication, ensuring any claims made about sustainability are clear, fair and not misleading - alongside ensuring sustainable fund strategies are oriented towards positive sustainability outcomes.

The scope of SDR is pretty wide as almost any reference to environmental, social or sustainability characteristics will now need to be explained, however, much of SDR is focused on what needs to be done if a retail fund is to adopt one of the new sustainable fund labels.

Although quite specific in some areas, the rules are not generally prescriptive and as such will enable diverse strategies to continue to co-exist. Funds can set their own objectives, inclusion (and exclusion) policies - and it will still be possible, for example, for an FCA-regulated retail sustainability labelled fund to focus on a single aspect of the sustainability puzzle - or to consider all aspects of the delivery of a sustainable, fair and circular economy.

The key elements of SDR are summarised on page 5, with different parts coming into force at different times (p12). In brief, these are:

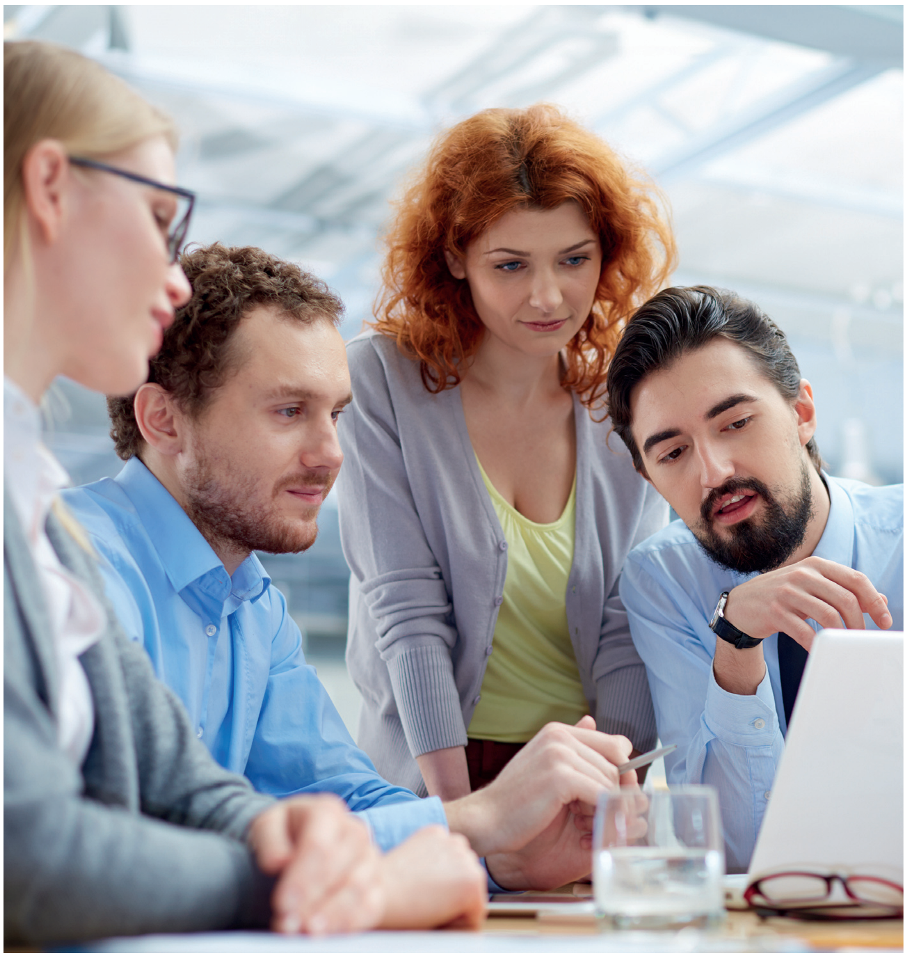
- the anti greenwash rule (31 May 2024)
- four new fund labels for sustainable funds (from 31 July 2024)
- naming and marketing rules (2 December 2024)
- consumer facing information (to accompany labels)
- detailed fund and fund manager information (2 December 2025 & 2026)
- requirements for distributors to publish labels and client disclosures ('as soon as reasonably practicable after [fund management] firms produce them' (p121)

Greenwash

The 'anti-greenwash rule' will be the first aspect of SDR to go live, but like much of this interconnected package, its form will shift somewhat as the additional elements come into force. Its initial purpose will be to reinforce existing rules – notably the need to be 'clear, fair and not misleading'. It will include the new 'naming and marketing' requirements only when they go live.

We are also waiting for further clarity around the anti-greenwash rules as, at time of writing, because the FCA bowed to industry pressure for an additional consultation period. I define greenwash as 'overstating sustainability characteristics for financial gain', but much may hinge on the FCA's final text. We expect additional information soon as the May 2024 deadline is unlikely to change.

The additional **naming and marketing** rules will flow relatively easily from the anti-greenwash concerns because their purpose is much the same. Broadly, any mention of (environmental and/ or social) sustainability related research or activity must be clearly explained and evidenced. For clarity, only



labelled funds will be able to use the three protected terms in their names: 'sustainable', 'sustainability' and 'impact' (p47). Other terms, such as: environment, ESG, responsible and social will remain usable, providing certain requirements are met. (The generic use of terms, for example to describe 'the business environment', is fine.)

Fund labels will be able to be used from 31 July 2024 onwards. The 'final' labels are different from those outlined in the consultation as there is now a fourth label, which will be a big help for portfolio managers. The labels are:

- **Sustainability Impact** – for funds focused on measurable sustainability outcomes
- **Sustainability Improvers** – for funds focused on improving the sustainability credentials of what may be contentious assets - typically through engagement and voting (stewardship) activity
- **Sustainability Focus** – for funds invested in assets that meet their published sustainability criteria. Typically, these will be assets regarded as having higher sustainability standards
- **Sustainability Mixed Goals** – a combination of the above.

These labels are to be accompanied by stand-alone client facing disclosure documents, which must be no longer than the equivalent of two sides of A4. Labelled funds will be required to publish 'positive' Sustainability objectives, a sustainability policy and strategy (which must be able to be evidenced), KPIs (to measure progress), resources and governance arrangements (which must be appropriate to deliver on the fund's objectives) and stewardship strategies (including escalation plans).

Labelled funds will also all be required to have (typically) at least 70% of their assets aligned to their published sustainability objectives - and no assets should conflict with a fund's objectives. While welcome, this combination may prove challenging. Lower risk funds and portfolios that may invest far more than 30% in assets such as unscreened derivatives, sovereigns or cash at present are likely to find this particularly challenging. Such options will need to consider their strategies and communications - and may choose not to adopt sustainability labels.

This makes sense because if a client chose to invest in a sustainable fund they should be able to expect its assets to invest in line with its published sustainability policy. However, the wider context also matters. If we are to reduce investment risk across the board climate risk must always be considered by asset managers - and logically sustainable funds should lead the way in this regard. (I have previously described the Institute of Actuaries and others' concerns about the failings of risk modelling, which continues to overlook potentially catastrophic risks like climate tipping points. See 'Actuaries vs Econs', September 2023). In short – consistency of sustainability strategy makes sense.

Back to SDR

The new rules also require labelled funds to have 'escalation strategies'. In other words, they need to describe how they will deal with assets that do not respond to the manager's stewardship (eg engagement) requests for sustainability-related improvements. However, the rules do not require an asset manager to employ the ultimate sanction of exiting such assets if engagement fails.

I'd encourage caution here because it is hard to imagine a constructive conversation with a concerned client who realises that after many years of engagement an asset's strategy has remained unchanged.

An example could be a company that is involved in illegal deforestation, which continues to be the case after many years of asset manager engagement, or a company that is suspected of having forced labour in its supply chain. The new rules for the 'Improver' label offer some assistance here, as such funds can only 'invest in assets that have the realistic potential to become more sustainable over time', alongside additional requirements. However none of this is easy, and remains to be tested, so I'd encourage all relevant parties to be mindful of the risk of being accused of greenwash.

The other labels also have specific requirements. The 'Impact' labelled funds will be required to articulate a 'theory of change' – essentially their vision of the future (the consultation reference to 'additionality' has been removed). 'Focus' funds will have to show that assets achieve their published 'standard' (ie as set out in fund policy, strategy and criteria), which will probably make these funds easier to understand than the other labels. The 'Mixed Goals' label is likely to be the hardest to explain, as it combines all of the above, but it will undoubtedly be useful for portfolio managers.

There is also some recognition that achieving these standards may be difficult for passive funds, which currently tend to be more ESG risk focused and have lower disclosure standards. The rules are likely to mean that such managers will have to work more closely with their index providers in future – or choose not to use sustainability labels. Chapter 10 of SDR explains further - describing 'in scope' funds which are broadly those the FCA regulates. Pensions are currently out of scope, and offshore funds are subject to further consideration by the Treasury.

The other key elements of SDR relate to additional fund and firm level disclosure requirements. These will come into force over the next two years – and may be linked to existing disclosure documents such as TCFD reports.

So, what next?

The published rules are pretty comprehensive but there are still a few areas that are yet to be finalised. I support this approach as attempting to finalise everything at once would have been risky – as would further delay. This may present challenges on occasions, but essentially the FCA had to start somewhere.

Some of the key additional information we are waiting for relate to greenwash, portfolios, ratings, offshore products and advisers.

Regarding advisers, I can shed a little light here, having been appointed vice chair of the FCA's new industry-led working group 'Advisers' Sustainability Group', alongside Daniel Godfrey (chair) and PIMFA (secretariat).

Our core aim will be to help advisers, planners and wealth managers move forward in this area, in part by identifying what good practice looks like. It is early days. We are currently appointing the members of a core working group, but are keen to hear from others via the PIMFA website.

This area may start to shift quite rapidly once the labelling regime is live, but I'd encourage fund buyers to guard against hasty decision-making. The SDR specifically allows potentially relevant funds to choose not to use the labels and not all funds will be ready to adopt labels in July. My sense is that quite a number of funds may delay making their decisions or decide to stay outside of the regime either temporarily or permanently. Examples could include some ethical funds or themed funds. This possible cohort, alongside funds that are currently out of scope, may be perfectly suited to clients' needs - in line with PROD, Consumer Duty etc - and should be treated as such.

I am delighted that SDR is now live - and confident that both the labels and disclosure requirements will help retail investment professionals and their clients. However, I would advise against decisions being made on the basis of labels alone. Specific fund strategies, whether covered by labels or not, will continue to matter to clients. Much will change this year, but the need to understand both client and fund (and portfolio) strategies will not.

Source
https://www.fca.org.uk/publications/policy-statements/ps23-16-sustainability-disclosure-requirements-investment-labels

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