SRI Services response to CP 22 20 - Sustainability Disclosure Requirements (SDR) and investment labels

Submitted by: Julia Dreblow

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Email to: cp22-20@fca.org.uk

SDR policy
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

I would firstly like to congratuate the FCA on the publication of the SDR consultation paper, which marks an important step in the right direction for the financial services and investment community. It is an excellent framework, that I am delighted to support by far the majority of.

Having specialised in this area for nealy 30 years, and as a DLAG member, it is clear that the FCA have listened carefully - and collated diverse opinions into sensible, workable sensible solutions that will help serve clients better, and aid the acheivement of wider sustainability goals.

This response is primarily to answer the questions, with some additional suggestions.

Suggested improvements include wanting to see a greater emphasis on ensuring clients personal preferences are met, and wanting to ensure that the ever changing realities of investing in this area are realistically represented and catered for. This area is continually evolving, companies, wider regulaton and public opinion constantly changing as we work to raise sustainabiity standards.

Funds, distributors and financial regulators must be able to respond. This includes the need to recognise that there will be crossover between labels, differences of opinions - and imperfection. We need to focous on the reality that every step along the way all investors should be doing all they can to encourage positive change, in their different ways.

Most importantly, the FCA must leave no room for doubt. The risk of not doing enough to improve sustainability standards far outstrips any risk associated with considering sustainability. No regulation should hinder or deter any investor from making or encouraging sustainability related improvements.

Provided the final SDR policy is sufficiently ambitious and adhered to, greenwash allegations will recede. The metrics may be imperfect. Measuring the benefits of collective investments via secondary markets is not straightforward - and it is important we do not exaggerate its value – but it must not be overlooked either. We can be confident that investment decision matter to investee companies - hence their battle to retain dividends in difficult markets and the existence of investor relations departments.

But the core focus must be individual clients. It is not the role of investment professionals to override, manipulate or ignore what clients care about. Investors who are not interested in sustainability have many investment options. This area is for the growing number of people who do not want 'profit at any price'. People are really worried about issues like climate change - and want to see progress being made.

Differences of opinion will always be a feature of this area, but that is no reason to risk misleading clients. Some funds have delighted clients for many years, often by learning from experience, but now this area has expanded so significantly regulation is needed. I would like to thank the FCA for all their hard work in this area, and hope the comments below are received in the spirit they are intended!

Julia Dreblow
Director, SRI Services

QUESTIONS

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?

Yes, these appear sensible. However broadly similar funds/products that are out of scope, but also intended for retail clients should be encouraged to use labels and adopt same 'standards' in order to avoid client confusion and potential forced sales from portfolios.

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

Yes, this appear sensible – although further clarification about the anti-greenwash rule would be welcome.

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.

I am not comfortable commenting on this in detail and suspect that individual business situations will vary significantly, however this questions misses the important, wider context.

> The cost of not responding to sustainability challenges will far outstrip the cost of taking action now. This must be conveyed alongside the benefits of mitigating greenwash related complaints, and a possible mis-selling scandal.

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?

Yes, but with the one caveat that the paper is not sufficiently clear about the need to focus on clients' 'personal preferences' and 'alignment to lifestyle choices' which is at the heart of giving sound advice to clients in this area. This should sit alongside or be part of the 'outcomes' process.

The paper is framed in somewhat technical/analytical terms in some places - which may mean some fund managers continue to rely excessively on institution methodologies - not retail friendly (hence the greenwash problem).

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?

Yes, I think this is excellent, and if we were to 'go live' with the paper as it stands this would mark significant progress, however there are areas that should be clarified in order to move this area forward, protect clients who are already invested, and aid the delivery of better outcomes.

Examples include:

- Focusing more on **meeting clients personal preferences or lifestyle choices as part of the fund's intentions** (focusing on hard to prove 'outcomes' and recognising that some will not be 'justifiable' with data – but are integral to client satisfaction is important. Examples include – meeting the needs of vegans, or those who dislike nuclear, genetic engineering, or mining – all of which are open to debate from a sustainability perspective). We need to bring retail clients' views into the heart of these requirements.

- **Give greater weight to the benefits and legitimacy of (and encourage) exclusions.** Negative exclusion bring clarity and are liked by retail clients (negative screening). Screening works well in retail because it brings clarity and reduces the scope for misunderstandings. Preventing greenwash, in many situations, involves fund managers saying '*No, the fund does not invest in that company*'. It would be very odd if managers are not encouraged to articulate where they will not invest under the new regime, should the fund chose to have exclusions. For context:
    - Many investors of an 'institutional mindset' do not like exclusions (as they increase tracking error) and so think differently from retail clients. Funds focused on engagement often do not dwell on exclusions as they seek alignment to benchmarks. Funds that (rightly) emphasise the 'positive' aspects of their strategies are also often reluctant to emphasise exclusions – as that risks them being framed as 'old school' (and therefore risking reduced inflows from major investors) . All of this is unhelpful in the mass market retail arena where many clients welcome the assurance that areas they dislike will not be held in a fund.

- Make it clear that issues that may be regarded as '**ethical**' (which are often social challenges) - if included should be dealt with equally professionally.

- Make it clear that the FCA understands that strategies will **vary within labels**, and that there will be **crossover in terms of holdings, between different labels**.
    - Fund manager opinions and stock selection decisions will rightly vary. The regulator should make it clear that they are aware that most companies have both good and bad attributes and as such will be viewed differently by different fund managers - and end clients – hence the focus on disclosure. A failure to do this would lead to queries about how companies can be held in funds with different labels.

- Make it clear that no company should be excluded from any sustainable fund for being '**too sustainable'.**

- Make it clear that 'things change over time'. This includes company activities and fund strategies, as well as regulation etc.

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:

Yes, the structure is excellent, but improvements are needed.

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?

The concept is broadly right. Some of the details are however of concern.

The fund examples in the CP do not accurately represent this sector. Although 'themes' are common it should not be viewed as thematic as implied.

The paper does not fully capture what I believe this label should represent – 'funds that require high sustainability standards from companies in order for them to be considered for inclusion'.

Client Aims

The types of people who invest in such funds is also relevant. These are people who want to invest in companies with high standards. They explicitly do not want to invest in companies with poor standards, that are doing significant harm and/or unlikely to succeed in a world where sustainability is taken seriously be regulators and others. These are not 'niche' investors. They will generally recognise that companies may not be perfect and are not entirely focused on impact. But they want to see the world change for the better, and benefit from having exposure to successful solutions companies and being part of 'the transition'. They are firmly 'the mainstream' of sustainable investment.

> This is 'the label' for people who want to invest in demonstrably sustainable assets.
>
> There are **79 OEIC funds** that Fund EcoMarket classifies as 'Sustainably Themed/Focused' that broadly represent the strategy described in the paper. Many are very large and long established.

70% limit

The proposed 70% limit does not work. Theoretically this could allow 30% of the fund to be 'unsustainable' – which would infuriate many clients as it is too lenient (it would be broadly in line with investing in the FTSE 100).

As the proposals stand this would trigger greenwash criticisms. The 30% level must either be reduced or redefined.

At present funds such as these tend to allow 5-10% of investee company turnover to relate to some 'unacceptable' activities. A limit of that kind would be likely to be accepted without generating significant criticism – as long as that proportion is not used to gain access to excluded / unsustainable areas. (For example this amount should not be used to gain exposure to excluded sectors *'in order to ensure the portfolio is better balanced'*).

There may be a (not unprecedented) workable middle ground, allowing relatively neutral assets (opinions will vary), such as cash, to be included purely for liquidity and (predefined) risk management purposes.

Defining neutral assets would however have pros and cons.

A risk would be that allowing 'neutral' (unscreened) assets could disincentivise innovation and progress. Another would be the benefit (perceived or otherwise) to the investee asset. Focusing on the former:

Responsible **cash equivalent funds** have started to be launched recently in response to demand from sustainable fund and portfolio managers. Most clients would probably want their managers to encourage the launch of more funds of this kind – and to invest in them. (Current managers include RLAM and BlackRock). Demand for progress of this kind is unlikely to stop, but ideally it should be encouraged.

Property is similar. Sustainable funds are not the only drivers, but demand for 'greener properties' - that can fit into sustainable portfolios - has helped drive investor activity. Some property funds are now held in sustainable funds and portfolios marketed as sustainable or ethical (eg LGIM). **Green Bonds** are another example.

If we are to achieve the enormous shifts that will be needed in order to achieve Net Zero investors need to be encouraging (incentivising) progress and innovation of this kind, engaging for change and *rewarding* assets with investment.

Gilts are more complex. Client views on gilts are often highly polarised. There is no consensus – and none should not be sought. Some people focus on the positives (education, health, infrastructure etc) others focus on areas they dislike (eg defence, imperfections in systems / environmental failings etc).

Transparency is the primary answer to this. We need to ensure clients are properly informed.

Not all 'sovereigns' are equal. There are also independent sources that fund managers could use to decide which gilts (or similar) they would view as allowable – such as the Freedom House index.

Independent assessment

Only **6** of those funds (which are typically the leading edge of this area) tell us they employ an **external committee that has the power to veto** where the fund invests.

It is unclear why this group has a requirement to be 'independently assessed' (Draft Handbook text 3.2.6 (2)). Independent assessment should logically apply to all of the labels – or none. All are important.

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?

This label works well and are clearly very different.

The following clarifications may help further.

- The rules should make it clear that no company should be expelled from a portfolio for improving its sustainability standards ('meeting sustainability objectives'). No asset should be too sustainable for any of the labels.
    - There appear to be fears that companies should be dropped if they meet objectives and that this could force sales.
- The regulation should make it clear that standards must increase over time and objectives should reflect this.
    - Eg for a fund that currently 'requires companies to have a carbon transition plan' or 'has Paris aligned targets' – there should be an expectation that the bar will be raised in order to ensure the sustainable funds demonstrate leadership above and beyond BAU.
- Rules need to make it clear that in order to qualify for this label, managers need to demonstrate an understanding of sustainability problems. (Naïve expectations must be dealt with). Eg:
    - No manager operating in this area should think a company 'has become sustainable' because a single simple measure has been achieved.
- Convey to clients that fund characteristics will vary.
    - Asset characteristics within and between funds will be different.
- Convey to clients that the reality is that most company operations are far from being sustainable. Sugar coating and greenwash go hand in hand.
- Indicate what proportion of the fund is required to meet the 'improver' criteria – if such levels are set for other labels.

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?

This label is proving problematic. The FCA needs to decide if it is intended to be used by 'regular retail clients' or not. Some options are:

- A label that focuses on "additionality" - the impact of the fund entity - and so only allow typically high risk, illiquid, direct investments, where 'additionality' is clearly demonstrated.
    - The **advantage** of this could be a greater emphasis on and visibility of the benefits of direct investment – which is undoubtedly needed.
    - The **downsides** to this would be that few regular retail clients would able to invest (as the are would be too high risk). Most of today's intermediaries would probably stay away (potentially because of PI issues), and funds that are marketed as 'impact' today would probably not be able to use that term in future (which would adversely effect their prospect of commercial success and the focus on impact in retail markets.) There are also potential misselling risk as clients who are looking for impact options could be drawn into less well regulated (and typically inappropriate) products.

- or:

- A label that will focus will be on the positive impacts delivered by the assets held in the fund, most of which will be listed on secondary markets.
    - These funds would hold listed shares, bonds etc (not direct investments). The direct benefits (additionality) for such investments would be hard to prove. The benefit an individual fund delivers by allocating capital to a specific listed company is notoriously hard to prove however collectively, as a market, it is clear that a failure to consider sustainability issues sufficiently across markets has failed to incentivise higher sustainability as investors have been largely indifferent until recently. And although there is greater emphasis on this now – investors are still generally not very discerning.
    - For this strategy 'additionality' should be removed and the intentions of the fund would remain to support companies that are driving real world change (solutions / theory of change etc).
    - Managers would be directed to focus on assets that deliver positive impact and environmental and or social solutions.
    - Measurement should remain a key feature of this area, but with caution. Funds should not be producing potentially misleading or out of context data, but should be expected to 'push the boundary' of what can be measured as part of improving the management of sustainability issues.

My suggestion is the latter. It is beneficial to put solutions and real-world impacts under the spotlight. However this must be carefully explained, and direct investment in solutions should also be encouraged.

The FCA must also convey that impact labelled funds are **not the only way investors can help to deliver positive real world impacts**. All sustainable funds have important roles to play in this (as does the inaction of other investors).

This calls into question the appropriateness of the term 'impact' for a single category, descriptions such as 'focused on listed solutions companies and other assets' may be more technically appropriate – but would not be workable for a retail label. 'Impact led' or 'Impact focus' might work. Maybe switch all labels to the word 'focus'.

Other impact related areas to consider:

- The impact related labelling requirements must be fiercely positive – with assets expected to deliver positive impacts and not deliver negative impacts. There should be an expectation that funds can prove this.
    - Thresholds such as '50% + of turnover relating directly to solving environmental and social challenges' should be expected. ('Solutions' would probably then need some metrics to ensure it this is not 'gamed'.)
    - Other useful metrics could include: R&D budgets (approaching 100% should be solutions focused), executive remuneration / incentives etc should be factored in.
- There should be an expectation that large and mega cap assets will be underrepresented relative to other funds, however we should be careful of unintended consequences. (It would be nonsense to exclude Orsted or Tesla because of their size.)
- Any surprise holdings should be listed / reported on regularly.
- The secondary markets / indirect nature of funds' 'impact' and should be articulated.
- The proportion of the fund that is required to meet the 'impact' criteria should be set – if such levels are set for other labels.
- Make it clear the bar should rise over time.

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

Yes, rewarding desirable practices with labels should be the focus of this work.

However, if markets continue to fail clients with an interest in sustainability (as evidenced by market research), or continue to fail to focus on major systemic threats (such as net zero), negative labels and sustainability risk warnings should be introduced.

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

- whether the criteria strike the right balance between principles and prescription
- the different components to the criteria (including the implementing guidance in Appendix 2)
- whether they sufficiently delineate the different label categories, and;
- whether terms such as 'assets' are understood in this context?

PAGE 46 [Q slightly unclear]

The qualifying criteria work very well as does the important balance you have struck between 'principles vs prescription' – however I have further suggestions.

> **Setting the scene:** I would suggest putting greater emphasis on the fact these requirements are primarily intended for retail clients and not institutions or trustees. As such they must be focus on market failings in retail markets, not elsewhere.
>
> The emphasis must be on 'how information is received by end clients', not the views of those promoting products to such clients.
>
> It is therefore useful to consider how funds work that have been successful in retail markets for many years and have dealt with client queries well (ie not attracted significant criticism).
>
> The following comments are made in the context of the above:

Comments on principles:

<u>Principle 1 – Sustainability objectives</u>

a. Objectives should reflect the sustainability related **'aims'** of the fund, its **'purpose'** - and point to **'what the fund does' and 'is for' -** and specifically, **'where the fund does and does not invest'.**
    a. This is not easy to summarise in a few sentences, but fund managers should be steered away from misinterpreting the term 'measurable' as meaning they should use often complex metrics - which are unlikely to make sense to end clients (and therefore tend to result in greenwash criticisms).
        i. An overreliance on metrics and methodologies that mean nothing to most clients fuels greenwash concerns.

b. Fund managers should be encouraged to place greater emphasis on clear **positive and negative screens (exclusions) in or alongside fund objectives** – as they are easier for clients to understand than metrics. Exclusions in particular bring essential clarity. **(**Nothing is more important to retail sustainable fund clients than where funds will and will not invest). Exclusions in particular make mapping to client's personal preferences far easier. 'The content of **Appendix 2**, Non Handbook Guidance: implementing guidance - Investment Policy and Strategy paragraph 7, point c, is important.

b. Linked to the above – The paper should make reference to **'lifestyle' or 'personal preferences'** – which do not currently appear in the document.

This is a problem because alignment to (real life) lifestyle choices are a major driver of client interest in this area. We need to guard against being overly academic – as most clients are not. (Funds' ability to drive change and deliver real world, measurable benefits are secondary considerations for many retail clients -although on probing most would probably want and expect the two to be linked.)

Funds should be encouraged to focus more on the following:

- Plain English – industry metrics are 'a means to an end', not the reason why people invest in these funds
- Understanding and reflecting how funds align to personal preferences and lifestyle decisions
- Real world 'actual/specific' sustainability issues rather than metrics
- Explaining how complexities are dealt with
- Explaining why any controversial stocks are considered acceptable/held
- Explain the 'direction of travel'.

Appendix 2, Sustainable Objective 1.c - includes an unnecessary **performance caveat**. '*potential financial trade-offs that may arise'* is also problematic should be reworded as 'variations in performance may arise', if deemed necessary.

The text used in the paper has negative implications and sends the wrong signal.

Fear of underperformance is deeply entrenched in the retail intermediary market but is based more on myths than reality. The reality is that many different factors drive performance and at any point in time different strategies will be in or out of favour.

It is more important that we emphasis **why sustainability issues must be considered by investors** ie because if we do not take sustainability seriously **markets will fail**, cities, and lives will be lost.

So, although the mechanisms for measuring successes and failures in this area are imperfect (still evolving - probably always will be) there is no doubt that **financial markets have a role to play** in making change possible and averting man made catastrophes. We also know companies pay dividends to attract and retain investors. No company wants to see a shareholder exodus.

Given the role of government (protecting their people) and financial regulators (protecting investors) this message must be made crystal clear.

Whilst we all want investments to be properly measured and managed spending too long perfecting analysis plays to the strengths of those looking to delay the necessary changes. Focusing on personal preferences, lifestyle choices, exclusion and screening criteria is imperfect, but it works. Objectives should reflect this.

Principle 2 – Investment Policy and Strategy

Excellent, however the way this is worded could be interpreted as maintaining current practices as it does not dig deeply enough into fund differences (terms like: design, measure, monitor etc need to be extended to explicitly require sustainability information).

This section should include more explicit reference to sustainability information.

Specifically, a sustainable fund policy should explicitly:

- Set out the sustainability (and other related) issues the fund strategy focuses on – or 'also considers'. (Strategies vary, some consider all relevant issues and evolve constantly, others have a single or multiple themes, some focus on one issue as measured by a single metric.)
- Say how the fund deals with different sustainability issues – broadly – avoid, support and/or engage. And for each – set out the criteria for inclusion/exclusion, required sustainability attributes (for inclusion or exclusion eg % turnover relating to specific products or services, rating / score.)
- Say how the fund views (balances) diverse positive and negative company characteristics
- Say how the fund will deal with different scenarios as they arise, for example accidents, pollution incident, failure to meet specific targets, supply chain scandal
- Set out what would trigger activities such as engagement, a vote against management, the sale of an asset (escalation strategy) – from a sustainability perspective.
- Explain the sustainability research and data points used by the managers and how that is combined with financial metrics (eg in a process chart)

Brief, binary 'will/will not' or 'invest only in companies that do…' statements should be viewed with caution as investee companies are complex, multifaceted and dynamic (eg 'things happen'). Text must represent reality, and be caveated where necessary.

Regulation must take account of 'real life' complexities, and expect policies to explain how issues are blended together and what the manager will do when realities might differ from what a brief objective implies. Fund policies and related disclosures should make this readily auditable.

- Policies should set out '**review processes'** for both assets and the policies. (Add to 4.56, bullet 5).

- Policies should set out what is allowable for both assets that are assessed/screened on a sustainability basis and any assets which are not – eg cash.

Principle 3 - KPIs

The information set out is very good, however use of the term '**evidence-based'** (4.57) is potentially problematic in retail as it is used for marketing purposes by some companies. Intermediaries are familiar with this and have mixed responses. (Suggest 'able to be evidenced')

- Collecting 'data' (which may or may not be relevant or useful in a sustainability context) is not the same as 'evidence' (which can be highly subjective) but the two are often conflated.

The core focus must therefore be transparency of processes, metrics, responsibilities, holdings / where the fund invests, engagement and voting activity – and a focus on proving that a fund does as is claimed.

It would be better to say '…credible, publicly available KPIs that can be evidenced, verified and proven'.

If applicable, funds should include as part of their KPIs statements that certain areas/ activities/ behaviours have been excluded, eg 'the fund did not invest in fossil fuel majors' .

Independent verification of this would be desirable but not necessary.

Listing holdings eg 3-6 months in arrears would generally suffice, although sources such as eg Thomson Reuters could be used to provide evidence of achievement of KPIs.

> See examples of policies in leading, established, mainstream sustainable funds with primarily retail clients.

The regulatory structure that sets out requirements for **'Sustainable Improver'** funds must not implicitly disincentivise the achievement of sustainability goals – the interpretation by some that success will force the sale of an asset because sustainability goals have been met.

> The FCA must make it clear that 'improvement is a good thing' and that no fund should be penalised or force to sell an asset because it achieves its sustainability objectives. **No asset should be sold from any sustainable fund for being 'too sustainable'.**

'Sustainable Improver' KPIs (and policies) must encourage **continual improvement**, setting new, more stretching or different additional targets for investee companies over time - and make it clear that managers will not be expected to sell a holding because the manager has 'helped the company to improve'.

> There appears to be a fear in some circles that funds which identify as 'Improvers' may need to change labels or sell stocks in order to retain that label. It should be made clear that whilst funds might choose to change labels on occasions, improvement targets may shift over time and that the regulator would welcome fund managers 'raising the bar'.

Ongoing alignment/continual improvement should be a central aim/purpose of these funds (raising the bar). Funds should articulate that raising the bar for aims, objectives and, or KPIs will be ongoing..

> For example, a company that has reduced carbon emissions should be encouraged to also reduce methane emissions (and other GHGs). If assets, for example, completely decarbonises within 5 years they may sensibly be encouraged by an asset manager to 'improve' land or sea based biodiversity related practices (moving from contributing to

degradation to facilitating regeneration) – or new areas that are under the spotlight at that time.

Possible fund text might read: 'the fund's sustainability policy currently focuses on reducing carbon emissions (using the following metrics…), however this may evolve over time as the aim of this fund is to encourage the transition to more sustainable lifestyles.'

The concepts of 'continual improvement' and 'not forcing asset sales on achievement of investee company improvement goals' are important clarifications for 'improvers'.

Principle 4 – Resources and governance

This is excellent, but could usefully be more 'retail friendly' in places – eg 'cross cutting' . This could lead to misunderstandings and greenwash allegations. Some clients like to know who is doing what.

Finding ways to make this clearer for end investors is essential for gaining trust.

4.62 should add 'company and other **asset level** research, in addition to 'data and analytic research'. The **assets a fund holds** are the most important aspect of this market for clients.

Principle 5 – Stewardship

All good.

• whether the criteria strike the right balance between principles and prescription

Yes they appear to strike a very good balance.

There may be (unhelpful) requests for more prescriptive rules from those who do not understand the diversity and continual evolution of the area. Additional guidance would help such companies.

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

Yes, in line with comments made previously, there should be **greater emphasis on the client's perspective**, factors client will understand and be comfortable with - such as alignment to their **lifestyles / personal preferences**. Drawing out the ways in which these can be met eg with **screening** would be useful and is efficient.

• whether they sufficiently delineate the different label categories, and;

This is not a helpful question or concept.

The rules should not be seeking to delineate too specifically between different labels – or put clear water between them. Doing so would be unhelpful.

The rules should focus on highlighting **the 'primary' (core) approach taken by a fund**. It would be nonsensical if a manager felt they ought not do too much engagement because they were not running an 'improver fund' – or for a fund to decide not to invest in 'solutions'

because it is an 'improver' or 'focus' fund. (Beware unintended consequences. We need all investors to do a lot more of each – such activity should never be discouraged).

The rules should make it absolutely clear that there will be **cross over between the groups as well as differences within the groups**.

Erecting false boundaries could cause problems for some of the best run funds that employ a complex range of strategies – eg those holding companies with sound sustainability practices, including solutions companies – and also engaging - often extensively - when issues arise. If their strategies were forced to change no one would benefit, and any big shifts could lead to misselling complaints.

The regulations must also make it clear that the FCA understands the realities of managing real companies - **no company is perfect**, or static, things change over time (both societal views and company behaviours), client needs vary and opinions differ.

Disclosure rules are designed to draw this out and ensure clients are not misled.

> **Eg Microsoft** could easily be held within any of the three labels. They claim to be carbon negative, but use off setting. Some managers may focus on them being carbon negative (saying they are sustainable and/or having a positive impact), others will focus on them using offsets (saying they need to shift away from offsetting and reduce absolute emissions to zero.) Both are technically correct – and there will be clients who agree with both.
> Trying to iron out what are essentially 'difference of opinion' would be a fools game. The rules must allow for variations in interpretation (within reason) - and focus on core strategies being made clear to clients.

• whether terms such as 'assets' are understood in this context?
I would expect an investor to know what an asset is.

Interested clients understand sustainability better than they understand finance.

We also can not expect clients to understand or trust tools, metrics, indices or measurement methods that are financial industry constructs as they are not part of their everyday lives or other lifestyle decisions. These must be minimised in client materials. Metrics such as this focus on 'how' an issue or outcome is dealt with or achieved – not 'what' the issue or outcome is. Clients focus on 'issues' (ie what funds consider) as sustainability issues are part of our every day lives now. The means by which they are addressed are financial services specific, and therefore raise more queries and concerns – hence the benefit of simplicity.

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Q9: Do you agree with the category specific criteria for:
• The 'Sustainable focus' category, including the 70% threshold?

The concept is right, the detail needs refining.

The threshold for potentially 'unsustainable' assets is too high.

This is the label that most established sustainable funds will fall in to.

Most people who invest in these funds do so because they care about sustainability and want to only invest in companies (or other assets) that are considered to be 'sustainable' (opinions, strategies and definitions vary). The purpose of these funds is therefore largely to invest in assets their clients will be happy with, although in addition many will be focusing on reshaping the future also.

Defining a category of this kind that allows up to 30% of its assets to not meet stated sustainability criteria will not work (although I would not expect existing funds to drop their standards.) This kind of 'tolerance level' would also be difficult for intermediaries – as clients either want to invest in sustainable assets – or they don't. (Those who are not overly bothered or are focused on pushing for change - engagement - would opt for the 'Improver' label).

Asset managers running funds within this label should therefore be aiming for all assets to either have met the funds sustainability criteria or be demonstrably neutral.

Managers of funds that have significant exposure to assets that are not demonstrably sustainable (that wish to use a sustainable label) should be working to encourage higher sustainability standards and therefore use the 'improver' label – or they may prefer not to use a label.

There are two grey areas that where compromise is 'tried and tested':

- Many funds of this kind allow a 5-10% de-minimus (tolerance) or 'undesirable' activities for investee companies where 'on balance' the asset is deemed positive / sustainable. The purpose of this is to ' not let perfection be the enemy of the good'. (Some activities eg weapons manufacture, generally trigger automatic exclusions). The percentage figure typically relates to turnover.
- investing in assets such as cash (or cash equivalents) that are regarded as neutral is widely accepted – provided it is used for liquidity and / or risk management purposes. Assets that are regarded as acceptable on that basis vary between funds.

Suggestions:

- I am aware some funds are more flexible than this, but as appoint of principle I would not recommend the SDR lowers the bar. People who want to invest in funds of this kind would be likely to have few alternatives, whereas funds that struggle to achieve sufficiently high standards could adopt the Improver label .
- Guidance should make it clear that the FCA expects sustainable fund managers to encourage and support innovation and higher sustainability standards. As such any sustainable fund manager should be expected (all other factors being equal) to favour investing in sustainable alternatives Eg sustainability aware cash equivalent funds instead of standard cash funds, green bonds in lieu of standard bonds/gilts, properties that have high GRESB ratings in lieu of standard property investments etc. (Exceptions may make sense for 'Improvers' if there is a legitimate chase for engagement).
    - It is often said that gilts cannot be screened. Whilst standard gilts where assets are not ringfenced for named projects are problematic, it is still possible to create a hierarchy of issuers (eg using Freedom House).
    - Similarly, other diversifiers / issuers – banks, development programs etc. They are not all 'equal' and can sensibly be 'rated'.

- Where no sustainable option is available assets should be explained in the 'surprise holdings' disclosures.
- The implications for portfolios must be considered.
- The FCA should periodically review neutral assets in order to understand relevant market failures (why is this 'need' not being met?) - and work to help increase innovation / remove barriers. Asset specific challenges should be considered.
- Given the ever changing nature of business and sustainability engagement (stewardship) must be regarded as central to this kind of fund strategy also. All companies are better at some things than others.

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

Yes, broadly, but it may be worth adding in that this is not a static relationship. Resources designed to support funds are often later adopted across fund groups (eg white phosphorous, global norms.)

For the avoidance of doubt, the following should be emphasised for this group:

- strategies should be expected to vary and evolve. (Some funds in this area are over 30 years old. The core 'purpose' of those funds may not have changed, specific metrics set in 1990 would look dated now).
- encourage fund managers to understand that the relationship between funds and asset management entities varies and may evolve (ie changes should not be held back by regulatory concerns)
- assets held in these funds may sensibly be held within funds with **other labels** (opinions and strategies vary.)
- managers will not be expected to sell assets because an named sustainability objective has been met. **No asset should be sold for being 'too sustainable'**. The manager would however be expected to continue to raise the bar.
- **escalation strategies and potential exit plans** are crucial for this group
- controversial holdings must be explained and regularly reviewed (in part to support intermediaries who may not be well placed to deal with client queries).
- Achievement of specific objectives will be welcomed but should be viewed in context
- Voting records should be published in full and available alongside information on these funds

• The 'Sustainable impact' category, including expectations around the measurement of the product's environmental or social impact?

There is a lot to unpick here.

'Background' considerations include:

- whether the term 'impact' primarily relates to the fund management company/entity **or** the assets held within a fund.
- How to ensure the label 'impact' does not imply superiority as delivering a sustainable future requires a range of actions, notably driving change amongst polluters – (hence the need for the 'focus' and 'improver' labels).
- Whether or not we wish to indicate that positive impact can only be delivered through underserved markets – or smaller companies - as this is not the case
- When and whether to use the term/concept 'additionality' in this context (suggest remove and replace with eg purpose, intentions etc – keep it 'client friendly')

To move forward with this label we should be looking to break this down into its component parts and focus on language that can be used with clients and intermediaries.

Eg the area currently referred to as 'impact' has two core strands:

- Investing directly into individual, typically illiquid assets often via specialist platforms
  - Benefits - environmental and social benefits are clear and often relatively easy to measure.
  - Downsides – not generally packaged for 'regular' retail clients (better for wealthier clients)
- Investing in listed entities (mostly shares and bonds) via collective investment funds
  - Benefits - raises profile of and helps direct capital towards 'solutions companies' that are delivering significant environmental and, or social benefits.
  - Downsides – positive impacts not directly attributable to investment manager – which makes measurement difficult.

The way the CP is worded means many of today's impact funds may not be able to use the impact label.

There are different ways this could be addressed. Probably the easiest is to remove references to additionality - as delivering additionality via secondary markets is notoriously difficult and probably not what clients are looking for through stop. Clients mostly care about where funds actually invest.

The removal of additionality does however bring potential risks as less committed or less well informed investors may contravene the spirit of the label, which is in part why references to 'theory of change' are welcome.

And whilst the label is intended to be positively focused, there would be an expectation that assets in a fund of this side would have minimal or no significant downsides. Options for dealing with this include screening (ideally explicit, potentially implicit) or adoption DNSH ethos.

Suggestions – below is a suggestion for how the 'Key distinguishing features' text (CP p37) may be improved:

- **Sustainability objective.** Alongside its financial risk return objective a sustainable impact products will have an objective ~~to achieve a~~ *that focuses on the delivery of* (predefined?) positive and measurable environmental and or social impact.
- **Primary channel for sustainability outcomes**. This category of product would pursue its sustainability goals by directing ~~typically new~~ capital to ~~projects and activities~~ *company and assets* that ~~offer~~ *focus primarily on the delivery of* solutions to environmental and social problems, ~~including often in underserved markets or to address observed market failures.~~ Products would be expected to have a stated theory of change and to pursue a highly selective asset selection strategy based on that theory of change.
- **Secondary channel for sustainability outcomes**. Driving continuous improvements in the sustainability performance of assets through investor stewardship activities would be a secondary channel.

Please consider whether there any other important aspects that we should consider adding.

See appendix.

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?

Yes. Although theoretically desirable independent verification should be optional.

This should remain the case until there is a functioning competitive verification market (a monopoly would be undesirable) or clear, auditable standards.

Although there are challenges around rating systems (not least, when they are poorly explained or verging on monopolistic) third party opinions should probably be encouraged in part to balance financial opinions/ ratings etc and help distributors. The core purpose of such reviews must be to 'aid the transition to a sustainable future' and 'help meet client's needs better'.

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?

Yes, but there are issues that might need further consideration, such as:

- 'Progress towards objective' is problematic. Funds are generally trying to help deliver a sustainable future and their role in it is hard to quantify sensibly. (And there are many issues beyond their control – companies are not only impacted by investors.)
  - Fund managers typically invest in 40-70 companies if active – or far more if passive. Many run broad based (multi themed) funds that will potentially be considering hundreds of issues, focusing on different risks and opportunities for different companies and situations (and geographies).
  - Investee company progress will vary significantly (can this sensibly be 'compounded' without the risk of misleading clients?)
  - investors may choose have a rolling schedule of engagement programme – and success is rarely rapid.
  - 'Focus' funds will find this particularly challenging as they will typically be dealing with issues as they occur. Depending on the situation they may engage or divest. 'Progress toward' does not really work in this situation. (Their 'focus' is to meet clients preferences and expectations.)

- Some suggestions:
  - Ongoing reports should be allowed to focus on different areas at different times – ideally giving **examples of successes, failures and work in progress**.
  - Consider amending this section to '**Alignment to objectives'**. Suggest this being brief - confirmation that objectives were aligned to, progress on KPIs, and information on any misalignment, and direction of travel.

- Non sustainable fund disclosures could usefully be introduced later sustainable fund labels – to avoid overloading managers.

- The success of this - in terms of getting the right information to end clients, so that the area will continue to expand - will hinge significantly on intermediaries and distributors.

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?

Overall, yes. Alignment of reporting (and other) methodologies is highly desirable wherever possible.

However, many initiatives are **still evolving, new**, or relatively untested, so relevant caveats and flexibility is welcome.

There is no reason to expect this to change any time soon - 'doors must be kept open'.

With '**continual improvement'** in mind, regulators must recognise that there will always be leaders and laggards.

So whilst regulators (worldwide) should aim to accelerate change amongst late adopters, they must be careful not to disincentivise innovation amongst leaders – who's practices may become 'tomorrows new normal'. (More established sustainable fund providers have generally dealt with more issues and challenges than others).

Of the 303 OEIC funds currently listed on Fund EcoMarket approximately 110 predate 2016 – when the Paris Agreement started to impact fund design.

See: https://www.sriservices.co.uk/about-sri/learn-from-our-partners/ for example publications.

Additional considerations:

- Funds that need to make significant changes in order to comply with new rules would be likely to trigger **client reviews** for intermediaries – which will have cost implications.
- Disclosures must be honest about complexities and imperfections.
- It would be helpful if when 'TCFD methodology' is **searched online** the relevant area of the TCFD website appeared high in rankings. (Dated / confirming if current or not.)
- ISSB is still at an **early stage**. Its aims are most welcome. It is necessary, and the UK should use it, but it may be forced to move at the speed of the slowest adopter, so should only be regarded as 'part of the desired solution'. The SDR is different -and appears more advanced.
    - If the UK is to become the **world's first net zero** financial centre, it will have to go further and move faster than international agreements (whilst of course contributing and supporting necessary international progress).

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?

Yes.

The 'reasonable consumer' concept is also most welcome – meaning someone who is interested in sustainability.

- It is important to ensure rules cater for eg a financial **adviser** who may be advising a climate scientist –links etc.

In 5.50 – principle 2, bullet 1. The text implies the investment strategy and sustainability policies are separate, with the use of the word 'align', often they are not – ideally the two should be fully integrated. The current wording may be open to criticism.

> Amend to read '[investment strategy] integrated into or aligned with [policy] …'.

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?

A mandated template would risk stifling innovation and would be unlikely to work for all current and future strategies.

> My expectation is that multiple organisations are likely to want to do this once the rules are finalised – this should be encouraged.

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

Broadly excellent, but a few comments:

Principles 3 (KPI's) and 4 (Resources and Governance) are not listed on pages 60/61. Although these are not formally part of product level disclosures. I would encourage them to be referenced in such disclosure, pointing readers to where they are disclosed. Clients should know what the fund is specifically aiming to achieve (KPIs) and how it is run.

5.47 says non sustainability labelled funds that consider sustainability should disclose what they do in their precontractual information. This could disincentivise the consideration of sustainability issues (across all assets). Some fund managers may struggle with evidencing, reporting or describing activities accurately. Further clarity should be given to what is meant by 'in a proportionate manner'.

> It may be useful to define options, such as 'considers', 'may consider', 'integrates', 'aligns' – and focus on requiring a summary of the likely extent to which sustainability is likely to drive stock selection, engagement and disposal decisions.
>
> The need to shift **all investments** to higher sustainability standards must factored in.

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.

Yes, subject to comments made above.

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?

Yes, but with two suggestions:

- We need to remember that retail clients do not look or ask for sustainable investment information. They generally don't know it exists or what to look, or ask for. Don't expect them to look for information unprompted.
- Sustainability information should be presented within or alongside existing core information to ensure it is 'available to all'. Separate microsites add clicks and therefore reduce 'traffic'. We must aim for / move towards full integration of information – if/where sustainability is truly integral to investment strategies.

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.

Yes, this appears very sensible, but please emphasise the need for 'user friendliness' - and brevity. The focus should be information that directly relates to real world sustainability – not industry constructs.

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?

Yes, broadly, but this is still early stage and as such not embedded in this industry yet.

We should work towards standardisation - with care.

- Need to avoid unnecessary costs whilst this settles down.
- Market dynamics. I believe the proposed rules cover this, but it is important that innovation in this area and 'being ahead of the curve' is recognised, understood, and able to be rewarded (in order to encourage further innovation). As such the rules should:
  - Allow sufficient time for managers who have developed their own methodologies (sometimes at significant cost), to adapt their processes. It is important to ensure their efforts are not penalised and be aware that some managers are expert, have operated in this area for decades and may have processes that are more advanced/sophisticated than eg ISSB – which relies on consensus. They have sold their funds accordingly and any shift may have implications for clients.
  - Support but not favour new/er entrants who will be able to adopt any new rules more easily as processes and communications will not need to be revised.

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

Yes, the anti-greenwash rule is a welcome and important element of this paper. Having an explicit anti-greenwashing rule is necessary.

The FCA should not underestimate the difficulties this may cause some companies as sustainability dynamics are poorly understood by many. Some will be poorly placed to recognise their own greenwash, many will need additional guidance.

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?

Yes, in principle. The product naming rules and prohibited terms are welcome and important but will need clarifying.

Much of this may be covered by the 'factual information' proposal (6.15, p75), but this is important and needs to come through in the rules, so here are some thoughts:

We are collectively in a period of 'transition', which means the considerations of sustainability issues (and therefore these terms) is increasingly becoming business as usual, and this must be encouraged for 'the greater good' - alongside specific client needs.

- The ideal long-term aim would be to no longer need labels - as all products focus on sustainability. (Although strategies would still need to be explained.) We must encourage everyone to be part of that process.
- Many of the terms listed are common language so would be difficult to monitor or own.
    - **Use of common terms.** The rules need to make allowance for terms that are in common use. The rules should make it clear that there is an expectation for managers to err on the side of caution, and that the overriding principle is ''clear, fair and not misleading'.
    - The following should be acceptable, eg 'the manager looks for *sustainable* income flows / dividends…'; 'our HR team is *responsible* for agreeing remuneration...', 'the war in Ukraine has had a negative *impact* on returns'.
    - The following should be unacceptable if employed without further explanation (as ambiguous): 'we invest in this company because it's strategy is sustainable', 'Our management team ensures all investments are responsible'. 'ESG is part of our DNA'.
- The terms identified are '**very now'** – many are new.
    - Assuming that process continues the list would need to be very different in just a few years time.
- **Encouraging across the board progress without misleading clients**. It is important to ensure that these rules do not disincentivise 'regular' investments from factoring ESG considerations and explaining to clients that they do so. Regulators (globally) need to encourage the mainstreaming of these issues – which is already happening. (10 years ago few funds integrated ESG, now many asset managers do so across the board.)
    - This will require something of a balancing act. The 'realistic' representation of ESG and sustainability activity is difficult to dictate as experience varies.
    - Similarly – the Stewardship Code, TCFD / net zero targets and other existing or future initiatives will require the use of these words.
- **Labelled funds.** Labelled funds will and should be encouraged to be as positive and impactful as possible and aim to improve every company they invest in. There should therefore be no restrictions on the use of terminology within specific labels, the rule should be the **'true and fair representation'** of what a fund does. Fund strategies will cross over into other labels territories, and that should be expected (situations change).
    - The focus must be on aiming for all funds to help deliver sustainability improvements – without misleading anyone.

A way forward?

- **Disclosure**. Fund managers should spell out the extent to which ESG, sustainability etc has impacted their stock selection decisions and engagement. Perhaps in entity level reports -

12 monthly. Attempting to represent this with precise measurements would be meaningless (eg as these will be a small element of the many factors managers consider), however managers could give a qualitative assessment, with examples of stocks avoided/ excluded / not invested in for ESG / sustainability reasons.

- **Rewording suggestion**
  - (See p23 Annex D, 3.3.2, (2 & 3) – possibly amend to: *"Use of the following terms is protected. Sustainability labelled products may use these terms in line with their label and disclosed strategy. Firms must not use these terms for unlabelled products unless their use is clear, fair and not misleading."*
  - *Use of these terms by labelled products must be proportionate to strategy and explained in disclosures.*
  - *This list of protected words will be updated periodically.*

Additional thoughts:

- Out of scope funds could cause (probably unavoidable) challenges for intermediaries and clients.
- Distributors situation will be complicated in part as led by what fund managers do, also because they will sell both in and out of scope products.

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

Broadly, but not specifically agree.

6.12 text runs contrary to the broader need to embed sustainability into all investment strategies and the reality that most funds may not adopt labels. See points made above regarding the complexity of issues, the realities of investment, crossover and variations within and between labels.

The focus must be "clear, fair and not misleading", with 'protection' being less prescriptive (eg guidance?).

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

Yes, the FCA should build on what we know about how clients think and what drives decision making as identified in research and found in other product areas. Aspects such as 'alignment to lifestyle choices' – particularly in client facing materials - will cut away the need for complexity that clients will not understand - and reduce greenwash risk.

Additional thoughts include:

- Avoiding 'too many clicks' for accessing sustainability reports.

- Considering of Paris Alignment is sufficient reason to qualify for a label (given that that is a commitment agreed to by most countries) . Is it a point of differentiation from BAU given the UK climate goals?

- Steer away from SDG washing – the way mapping to SDGs is used when assets are not demonstrably focussed on delivering a sustainable future. (Focus on where reference to SDGs may be interpreted as window dressing).

- Use of imagery, icons and colour to indicate green credentials that are not borne out by strategies.

- Marketing headers and urls – managers may benefit from assurance that shortened summaries are acceptable. (ESG risk mitigation oriented options and labelled sustainable funds are likely to be on the same area of websites.)

- Encouraging realistic, grounded and unambiguous marketing relating to where funds invest – discuss the balancing of pros and cons (both via data driven and active funds), explaining that real companies are imperfect and constantly changing etc.

- Disclosure of fund holdings to be strongly encouraged (required?). Clients care more about where funds invest than anything else.

- Encouraging the publication of links to relevant primary data sources as a means of addressing greenwash (eg regulatory requirements, IPCC reports, UN agreements and norms)
- Context. Avoid self-congratulatory mis-messaging given that collectively we are failing to meet targets. Encourage everyone to be humble - realistic.

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

There is nothing in this section that I disagree with (given my current understanding).

However that there is additional work to be done in this area.

- **Financial Advisers.** The paper notes that additional work (consultation) will be carried out relating to financial advisers. That makes sense, however it should be made clear when the new rules are published that advisers (and other client facing 'channels') are expected to understand this area, its aims and its mechanisms. They must be equipped to understand and explain what the labels mean and where to go for additional information.
- **Platforms.** This will be a significant piece of work for platforms also. Concerns include:
  - Where will the labels come from? (Information is not normally direct from funds – should obligations include other service providers?)
  - Should platforms offer links to support materials – if so where, how?
  - Should processes differ between B2B and D2C platforms?
  - Why would additional labels not be allowed? Will that help or hinder client understanding? (From a financial perspective funds typically display a range of ratings/accreditations / 'labels' etc eg here .
    - I understand that the SDR labels should be positioned as 'the UK regulatory regime' (ie more visible), but doubt excluding eg SDFR labels would benefit anyone. Similarly – I do not believe including our SRI Styles, Morningstar ratings or any other 'opinion' should be blocked – providing they are explained properly.
  - Links to consumer facing information for non-sustainable options could be introduced after the SDR sustainable fund labelling requirements to avoid unnecessary cost.

- **Portfolio managers as distributors and service providers – via a platform**. I am unclear on who will have to do what if an MPS is sold by an adviser or selling direct to a client.
    - **Investment chain complexities** – a client may be dealing with an adviser who recommends an MPS (or two) both of which invest in ten different funds (with multiple labels) – and the investment is made via a fund platform.
    - In the scenario above, how would the proposed rules help the client or address greenwash risks?
        - The answer may be for the adviser to be required to provide links to all funds held in the portfolios, which in practice would be managed by the Platform. (There are presumably parallels in other product areas?)

- Kindly search 'intermediary' and 'distributor' for other comments about this area, and Appendix.

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?

Regulators should be aiming for as much alignment as possible – both nationally and internationally.

ISAs and Pension funds are often used interchangeably in the UK. Clients (and their advisers) should be able to compare them easily, if labels are used in one area but not the other this could influence buying decisions (potentially adversely).

In most instances unit linked retail pension funds invest via OEICs or have OEIC equivalent funds, so deciding which label would apply to a pension fund would generally be straightforward for the fund manager.

Personal pension products should be allowed / encouraged to align to FCA rules – perhaps initially on a voluntary basis.

Pension schemes should probably be dealt with separately, with a view to arriving at the same end point.

Additional points:

- Sustainability is more important for longer term products such as pensions than other product types.
- Focus on the point at which a decision is made for the individual investor
- Yes – fund level focus is appropriate with regard to this paper
- Products that cater for client journeys eg lifestyling – have been proven deeply flawed recently (and cost many clients a great deal of money), but they are not inherently problematic in this context. It exists already – eg Aegon.
- Sustainable fund strategies are not inherently equity only, higher risk or fixed in any other part of the market. There is no reason why 'sustainable lifestyling' is not possible. Different selection criteria may apply, policies and strategies may be / are slightly different (eg a focus on supranational with positive attributes and screened banks, or ringfenced loanstock - rather than unscreened gilts – but the principle is the same.)

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 same principles must apply to both areas – although a 'transition' period may be needed. A failure to deliver consistency will confuse clients.

The labels and disclosures should be identical.

Pensions do not need lower thresholds.

> To indicate that lower thresholds may be needed is to indicate the FCA may think or feat that higher sustainability standards to lead to (or potentially lead to) underperformance, which is worrying.
>
> This is out of line with the purpose of this paper - but not unusual.
>
> Performance is multifaceted, making predictions is impossible, and asset types, geographic regions, sectors etc have stronger and weaker periods – hence the benefit of portfolios.
>
> All other factors being equal poor sustainability standards (and the mismanagement of ESG factors) are more likely to lead to underperformance – particularly over the term of a pension product - as the drive to higher sustainability standards and net zero over progresses.
>
> However, given the design of the proposed labels, and the reality that almost all asset group and types will have more 'sustainable constituents' and 'less sustainable constituents' (which should be made clear) – the need for concern is minimised.
>
> The bigger 'macro' risk is the failure to consider sustainability sufficiently – which investors can help address.
>
>> Regulators should not risk future criticism from clients who find themselves in a fund with a lower sustainability standards because they selected the 'wrong' product type.

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 rules or DWP's requirements?

This is a big subject (that I have also previously been involved with). DB schemes present different challenges – and the DWP has already done much good work in this area.

The principles are broadly the same however. We need to swiftly achieve net zero (the UK should be looking to lead and has expressed an interest in doing so). Investors need to be part of the solution for the delivery of a sustainable future to secure the future of humankind – and as we progress through the current transition phase part of what will drive financial returns will be corporate (and other) responses to sustainability risks and opportunities.

Alignment of all areas of the pensions and investment market would be helpful to clients, help demystify investment and reduce greenwash criticisms.

That is not however the same as saying all products will invest identically. They will not and must not. Asset mixes will vary. The high level structure of this paper and the labelling regimes can cope with this, providing those involved understand the intersection between sustainability and investment sufficiently well.

In considering greater alignment with the DWP the FCA should also consider the role of intermediaries in that market. Advisers, trustees, consultancies etc have not always been helpful. Advice and investment fund selection decisions do not always match corporate statements.

Industry constraints and culture are major challenges. There has also been a tendency to focus on engagement as a legitimate strategy in order to avoid making investment decisions that may impact tracking error. Such decisions are ill informed.

Generalising is dangerous, but engagement has not always proven its worth and tracking error is no guide to future performance. The use of tilts etc have had the effect of largely maintaining the status quo, which coupled with the use of complex financial instruments and jargon are likely to have undermined client/member engagement and satisfaction.

> This is not a new problem. The 'Fair Pensions' project was set up in the early 2000's has grown significantly and been renamed ShareAction. Other groups have joined them, such as Make My Money Matter.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie 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?

I would want to research this further before making firm recommendations, but in many regards, pensions are ahead of 'investments' in this area - so major show stoppers are unlikely (beyond workload).

In general:

- Member engagement is likely to be problematic.
- When members do become engaged the results can be surprising.
- Members should be encouraged to make informed choices and align to other lifestyle choices wherever possible
- The role of trustees, intermediaries, trusted advisers etc is important and likely to be problematic. (Culture can be an issue).
- Platforms must also be part of the solution.
- Alignment should be sought wherever possible.
- Member should be given information on labels in the same way as other product types - where allowable.
- Focusing on default funds is important.
- Schemes should be able to label and promote funds with sustainable labels similarly to other retail areas.
- Normal investment rules (always) apply but eg a DB scheme with more outflows than inflows should still be run prudently. Some riskier asset types may be inappropriate– but in most cases sustainable alternatives will be available. (There is no theoretical reason why eg

annuities cannot be run more sustainably – there are green(er) gilts, bonds, cash equivalents etc). (Think 'supply and demand').

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?

I am not sure I fully understand the question (or how it maps to the preceding text), but would be happy to discuss further.

The basic TCFD structure is sound and should be made use of where possible.

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

I would encourage voluntary adoption of pension labelling.

Fund options snapshot:

- The unitised pension fund market is not significantly different from OEICs
- Our Fund EcoMarket database lists 270 pension funds with sustainability, ESG, ethical options – including strategies we refer to as ESG Plus and Sustainability Tilted.
- This drops to 203 funds if you exclude 'Sustainability Tilt' or being ESG Plus'.
- 102 of these 'aim to deliver positive impacts / outcomes'.
- 63 of these 'invest 50% or more in environmental or social solutions companies'.
- This list is due to be updated shortly and is almost certainly an underestimate in part as we do not list all date targeted options (which are largely duplicated and information is available from the same source).
- Lifestyling options exist but are shown as a single fund.

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.

If the core focus of this proposed policy is to ensure clients are not misled, address greenwash, and ultimately help achieve net zero, and higher sustainability standards, yes consistency is essential.

Clients and intermediaries will find it very difficult if products are excluded from the regime – particular if they may be held in the same portfolio or range of portfolio options.

- From a retail client's perspective, they are all simply 'investments'. Clients typically do not understand investment products (although HNW's, particularly those with free time, may have a better understanding of tax status/wrappers).
- Wealth should not however be used as an indicator of interest in sustainability. (Such measures - including age, sex etc tend to be fraught with risk if relied upon too significantly.)
- Exchange traded funds and life products (and any other areas that are commonly head by retail clients) should be included as soon as possible for that reason.

- Encouraging alignment will significantly help portfolio planners, DFMs, platforms etc.
- These areas should generally be able to move forward faster than the pensions market, in part as they are would not need employer involvement.
- Forced sales should be avoided where possible.

APPENDIX

1. Overview
2. Meeting clients needs better
    a. Lifestyle
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1. Overview

The backdrop to this paper is that despite many decades of concern about environmental and social failures, and some notable successes (such as ozone depletion, acid rain and reducing poverty in China) there are many aspects of sustainability where we are failing.

If our standards of living are to be maintained, we must transition to what is loosely referred to as a 'sustainable future'. The precise role investors will play in this is not clear cut, particularly in secondary markets - but we can be confident that investors are all part of the solution.

Retail investors are at the intersection of 'public opinion' and the need to generate profit. Their opinions are naturally varied. Some are motivated almost entirely by profit, but that number is dwindling. Some will have been drawn to sustainable investment and ESG because they believe it represents an opportunity to gain financially. Although relevant and important, in part because of their growing numbers, these people should not be regarded as the core focus of this paper.

This paper should emphasise the protection of people who are drawn to sustainable investment *because* it focuses on sustainability. These are people who understand that business as usual cannot continue and want to help accelerate the transition to a sustainable future in any way they can, however complex and imperfect.

Their views vary, as do their financial needs. Some are fearful, others are more bullish. But broadly they want to invest in decent companies and not be shocked by where funds invest. Greenwash is borne of the mismatch between expectation and reality – and if we are to tackle this head on their preferences and expectations must run through every sinew of the way we operate.

The SDR must be based on 'radical honesty'. We must not pretend everyone will be happy with every strategy all of the time. They won't be. We can however help people find funds that suit their

point of view, their lifestyle choices – and help nudge (or push) – companies to move in the right direction. The nuances this points to are the realities sustainable investors face – and why principles work better than prescription here. Facing new challenges and opportunities is normal here.

Much of requires thinking differently. Regulators need to make it clear to all that the world will be different in future, because how we lead our lives today cannot be sustained.

The following are some suggestions regarding how this might work:

2. Meeting clients' needs better

a. Lifestyle & personal preferences

The paper makes no reference to lifestyle choices or personal preferences.

Although understandable, as that is not how investment professionals tend to think, these drive what many sustainable investment clients are looking for so must not be ignored.

Focusing on lifestyle choices and personal preferences is one of the most transparent and popular way to run funds in this area possible and should be higher profile in SDR.

b. Ethics

This area grew out of the area known as 'ethical investment' - and is still called that by many in retail markets.

Many investment professionals dislike the term 'ethical' – but many retail clients like it.

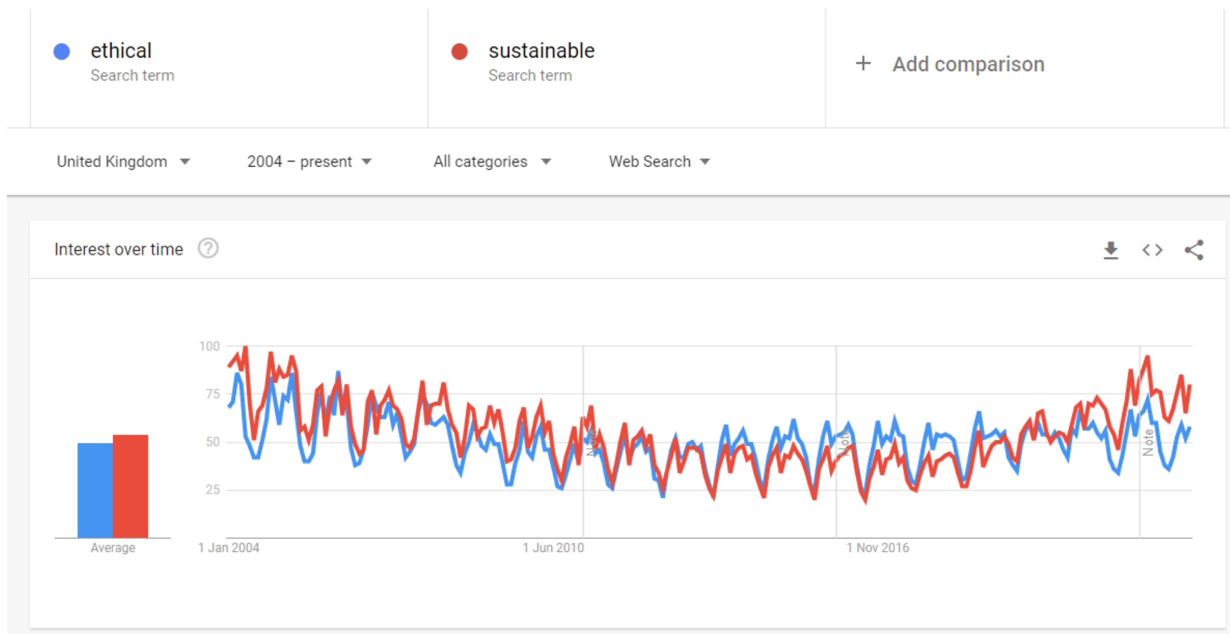
In reality there is much crossover between 'ethics' and 'sustainability'. Many ethical issues can be reclassified as 'social issues' (and not long ago environmental issues were regarded as 'ethical' concerns also.)

It would not make sense to focus heavily on every known ethical issue in SDR. Most ethical issues are not existential threats. However if a fund considers 'ethical values' they should be considered and explained as professionally as other issues. Were claims are made, related activity (KPIs etc) should be disclosed to ensure clients are not misled.

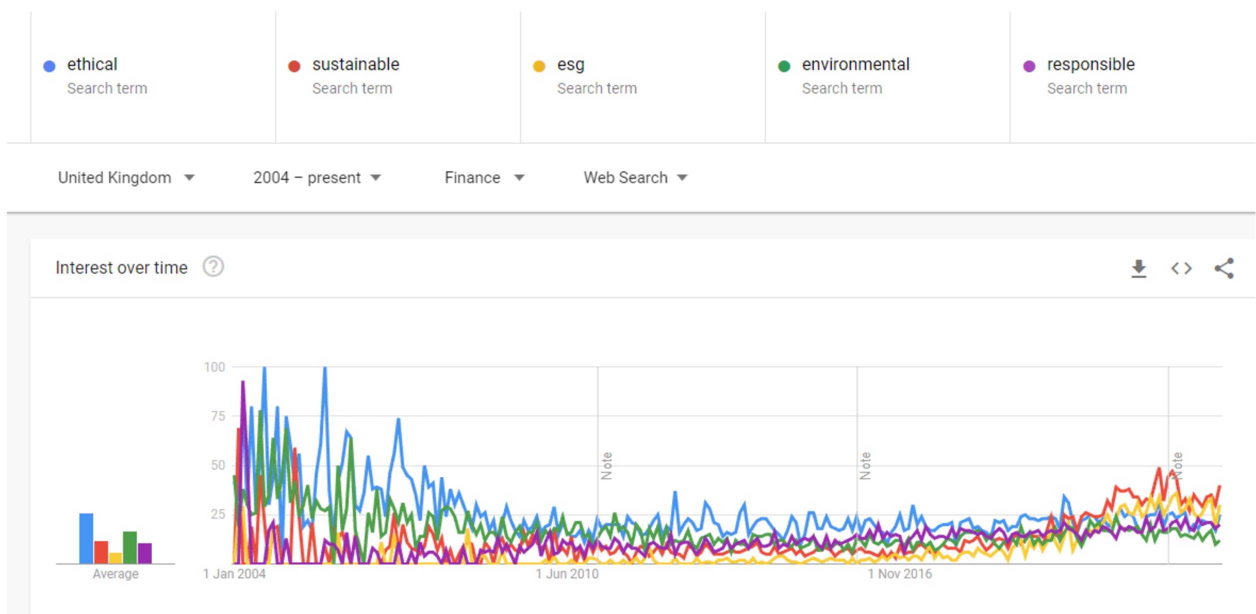
Use of the term 'ethical'

'Google Trends' indicates across 'all categories' public searches with the word 'ethical' have been relatively consistent for many years, although the term 'ethical' was overtaken by 'sustainable' in 2019 (covid related?). (Searches for both dip July).

> [The grey lines indicates when Google revised their methodology, so focusing on relative performance at specific points in time is probably more useful than the longer term trend.]



'Google Trends' indicates that in 'finance' category searches use of the term 'ethical' is not significantly different from other keywords – although 'sustainable' and 'ESG' have taken the lead since May 2020.



c. Screening

The SDR should give greater profile to the usefulness of 'screening' in retail markets – particularly negative screening.

There are elements of the CP that appear to be influenced by the institutional market's dislike of exclusions, which does not translate across to retail. Individual investors tend to like clarity. Greenwash problems have emerged since more opaque, complex products have become popular.

> It is easy to get into largely philosophical debates about what strategy is better for the planet or financial performance – however the core principle is that there is no good reason for knowingly directing someone's investment into areas they dislike.

To explain further:

1. **Clients like exclusions because they are easy to understand**. They bring greater clarity than other methodologies.

    They can easily be mapped to personal preferences and lifestyle choices, so selecting a fund that is 'appropriate' from an ethical/sustainable/ESG perspective is made easier.

    The simplicity can also bring cost benefits both for research and reporting.

2. **Positive and negative screens are two sides of the same coin**.
   The way screens are presented is often more about market 'trends' than anything more profound. Many fund managers want to position their funds as being more positive and so use different descriptions from funds that emphasise negative exclusions, but the output is often very similar.

    Eg; 'Excluding companies that generate less than 50% of their revenue from environmental solutions' gives you the same starting point as 'Invests only in companies that generate 50% or more of their revenue from environmental solutions.'

3. **Most retail sustainable funds use negative screening of some form.**
Most retail sustainable funds today employ a combination of approaches. Exclusions are often the starting point for asset level research and filtering. They help strip out assets that will not meet the intended selection criteria.

3. Labels, greenwash risks, complexity and progress

Some further thoughts include:

- The SDR must make the diverse and dynamic nature of this area clearer. Things change constantly both in sustainability – and in companies.
- Making it clear that differences of opinion exist amongst investors - as they do amongst members of the public. There should not be an expectation of alignment within labels.
- Making it clear that no fund is 'perfect'. We are a long way living in a circular economy. Recognising imperfections is important (and the first step to addressing them). For example the shift to EVs is putting significant pressure on countries (people and nature) where resources are mined. However EVs are widely supported as a step in the right direction. Some funds also exclude mining stocks.
- Bring uniformity to high level labelling and disclosure requirements where possible. Strategies will vary but eg if external verification is needed for one group it should be needed for all groups. Similarly governance structures, tolerance limits and disclosure requirements should aligned where possible.
- Focus on principles not prescription - because things change. The words that will need to be protected will change.

- Don't underestimate the challenges that are ahead of us. Managers should be encouraged to be ambitious and think broadly.

4. Framing performance

It is clear that this is not the intention of the paper, however there are occasions where performance references could be misinterpreted by those who disagree with investing sustainably.

> The FCA must make it clear that meeting net zero and addressing sustainability challenges is in every one's best interest (both financially and more generally) – and that the failure to do so would ultimately lead to financial collapse.

The wording of some of the text eg '….expected impact on the financial returns' is particularly sensitive in the intermediary market where client and adviser views may differ.

Considering sustainability does not make investments inherently higher risk, and therefore likely to underperform. 'Performance impacts' will result from market conditions at particular points in time, as they do in any area. The SDR must make this clear.

Fear of underperformance can lead clients to be directed away from sustainable options. When this happens, clients being directed towards (so called) 'safer' options that have lower tracking error ie where investment variations are minimised), which is often **out of line with what a client wants.**

This is particularly problematic **for retail investors** as most invest for the **longer term**, often on an '**invest and forget'** basis (particularly if less wealthy).

This should be flagged within the SDR and specifically addressed within the future intermediary work.

Relevant text: 5.38, 5.50 and draft regs client disclosures section 4.4.2 (4) a. (Text refers ambiguously to "Expected impact on financial return").

5. Portfolios

The paper would benefit from additional clarity for portfolios.

My original interpretation was that portfolios will need to have 90% of their assets in a single sustainability label in order to be use a sustainable label.

> I understand that that is not the intention as portfolios will be able to use the term 'sustainable' if they have a mixture of labels. The 90% rule applies to the use of specific 'labels'.

However, this leads to the question of whether there are **three - or four - labels**? And, so, if a portfolio can have a combination of labels and call itself 'sustainable' (which is eminently sensible), could other funds do the same? Ie. Should there be a general 'sustainable' label? Many funds currently combine different approaches. (The paper's thesis is sensible – but could open a can of worms.)

Further questions include – is 90% too onerous? Should there be a 'neutral' asset exemption – eg cash and other diversifiers, sovereigns, alternative investments, futures?

Would it be preferable to say all options should be demonstrably in line with label requirements ('sustainable'), or 'neutral' (within a predefined set of characteristics – ideally principles based)?

I suggest:

- The FCA should consult with specialists / experts in sustainable portfolio management to understand what would be both stretching and acceptable to clients with a genuine interest in sustainability. There may be related areas of regulation that need to be reviewed in order for this to work.
- 'Surprise holdings' disclosures will be very helpful but may take time to settle – particularly for portfolios.
- Fund managers should be instructed to support portfolio managers with this additional support – eg potentially contentious holdings information. Portfolio managers should be helped and encouraged to be 'on the front foot'.
- Managers should make every effort to invest in 'sustainable' diversifiers when managing risk and liquidity, and publish what they do. (Keeping in mind that innovation is unlikely to occur without demand). As with individual labelled funds, managers should seek the best possible compromises – such as using the Freedom House register for sovereigns – to identify investments in countries with typically have higher social standards that are more likely to be aligned to the needs of sustainable investment clients. Also - green bonds etc.

6 Constant evolution and the need for change

SDR must take into account and reflect the fact that this area is not static. Change is constant. Much needs to change.

> Areas, such as KPIs, labelling criteria, and protected terms (marketing) must clearly reflect the need to respond to changing circumstances – as we collectively shift, companies adapt/change strategies (grow, shrink etc) - and new measurements become possible or evolve.

Historically this area has reinvented itself every few years.

The regulatory framework and specific requirements need to be able to cope with this.

My view is that the structure of this paper will cope, some of the detail may not. This means the focus on primarily employing 'principles' - pointing to what needs to happen - is valuable.