



FCA – SUSTAINABILITY DISCLOSURE REQUIREMENTS (SDR) AND INVESTMENT LABELS

This is Third Generation Environmentalism (E3G)'s response to the consultation from the Financial Conduct Authority (FCA) on designing the Sustainable Disclosure Requirements (SDR) and Investment Labels, closing on 7th January 2022.

E3G is pleased to provide feedback on the FCA's proposals on introducing Sustainable Disclosure Requirements and Investment Labels for asset managers and certain FCA-regulated asset owners. These interventions are being developed following the commitments made in HM Government's 'Greening Finance: A Roadmap to Sustainable Investing Roadmap' published in October 2021. The FCA aims to introduce these tools to build trust in the market, increase transparency and meet the informational needs of institutional investors.

In recent years there has been an increase in the quantity and diversity of sustainable financial products offered to consumers. Without common standards, clear terminology and accessible product classification and labelling, however, there is a risk that consumers will be confused or misled by ESG-related product claims. This could lead to a lack of trust in the market in relation to sustainable investment products. Through this consultation the FCA seeks to inform the development of the following products:

- > Sustainable Investment Labels
- > Consumer-facing disclosure for investment products
- > Client- and consumer-facing entity-and product-level disclosure by asset managers and FCA-regulated asset owners.



Overview

The UK has committed to creating a world-leading net zero financial system which mobilises finance at scale to support the wider systemic change required for decarbonisation – creating a sustainable, global net zero financial centre.

E3G is pleased to see the FCA consult on the development of the Sustainable Disclosure Requirements (SDR) regime and investment labels. These tools will enhance disclosure of climate and sustainability related information, adding transparency and risk information which are needed to support a market-led transition. Furthermore, E3G supports embedding transition plans within SDR disclosure to ensure that firms across the economy have a science-based plan for net zero alignment. The delivery of the SDR and investment labels will be important to ensure a coherent net zero finance system which provides clarity and detailed information on firms' financial activity.

To promote standardisation and clarity, E3G recommends that the SDR and investment labels scheme align with the UK green taxonomy as soon as possible. This is because the UK green taxonomy will be in a position to provide the gold-standard, science-based definition on what economic activities, and thus investments, can be considered green.

E3G encourages the UK Government to support the development of common international disclosure standards through forums such as the IFRS Foundation's International Sustainability Standards Board (ISSB).

Outline

Our consultation response is focused on the following 12 questions provided in the discussion paper. A short summary of our response to each of these is outlined below.

Question 1 – We agree with the proposed tiered approach to distinguish the different categories and informational contents of product labels, consumer-facing disclosures, and product- and entity-level disclosures. There should be alignment of the categories with the upcoming UK Green Taxonomy tool to provide clarity and consistency as to which investments are compatible with the UK's net zero and resilience targets.

Question 2 – We agree with the FCA's proposal to include real economy companies, listed issuers, asset managers and asset owners within the scope of requirements for labels and disclosures. E3G proposes that firms below the £5 billion threshold to voluntary disclosure with eventual mandatory disclosure overtime.

Question 4 – E3G recommends that the labelling classification categories are aligned with the definitions provided by the UK Green Taxonomy.



Question 9 – The classification of ‘Responsible’ investment labels should align with the EU SFDR Article 6, which categorises products that don’t include sustainability characteristics as ‘not promoted as sustainable.’ Further detail should be provided for the definition of a ‘Responsible’ to prevent multiple interpretations of this definition. The categories of labels should be aligned with a science-based UK Green Taxonomy framework to ensure a climate change alignment with a 1.5-degree pathway and prevent greenwashing.

Question 12 – The role of derivatives should be supported by the FCA by better disclosure rules; and guidance from stock exchanges and finance firms will likely update market prices to better reflect climate change risks. Derivatives can be used to support the transition because they facilitate transparency, help firms hedge risks and enable the UK to raise and channel the necessary capital towards sustainable investment.

Question 13 – The disclosure requirements under the SDR should build off the TCFD’s existing structure and include new guidance for transition plans. The disclosure regime should demonstrate whether and how net zero transition plans are being developed by market participants. The UK should seek to make the SDR regime consistent with the disclosure regulations of the EU SFDR to assist the competitiveness of UK firms.

Question 14 – E3G supports the FCA’s suggested content for inclusion in consumer-facing disclosures and supports the development of a baseline level of prescription, and a high-level ‘ESG factsheet’ to be the appropriate method for providing supplementary information. The consumer-facing disclosures should be backed by science and is eventually captured within the UK Green Taxonomy framework.

Question 15 – E3G supports coherence of product-level disclosure with the EU SFDR’s approach, which could strengthen the consistency between the EU and UK disclosure regimes and foster a balanced approach to materiality within the UK SDR. Further, E3G proposes that product level information should contain detail on how investors address adverse impacts through their stewardship and engagement.

Question 16 – Entity-level sustainability-related disclosures should align with the EU SFDR, to reduce regulatory confusion amongst UK firms operating in the EU and to integrate balanced materiality considerations. E3G proposes that net zero transition plans should be included within entity-level disclosure for firms operating both at national and international jurisdictions.

Question 17 – The FCA should look to engage with the forthcoming ISSB standard to ensure international interoperability of standards to ensure alignment of the SDR with requirements in the EU and other jurisdictions. The FCA should collaborate closely with counterparts in different jurisdictions to support international alignment of standards and requirements. Further overseas funds operated by UK firms should be captured through entity- and product-level reporting requirements, within the SDR disclosures.

Question 18 – E3G recommends the FCA to apply the principles of the SDR and investment labels scheme to trading activities related to the London Stock Exchange (LSE).



Question 19 - Third-party verification will be important in ensuring that disclosures made under the proposed SDR regime are credible and robust. The FCA can push for mandatory verification requirements for market participants

Consultation Response

Question 1. What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.

- > E3G supports the proposed tiered approach to distinguish the different categories and informational contents of product labels, consumer-facing disclosures, and product- and-entity-level disclosures. Having a tiered structure could provide consumers and institutional investors with the appropriate levels of clear informational needs and in practice reduce confusion and complexity of climate and sustainability information. E3G recommends that clear definitions are applied to product labels on a system-wide basis to clarify what is and what is not a green financial product, and to drive consistency across tiers. The new UK Green Taxonomy is the tool which should be used to provide clarity as to which investments are compatible with the UK's net zero and resilience targets. A consistent approach will help leverage private finance for sustainable investments and to support new net zero markets.
- > It will be important that the information provided at each level of disclosure tier is consistent, and that the overall framework provides differentiated levels of detail between tiers.

Question 2. Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of products than for others, please provide examples.

- > We agree with the FCA's proposal to include real economy companies, including listed issuers, asset managers and asset owners in the scope of requirements for labels and disclosures. We would encourage the FCA to work closely with stakeholders subject to SDR disclosures to develop methodologies. To further ensure consistency across the economy there will be a need for sustainable labels to also be applied to public investments, to support transparency across both public and private finance.
- > The FCA should also encourage smaller firms that are below the £5 billion threshold to disclose on a voluntary basis - with a view to this becoming mandatory over a longer timeline - and provide resources to help them on their disclosure journey.

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- > E3G proposes that the SDR regime is used to prevent carbon leakage by including within the scope of companies subject to product-level requirements those overseas funds which are operating in the EU and marketing their investments to the UK. This will maintain disclosure consistency between UK- and-EU-based asset managers.

Question 4. Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.

- > We recommend that the different labelling classification categories are aligned with the definitions to be provided by the UK Green Taxonomy. The FCA should reduce the risk of greenwashing by setting out clear objectives and well-defined categories from the starting point that provide clear detail and information about which products can and cannot be included at each category of labelling and classification.
- > Further comments on alignment with the SFDR are provided in our response to Question 9 below.

Question 9. What are your views on potential criteria for ‘Responsible’ investment products?

- > E3G proposes that further detail is provided for the criteria defining a “responsible” investment, as the currently broad definition may lead to multiple interpretations. At the same time, we support the principle of market choice and note that for some consumers “responsible” may refer to some very specific aspect of investment, e.g., the avoidance of investments in the arms industry, and that such options should remain available in the market. The definition of “responsible” can therefore potentially remain relatively flexible. However, the integrity of the “sustainability” label should be protected, should encompass a range of sustainability criteria, and should remain science-based.
- > E3G proposes that the classification of responsible product labels is aligned with that of the EU SFDR Article 6, which categorises products that don’t include sustainability characteristics as ‘not promoted as sustainable’. It is important to highlight that the terms “responsible” and “sustainable” have been used fairly interchangeably to date within the market, and broader society, and therefore that in articulating the sustainability factors the difference between “responsible” and the tiers of “sustainable” will be vital, particularly in the case of consumer-facing products.
- > The criteria for investment products classified as “sustainable” should (for environmental aspects) be aligned with a science-based UK Green Taxonomy framework. Elements relating to climate change should be aligned with a 1.5 degree pathway. In this context E3G will be separately recommending to HMT that the UK avoids replicating the approach to taxonomy

currently being proposed (although not yet agreed) by the EU in a new Delegated Act which will potentially give a ‘green’ label to nuclear power and power generated by fossil gas. We recommend that the UK maintains a science-based approach and treats these activities as ‘not promoted as sustainable’. Replicating the proposed EU course of action would create additional complexity for disclosures, not least because according to the EU’s proposed scheme a further category of activities would need to be disclosed – it is not clear where this category would fall in terms of the division proposed by the FCA between ‘Responsible’ and ‘Sustainable’. Early reactions to the new EU proposals by institutional investors suggest that this new EU disclosure category is likely to be treated in practice as not representing a truly sustainable investment.¹

Question 12. What do you consider the role of derivatives, short-selling and securities lending to be in sustainable investing? Please explain your views.

- > Derivatives form one of the largest financial markets globally and perform a critical role in economic activity by enabling and helping businesses and investors better manage the risks to which they are exposed and align their exposures more effectively with risk tolerance and risk management requirements². Interest in sustainability linked derivatives is growing. The first ESG-linked sustainability-improvement derivative (SID) was launched in August 2019³. Asset managers and other institutional investors investing directly in SDR-compliant companies can therefore potentially use derivatives to manage market risk.
- > Derivatives can be used to support the transition because they:
 - Can enable the UK to raise and channel the necessary capital towards sustainable investments
 - Help firms hedge risks related to ESG factors
 - Facilitate transparency, price discovery and market efficiency; and
 - Contribute to long-termism.
- > Although E3G does not propose that the Government mandates which derivatives traders should trade to support sustainability outcomes, we note that better disclosure rules and guidance from stock exchanges and finance firms will likely update market prices to better reflect risks such as climate change. The FCA should support financial product innovation to attract this growing market and support the growth of sustainability-linked derivatives in the UK.

¹ <https://www.responsible-investor.com/articles/proposed-disclosure-rule-change-essential-for-EU-Taxonomy-to-remain-useful-for-investors-market-reacts-to-plans-to-classify-nuclear-and-gas-as-green>

² <https://www.e3g.org/publications/a-net-zero-uk-financial-centre/>

³ This is a financial instrument that hedges the risk (e.g. against moves in interest rate or currency) of a sustainable investment. The price is linked to the company’s trading risk, profit, capital requirements and ESG performance.

Question 13. What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

- > Since the publication of this consultation from the FCA, the Chancellor made an announcement at COP26 that there will be new requirements for UK financial institutions and listed companies to publish net zero transition plans⁴ that detail how they will adapt and decarbonise as the UK moves towards to a net zero economy by 2050.
- > The disclosure requirements under the SDR should build off the TCFD’s existing structure and its new guidance for transition plans⁵. The disclosure regime should demonstrate whether and how net zero transition plans are being developed by market participants (companies, corporates, asset managers, asset owners and real economy actors).
- > Clear instructions should be defined on the format, location and frequency of reporting required to be in line with the SDR. In alignment with TCFD, this should include a requirement for disclosure to take place within the Annual Report. To assist the competitiveness of UK firms that have operations in the European Union, the UK should seek to make the SDR consistent with the disclosure regulations of the EU SFDR model. This will reduce confusion around disclosure requirements among bilateral operations between UK – EU market participants as well as prevent overburdening organisations with similar but slightly different reporting requirements. Consistency with the EU’s SFDR regime will integrate a balanced approach to materiality concerns into investor disclosures and considers a broader range of sustainability factors.

Question 14. What are your views on consumer-facing disclosures, including the content and any considerations on location, format (e.g. an ‘ESG factsheet’) and scope?

- > E3G supports the FCA’s suggested content for inclusion in consumer-facing disclosures. E3G also supports the development of a baseline level of prescription within the consumer-facing disclosures, and high-level ‘ESG factsheet’ to be the appropriate method for providing supplementary information. E3G proposes the inclusion of a short summary within the consumer-facing disclosure to inform retail investors of the objectives and aims of the factsheet.
- > E3G supports the FCA’s approach to carry out experiments aimed at understanding the elements of consumer-facing disclosures. In doing so, E3G emphasizes the need to ensure that disclosures are communicated concisely. With regards to the inclusion of a baseline of sustainability metrics, E3G proposes that the metrics should be limited to those that would inform credible retail investment decision-making and increase the consumer understanding of the sustainability characteristics of investment products. As an example, this may come in the form

⁴ <https://www.gov.uk/government/news/chancellor-uk-will-be-the-worlds-first-net-zero-financial-centre>

⁵ <https://www.gov.uk/government/news/chancellor-sets-new-standards-for-environmental-reporting-to-weed-out-greenwashing-and-support-transition-to-a-greener-financial-system>



of a carbon intensity metric, reported against the total carbon intensity under a business-as-usual scenario. Consumer-facing disclosures should factor in material impacts and the need for organisations to disclose on the sustainability aspects that impact their business and where they have the biggest (real or potential) environmental and social impacts.

- > E3G proposes that the definition of consumer-facing disclosures is backed by science and is eventually captured within the UK Green Taxonomy framework (once finalised) to ensure overarching coherence between products as well as the wider financial system, and to provide information in a format that is salient to consumers.

Question 15. What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?

- > E3G supports the SFDR's approach towards product-level disclosure information, including the SFDR's Principal Adverse Impact Indicators (PAIIs) which could provide a useful starting point for the development of sustainability metrics. Conherence with the SFDR could strengthen the consistency between the EU and UK disclosure regimes and foster a balanced approach to materiality within the UK sustainability disclosure framework.
- > PAIIs lack clear information on the actions that investors can take to influence and mitigate the trajectory of adverse impacts. E3G proposes that product-level information on PAIIs and adverse impacts should contain detail on how investors are addressing such adverse impacts through their stewardship and engagement, as well as through collaborative initiatives, e.g., groups such as Climate Action 100+.
- > E3G proposes that the SDR regime is aligned with the SFDR's Article 6, points 1 a, and b, stating that financial market participants disclose the following in pre-contractual disclosures: the manner in which sustainability risks are integrated into their investment decisions; and, the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available. Consistency with the SFDR would increase transparency around sustainability impacts. Product-level disclosures should communicate an alignment between the product and the overall net zero and/or sustainability goal (e.g., sustainable supply chain sourcing, lower energy intensive manufacturing, social impact on society).
- > The overall sustainability-related impact of a financial product should be reported regularly including its performance against relevant indicators. If an index has been designed as a reference benchmark for the indicator, information on the methodology used to calculate such index and its performance against a benchmark should also be provided.

Question 16. What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?

- > Currently, sustainability disclosures made by financial institutions and companies are often structured in relation to the organisation's own sustainability strategy and self-defined material issues with reporting against specific reporting frameworks (such as GRI, UNGC, SASB) detailed in report appendices that refer to individual sections and pages.
- > This has made comparability of disclosures challenging. Without clear guidance on the FCA's expectations for disclosures (including structure, level of detail, issues that should be included etc.) it is likely that ensuring, and enforcing, consistent and comparable disclosures will be challenging.
- > We recommend the alignment of the SDR with the EU SFDR, to reduce regulatory confusion amongst UK firms operating in the EU and to integrate balanced materiality considerations within the entity-level SDR disclosures. This should include:
 - Entity-level policy on sustainability risk;
 - Net zero portfolio alignment to ensure stewardship, as well as information on the methodologies used to calculate such alignment to maintain transparency.
 - Adherence to SDR engagement policies (comply or explain basis)
- > E3G proposes that the disclosure regime should include the disclosure of transition plans within entity-level disclosure for firms operating both at national and international jurisdictions. E3G emphasizes the importance of transition plans for international firms as a measure that will prevent carbon leakage from a given entity (e.g., a given stakeholder will not drive investment towards regions where sustainability disclosure regulations are not in place). For this reason, it is important that individual entity-level disclosures are reflective of and are reflected in entity-level disclosures and transition plans as appropriate. This includes an articulation of how progress against targets, such as net zero targets, feed into entity-level performance whilst capturing greater nuance on the specifics of the entity's strategy and activities.

Question 17. How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.

- > The FCA, and other UK regulators as appropriate, should collaborate closely with counterparts in different jurisdictions to support international alignment of standards and requirements.
- > A particular area where cooperation will be required will be on the development of requirements for transition plans as thinking and best practice is still emerging, with the UK's Transition Plan Taskforce a key source to leverage and build on in international fora.

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- > Alignment with the forthcoming ISSB standard will be key in ensuring international interoperability of standards. The FCA should look to engage as much as possible in this process and in the interim should consider the recommendations on a Climate-related Disclosures Prototype made by the Technical Readiness Working Group, chaired by the IFRS, to the ISSB.⁶
 - > E3G emphasises the importance of overseas funds, operated by UK firms, being captured by the sustainable disclosure requirements – both through the entity-level and product-level reporting requirements. The FCA needs to consider how to capture and/or enforce that SDR disclosures are applied to overseas funds, by embedding SDR regulation within the Overseas Fund Regime (OFR) to maintain consistency of sustainability disclosures of financial firms in the UK and broad.

Question 18. What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?

- > E3G recommends that the FCA apply principles of the SDR and investment labels to trading activities within the London Stock Exchange (LSE). As the development of the SDR regime and investment labels scheme progress, it could capture nuances regarding sustainability related information relevant to the trade of stocks, bonds, and commodities. In principle investment labels can be applied to listings and/or trades on the LSE, to provide traders with sustainability-related information with greater granularity than at the product-level.
- > Financial advisors should be supported to develop the technical knowledge required to fully engage with the SDR regime and investment. Their role will be necessary to provide nuanced analysis of the implications that SDR disclosure will have on assets, investments and investment firms and to relay sustainability-related information along the investment chain.

Question 19. Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?

- > Third-party verification will be important in ensuring that disclosures made under the proposed SDR regime are credible and robust. The FCA can push for mandatory verification requirements for market participants.

⁶ <https://www.ifrs.org/content/dam/ifrs/groups/trwg/trwg-climate-related-disclosures-prototype.pdf>



About E3G

E3G is a not-for-profit public interest organisation with offices in London, Brussels, Berlin and Washington DC. E3G's mission is to accelerate the global transition to a climate-safe world. E3G has a track record of experience and expertise on sustainable finance and international climate finance.

Annex

The following list of questions were not addressed by E3G as a response to the FCA's discussion paper.

Question 3. Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?

Question 5. What are your views on 'entry-level' criteria, set at the relevant entity level, before products can be considered 'Responsible' or 'Sustainable'? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.

Question 6. What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

Question 7. Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics:

- intentionality
- return expectations
- impact measurement
- additionality
- other characteristics that an impact product should have

Question 8. What are your views on our treatment of transitioning assets for:

- the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label?
- possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?



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Question 10. Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?

Question 11. How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

Question 20. What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine-readable format to better enable data collection and analysis?