sifma

asset management group

SDR and labels policy
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SIFMA Asset Management Group response to CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels

Introduction

The Securities Industry and Financial Markets Association's (SIFMA) Asset Management Group (AMG)[1] welcomes the opportunity to comment on the Financial Conduct Authority's consultation on Sustainability Disclosure Requirements and Investment Labels. We agree with the FCA that it is important that consumers can trust sustainable investment products.

We have two general points. First, it is important that this regime in its final form does not duplicate or adversely overlap with other existing rules or regulations which also offer protections for consumers more generally. For example, the Financial Services and Markets Act 2000 includes a Misleading Statements and Practices Order (2001) and FCA rules on financial promotions also already influence firms.

Second, capital markets are global and asset managers are very active on an international level. For investment internationally (including by foreign investors into the UK) to be optimal in its contribution to economic growth, it is important that rules and regulations between jurisdictions are broadly consistent and inter-operable with one another. As well as the frictions divergence introduces to cross-border investment, it also can make operations in multiple jurisdictions significantly inefficient. We make more specific reference to this later in this response but it also applies to the FCA's engagements and coordination with foreign regulators – for example, the UK/U.S. Financial Regulatory Working Group - where this issue should be on the agenda so you can set out the FCA's views and take input or questions from your foreign counterparts. We note that the FCA plans to consult separately on its approach to overseas products and we look forward to engaging with that exercise in due course.

The requirement for an explicit sustainability objective is very welcome as it is critical for increasing transparency and reducing the allegations of greenwashing. However, the aim to focus this objective narrowly on a specific theme – sustainability - may be inappropriate for many broad-market funds. The most material impacts of different industries are not the same, so there should be an option to offer funds that focus on addressing other societal objectives as appropriate.

For example, consider a broad market fund whose only objective was mitigating climate change. In many industries, this would be an important objective. But there are still many issuers (including in software and technology, gaming and other services) whose influence on climate change will have little effect on actually decarbonizing the economy. However, issuers in those industries do face other important *S & G* issues. Given the sole focus on climate change, though, such issuers would likely be included in the fund on the basis that they simply have limited climate impact, even if their other, more material impacts are significant. Funds can be built that consider a range of society's goals through robust and holistic ESG ratings designed for that very purpose. Such funds focusing on those types of investments should be allowed.

Section 3: Scope[2]

SIFMA would appreciate clarity on the geographical parameters of the proposal - specifically clarification on whether the regime only applies to UK institutions operating within the UK. Or is it is intended to extend to foreign institutions and their UK businesses or UK firms with overseas presence? We do not think subjecting non-UK managers offering products to UK investors to detailed product and firm disclosures is warranted at present. We also again note that we look forward to engaging in the upcoming consultation focused more exclusively on overseas products.

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[1] SIFMA's Asset Management Group (SIFMA AMG) brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms – both independent and broker-dealer affiliated – whose combined assets under management exceed $62 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[2] Section numbering reflects the numbering of the FCA consultation.

With regards specifically to the *firms* covered by the proposal, we would support as little divergence as possible in the scope of entities included within the SDR regime, the FCA rules on Task Force on Climate Related Financial Disclosures (TCFD) implementation and regimes being developed in other jurisdictions. A top-level approach of consistency of scope across all regimes would be the optimal outcome. The same point applies to *products* in scope.

In addition, including the requirement to disclose whether pursuit of the sustainability objective could involve trade-offs or adverse environmental or social impacts is concerning for two reasons:

- Unless companies or assets have minimised their negative impacts on the environment and society for 100 percent of their products and services and in 100 percent of their operations, there will be adverse environmental and social impacts associated with most economic activities by most companies or assets. As a result, the proposed requirement would either entail disclosure of trade-offs at an individual holding level, which will be extremely onerous, or will end up as a generic statement, which will not be helpful. The FCA could instead require that asset managers put in place minimum safeguards to ensure that severe environmental and social harm is avoided in pursuit of the sustainability objective.
- The ‘articulation of any financial trade-offs that may arise’ is also very hard to achieve as asset managers would struggle to quantify this and it can create false expectations in the marketplace. Also, this information can already be communicated qualitatively through existing risk-based disclosures.
- Finally, we ask that firms be given at least 24 months to comply with the final rules.

<u>Section 4: Classification and Labelling</u>

The requirement to ‘provide a summary of the types of holdings that the firm would reasonably expect consumers of the product to find ‘surprising’ (i.e., inconsistent with the sustainability objective)” appears unachievable. This is because consumers will have their own viewpoint as to what is unexpected, but this is likely to be subjective in the context of that consumer’s individual perspective on sustainability[3]. This disclosure would be especially challenging for the 'improvers' category, or for investment products pursuing sustainability objectives against a broad set of E, S and G issues and investing across many industries and sectors, because different investments could be classified as unexpected for different reasons depending on the issue in question and the viewpoint of the consumer.

At the same time, the lack of any standards around this could result in products with similar portfolios and the same objectives making completely different disclosures on 'surprising' investments, reducing comparability and creating confusion.

A better approach would be for fund advisers to show what is held in portfolios – at the sector level and/or top ten fund holdings - and let consumers decide themselves whether there is anything 'surprising' held based on their perspectives and preferences which they are best placed to judge.

'*Channels*' toward sustainability

The FCA has helpfully identified several channels by which a positive sustainability outcome can be achieved: via capital allocation, active stewardship, and; influencing asset prices and the cost of capital. It would indeed be helpful for end-investors to understand how managers aim to deliver sustainability outcomes and the channels they use. However, the proposed use of primary and secondary channels in the consultation paper raises concerns.

The channels used to achieve the desired sustainability outcomes would depend on the investment strategy and the asset class among other factors. For example, active ownership could be a major channel for delivering

[3] For example, according to the FCA (p. 120) "in disclosing the sustainability characteristics of assets in which it will invest, a firm should consider the expectations of a reasonable client; for example, if a sustainability product's sustainability objective targets investment in assets issued by companies that develop environmental solutions, a client might reasonably expect the product to avoid investments in assets issued by companies in sectors of the economy with high carbon emissions." However, it would not be unreasonable to expect that companies developing environmental solutions would also be in sectors with high carbon emissions. E.g., companies developing renewable aviation fuel, electric vehicles, low-carbon steel and cement, energy efficiency solutions for buildings, etc. are mainly operating in carbon heavy sectors. This example illustrates that the view of what is reasonable can vary dramatically depending on the perspective; and it would be very difficult for a fund adviser to determine what is reasonable in this case.

desired sustainability outcomes in an *equity* portfolio but could play a much more limited role in a *fixed income* portfolio.

Prescriptive requirements for primary and secondary channels under sustainable labels will likely disqualify many legitimate ESG/sustainability strategies from applying for an SDR label. For example, companies expected to improve their ESG practices over time can be identified and monitored through research and screening, which would be an alternative way of creating a sustainable improver portfolio as compared to using the proposed active stewardship channel.

It is extremely challenging to identify and prove a causal link between the investment or engagement activities of a fund or a single firm and direct outcomes from a company's behavior or its cost of capital, as there are many different factors influencing these. Attempting to do so in asset classes where investors do not have direct control over investee companies/assets can lead to greenwashing *allegations* and elevated reputational and regulatory risks.

The "channel" argument is particularly relevant for the sustainable improver label. Active stewardship, which is proposed as a primary channel for achieving improvements in the sustainability profile of assets, will not be a primary or an effective channel for securing desired ESG improvements for many asset classes (such as debt investments in public and private markets).

Furthermore, the focus on active stewardship may disadvantage smaller asset managers, as those with less capital are likely to be less influential in effecting change as a shareholder.

Active stewardship, which is proposed as a primary channel for achieving improvements in the sustainability profile of assets, will not be a primary or an effective channel for securing desired ESG improvements for many asset classes (such as debt investments in public and private markets) and also passively managed funds such as ETFs and tracker funds. Furthermore, the focus on active stewardship may disadvantage smaller asset managers, as those with less capital are likely to be less influential in effecting change as a shareholder. Also, many sustainability improvement or transition focused strategies seek to achieve their objectives by identifying companies and assets that are best-placed to improve their sustainability profile over time at the point of inclusion in portfolio, monitoring their progress and replacing holdings if the desired progress has not been achieved within the established timeframe. Consequently, other channels – i.e. capital allocation and influencing asset prices and the cost of capital - should be explicitly allowed as primary channels. This is consistent with the view expressed in the consultation paper that the three main channels are not mutually exclusive and are often pursued together (see 4.10, Box 3).

Ensuring the labelling regime reflects the diversity of funds available to investors

We also believe the labelling proposals should be re-examined in the context of the diverse types of funds available to investors. In particular, the proposed three pillar criterion does not account for the existence and importance of mixed investment funds where capital is allocated across a range of equity instruments (and fixed income securities also). In such a scenario, sustainability labelling becomes a grey area where *some* investments within a fund may fully meet the proposed criteria and others do not - single label alignment is unlikely achievable in a diversified portfolio. In such as case, regulatory flexibility is needed so (a) consumers are signaled about the presence of the sustainable portion of a portfolio and (b) to ensure that funds remain incentivized to include such assets in the first place.

Similar concerns also surround funds which have a mix of 'focus' and 'improver' assets, which is common in the market. How would the proposed requirements apply to a fund which had majority improver assets, but then some of these assets reached a standard of sustainability, which no longer meant stewardship needed to be the primary channel of influence? It would be detrimental If investors would have to divest from these assets if they wanted the fund to remain an 'improver' fund but didn't yet have 70 percent assets meeting a credible sustainability standard so couldn't be a 'focus' fund either.

It is proposed that portfolio management services can only use a label if 90 percent or more of the value of all constituent products in which they invest qualify for the same sustainable investment label. In addition to this threshold being materially higher than the 70 percent being applied to other products, SIFMA members wish to highlight that certain asset classes are less likely to have products with labels (cash, sovereign bonds, commodities) making the 90 percent threshold unachievable for most diversified portfolios.

Relatedly, the FCA propose that ’these products aim to invest in assets that a reasonable investor would regard as being environmentally and/or socially sustainable’. The definition is too vague given a huge divergence of views among investors, as well as vigorous public debate, on what is considered sustainable. Specifically, the FCA should indicate that environmental and social sustainability can be defined in relation to invested companies and assets’ products and services as well as operational or business practices of investee companies or assets.

The FCA does not wish to specify what a ‘credible’ standard of environmental and social sustainability (4.30) looks like. However, it is not clear how asset managers are supposed to demonstrate that the standard is “credible, consistent, rigorous and evidence-based” given that all four requirements are highly subjective. Consequently, the SDR implementation may encounter experienced as a result of the vagueness of definitions of certain key concepts under the EU Sustainable Finance Disclosure Regulation (SFDR). To this end, the FCA should either set more objective criteria for a ’credible standard’ or adjust the requirements to remove the reference to a ’credible standard’ for asset classes/ sustainability issues where no such standard exists.

Independent Assessment

The FCA should also clarify what “independently assessed” mean. Does it mean that the FCA believes that only third-party data and rating providers could provide a credible standard?

SIFMA AMG agrees that independent verification on the categorization of sustainable investment products before displaying the labels publicly should not be required and would significantly increase the costs and burden on firms, potentially disadvantaging smaller firms. Moreover, independent verification shouldn’t be needed if the labelling regime is underpinned by robust criteria. Any steps to re-visit this issue in future would need to be careful and fully open to consultation and dialogue with external stakeholders.

In the absence of a globally recognized standard methodology for determining a ‘sustainable’ asset, asset managers’ proprietary frameworks and methodologies should be explicitly allowed to act as a credible standard, and ’independently assessed’ should refer to the independent assurance process as regards the application of the framework/ methodology selected by the asset manager, as opposed to independent assessment of individual portfolio holdings.

To be clear, there should be no requirement for the verification of the credibility of such proprietary methodology by an external third-party as:

- it is not clear which third party providers would be uniquely qualified to make such a verification; and
- such a requirement would likely give currently non-regulated ESG data and ratings providers (particularly large ones) an even more prominent role within the sustainable finance market, which will reduce competition, restrict managers' ability to innovate and add to the rising cost of sustainable investing.

A further concern with verification is that it may lead to less scrutiny on the actual disclosures. We have seen a similar effect with Second Party Opinions (SPO) relating to Green Bonds. The FCA should take care to ensure that determining whether or not a fund's disclosures meet the SDR standards is not mistaken by users as an assessment of the overall quality of the product being verified.

Meaningful and effective targets

As regards improvement *targets*, these should be allowed at both individual holding and/or an overall portfolio levels as appropriate for an investment strategy. Targeting improvements at a holding level requires a very targeted investment approach that is more suitable for concentrated, activist-like or impact-focused strategies.

Portfolio-level target setting approach would also allow firms to articulate, if appropriate, how stewardship has helped to meet the investment objective at the aggregate level across the entire portfolio. This would allow stewardship activities to be focused on companies and assets where most progress is needed or likely to be achieved.

Focusing on holding-level improvement targets would also require extremely sophisticated reporting and can become very confusing. For example, as the sustainability profile of the company improves, the fund may sell its shares and buy shares in another company, which is at the start of its sustainability journey. Also, engagement may take place over a number of years before delivering a positive result, or, in some instances, firms may have to change engagement goals depending on the company's response or market developments. Therefore, careful consideration should be given to how the fund can capture progress in engagement, in the company's performance, and changes in the portfolio throughout the reporting period.

When it comes to public equities/debt, measurable improvements are difficult to demonstrate for many ESG criteria due to data issues; hence many managers elect to use ESG, SDG and other type of ratings/scores to capture and report companies' ESG performance.

Impact investing

The proposed sole focus on investor contribution to positive sustainability outcomes under this label is concerning. Impact strategies should be permitted to consider both enterprise contribution and/or investor contribution as appropriate for the investment strategy and asset class. A sole focus on investor contribution undervalues one of the core capabilities of the asset management industry – allocating risk capital to enterprises that would use it most effectively to achieve the desired investment outcomes in relation to sustainability and other issues. It also disadvantages smaller asset managers. Identifying investments that would create a desired positive impact through serving underserved stakeholders or through products and services that contribute to social and environmental solutions is, in our view, as important as playing a direct role in creating impact.

The definition of impact also needs to be broader than seeking to demonstrate financial additionality achieved by supplying new capital. The proposed approach would restrict impact investing in listed equities to IPOs and secondary capital raises; in fixed income, it would be limited to primary debt issuances. However, while refinancing existing green assets has lower real-world additionality than financing new green assets, it is still environmentally positive and impactful. A diversified impact fund may, for example, achieve its impact objectives via reducing cost of capital for existing impact-generating assets as well as providing new financing for impactful assets.

Impact investing in public secondary markets should therefore be allowed and recognized as these markets play a unique and complementary role in the impact investment ecosystem.

Moreover, ‘additionality’ is not necessarily seen as a core requirement for an impact fund, and the Global Impact Investing Network (GIIN) definition does not require that impact funds demonstrate additionality.

The FCA should adjust the definition of impact investing as per the above and remove the focus on investor impact and the provision of new capital under the Sustainable Impact label.

<u>Section 5: Disclosures</u>

SIFMA AMG would welcome additional information on how the two proposed tiers would relate to one another and align. We would find additional guidance helpful in terms of the extent of the disclosures that can be made in this regard, as detailed further below in our response to question 21.

SIFMA AMG members also strongly support the proposal that firms should be able to describe sustainability-related investment policies and strategies that are integral to their broader investment policy and strategy factually and in a proportionate way in their disclosures. However, it is important that this new consumer facing disclosure for sustainability characteristics be included in existing documentation such as, for example, Key Investor Information Documents or fact sheets. Creating a new document, which some investors may not be able to read on top of other existing disclosure materials, would be a significant development cost.

International regimes

Allowing compliance with comparable rules adopted by bodies other than the European Commission, such as the Sustainable Finance Disclosure Regulation, will conserve regulatory resources at the Commission and international regulators, decrease costs and burdens faced by those issuers and reduce the incentive for those issuers to only allow non-U.S. retail investors to participate in offerings or to deregister under the Exchange Act and cease reporting under the Commission’s rules entirely. We strongly support international alignment and cooperation especially as the TCFD develops further detail and clarity.

As discussed above, SIFMA AMG would also value clarification regarding the territorial scope of the proposed SDR. We appreciate that there will be a subsequent consultation on overseas investments. Meanwhile, clarity as it relates to this set of proposals would be helpful for business certainty.

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

We do, however, note that SDR is being developed before UK TCFD disclosure requirements have had time to properly bed in. This could create a situation whereby a firm commences TCFD reporting and is then required to essentially repeat the exercise and amend these disclosures for SDR. This again underlines the importance of international cooperation and dialogue through multiple and complementary channels.

Consistency in marketing rules, including from an international perspective, is discussed below.

Data and future performance

The requirement to set credible, rigorous and evidence-based Key Performance Indicators (KPIs) aligned with the sustainable investment product's sustainability objective, and monitor these on an ongoing basis, could limit the variability of sustainability objectives to those where data is readily available. As demonstrated by the Principal Adverse Impacts disclosure requirement under the SFDR, this is mainly due to the difficulty of measuring progress against sustainability objectives beyond climate-focused metrics. This is particularly difficult for products which focus on social characteristics where there are very few data-driven frameworks currently in operation and, therefore, progress assessment could be open to significant amounts of subjectivity. Third party data providers in this area are creating data points based on proxies and subjective opinions which will create significant diversity of views with regard to progress, making it difficult to compare the products.

For many themes, data availability is low - for instance, under the EU's SFDR, investors are finding that data on emissions to water is extremely limited. These are important themes that require addressing, but investors may choose not to focus on them in the first place because they cannot immediately produce quantitative data points on them. The same principle holds for markets where data coverage is poor. For instance, leveraged finance and emerging markets have lower data availability. Rather than increase the focus on ESG in relation to these themes and markets, and thus encourage better provision of relevant data, the requirement to report on KPIs could lead investors in the opposite direction and hinder progress.

Section 6: Naming and Marketing

The FCA note that marketing materials are key to a retail investor's understanding of a product's features, so it is vital that relevant information about the sustainability attributes of investments are not inadvertently concealed from such consumers. ESG Marketing rules therefore need to recognize this to ensure retail investors have a comprehensive overview of the product they are investing in, and that they understand the impact any ESG considerations relevant to the fund may have on the performance. Prohibiting the use of ESG terms in the marketing materials of products[4] not categorized under one of the FCA's sustainable investment labels may undermine this objective, as such materials wouldn't be able to provide a fair description of the key sustainability features of a product and their impact on investment outcomes. This could lead to retail investors making uniformed investment decisions.

When considering these impacts, we believe that by prohibiting marketing materials from using sustainability terminology risks firms' compliance with existing FCA rules requiring financial promotions to be 'fair, clear and not misleading". For example, Conduct of Business Sourcebook 4.5.5 outlines that when communicating information, a firm should consider whether omission of any relevant fact will result in the information being insufficient, unclear, unfair or misleading'. We believe that not including any information relating to sustainability in marketing materials for products for which sustainability considerations has a material impact on investment approach (but for one reason or another doesn't qualify for an FCA label) risks falling foul of this rule. So, as noted above, our members therefore strongly support the proposal that where firms adopt sustainability-related investment policies and strategies that are integral to their investment policy and strategy, firms should be able to describe these factually and in a proportionate way in their marketing materials.

[4] While such information is also included in disclosure documents (i.e., the prospectus and KID) the other 'non-disclosure' marketing materials are a key way for investors to receive information about the product in a manner that is easy to digest.

We also believe it is important for the FCA to consider its proposed naming and marketing rules in the context of the rules other jurisdictions are considering, for example in the U.S. and EU. As far as we are aware, in no other jurisdictions have there been proposals to prohibit the use of specific ESG terms in marketing materials. Instead, the general approach has been to ensure that managers use naming practices in line with the investment approach of products.

For these reasons, we would recommend removing marketing materials from the scope of the prohibition, and instead suggest introducing a set of principles to apply to marketing materials to protect against greenwashing. This could include a requirement for a prominent disclaimer in all marketing materials (not just disclosure documents) that the product in question is not classified under one of the FCA's sustainable investment labels. This could be supplemented with a requirement that the sustainability features of a product are described in a manner proportionate to the role sustainability plays in the overall investment approach of the product and are not exaggerated (i.e., sustainability features should not be given undue prominence).

SIFMA members wish to raise the potential impact of the proposed product naming rule on products which do not use a sustainable investment label but nevertheless have some sustainability-related characteristics. Consumers should be provided with clear information in relation to the sustainability-related features of such products as these may still meet the needs of a particular consumer who may otherwise be limited in their ability to identify such products if the prohibited terms cannot be used to describe the relevant sustainability-related features.

In addition, marketing funds without a description of their sustainability characteristics does not work from a practical perspective and will be potentially misleading to investors. Specifically, for funds that follow ESG integration, communication on what this means is essential. Similarly, funds that are seeking to achieve net zero need to communicate on climate change and progress toward net zero. Another example where challenges could arise is index linked funds where the fund takes on the name of the underlying index but where the index is not subject to the to the UK proportionality rule. Please also see our comments above regarding portfolio management.

SIFMA members would however appreciate further guidance on what a 'factual and proportionate' disclosure should look like for these purposes to help clarify the parameters of what the FCA considers acceptable for such disclosures.

<u>Conclusion</u>

We hope these comments are helpful and constructive. We would welcome the opportunity to elaborate and clarify upon them through further dialogue if doing so would be helpful. We also stand ready to assist with providing any further information that the FCA may find useful.

Thank you for considering these comments.

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