SDR implementation: Taking the time to get it right

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Wendy Saunders May 9, 2023

In October 2022 the Financial Conduct Authority (FCA) published consultation paper CP22/20 Sustainability Disclosure Requirements (SDR) and investment labels. The consultation closed in January 2023.

In this update we set out a broad overview of matters covered by the consultation, how it fits into the broader ESG regulatory landscape, where we are now and next steps.

Who are the SDR proposals aimed at?

The primary focus of the CP is on funds and portfolio management based in the UK. It sets out the proposed sustainability labelling and classification system for funds and portfolio management arrangements as well as disclosure requirements for asset managers, initially, with a view to expanding the regime to certain FCA-regulated asset owners and other investment products (eg pensions).

Financial advisers may fall into scope in their capacity as distributors of product-level information (rules on product suitability for financial advisers will be considered separately). However the CP does also include a proposed "anti-greenwashing" rule reiterating requirements for all regulated firms that sustainability-related claims must be fair, clear and not misleading.

What is the rationale behind the proposals?

The FCA has growing concerns that firms may be making exaggerated, misleading or unsubstantiated sustainability-related claims about their products that don't stand up to closer scrutiny - otherwise referred to as "greenwashing".

Trust and integrity in sustainable investment products is important to the transition to a more sustainable future - by putting in place mechanisms to ensure consumers can trust the claims firms make about their products this should protect the flow of much-needed capital to investments that can genuinely drive positive change.

How does this CP fit into the broader ESG regulatory landscape?

Firms might understandably find it challenging to keep up with the pace of regulatory developments in this area. The FCA set out its concerns in relation to funds marketed with a sustainability and ESG focus in a Dear Chair letter in July 2021. CP22/20 followed on from earlier views set out by the FCA in its discussion paper DP21/4, published in November 2021 at the same time as the FCA's ESG strategy, which itself followed on from the UK Government's "Greening Finance: A Roadmap to Sustainable Investing" published in October 2021.

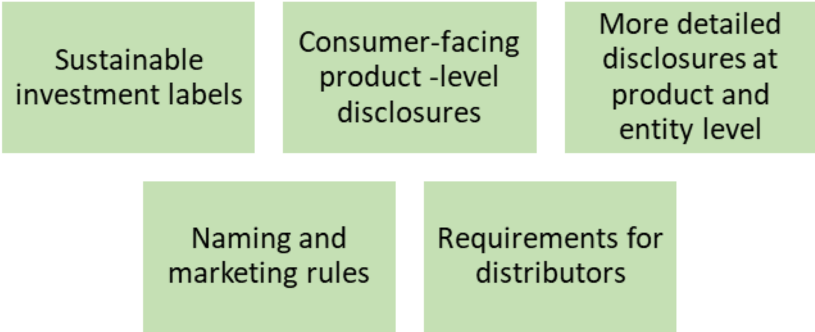
In December 2021 in PS21/24 the FCA introduced a new Environmental, Social and Governance (ESG) sourcebook containing rules and guidance for asset managers and certain FCA-regulated asset owners to make disclosures consistent with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). The TCFD-aligned disclosure requirements and the International Sustainability Standards Board's draft general sustainability disclosure requirements (the final version of IFRS Sustainability Disclosure Standard is expected around the end of Q2 2023) are said to have informed the proposed disclosure requirements in CP22/20.

Alongside the above, in March 2023 the UK government published its updated Green Finance Strategy, which amongst various proposals envisages a consultation on the UK Green Taxonomy in Autumn 2023 (which, once developed, may assist firms in demonstrating that assets meet a credible standard of sustainability). Lastly UK HM Treasury has just launched a consultation on regulating ESG ratings providers.

More broadly, from an international perspective, the FCA notes that it has sought international coherence with other regimes while emphasising the need for robust standards for the UK to remain at the global forefront of sustainable investment.

At a high level, what are the SDR proposals?

The proposals in the SDR cover the following areas:



Classification and labelling

The FCA is proposing three sustainable investment labels, each of which has a full description and a consumer-facing description (the latter is included below).

- **Sustainable focus**: invests mainly in assets that are sustainable for people and/or planet.
- **Sustainable improvers**: invests in assets that may not be sustainable now, with an aim to improve their sustainability for people and/or planet over time.
- **Sustainable impact**: invests in solutions to problems affecting people or the plant to achieve real-world impact.

To set an appropriate quality standard for products to qualify for any one of the three sustainable investment labels, the FCA has developed a set of threshold criteria that must be met in full and on an ongoing basis in order to use that label. The criteria include five overarching principles, and for each of those principles there are a number of key cross-cutting consideration plus category-specific criteria relevant to the label in question.

The five overarching criteria include:

- Principle 1, **Sustainability Objective**. A sustainable investment product must have an explicit environmental and/or social sustainability objective.
- Principle 2, **Investment Policy and Strategy**. A firm's investment policy and strategy for the sustainable investment product must be aligned with its sustainability objective.
- Principle 3, **Key Performance Indicators**. A firm must specify credible, rigorous and evidence-based KPIs that measure a sustainable investment product's ongoing performance towards achieving its sustainability objective.
- Principle 4, **Resources and Governance**. A firm must apply and maintain appropriate resources, governance and organisational arrangements commensurate with the delivery of the sustainable investment product's sustainability objective.
- Principle 5, **Stewardship**. A firm must maintain its active investor stewardship strategy and resources (at firm-level or product-level) in a manner consistent with the sustainable investment product's sustainability objective.

Disclosures

The consultation sets out detailed proposed requirements in relation to two types of disclosures:

- **Consumer-facing disclosures** will provide a summary of the products' key sustainability-related features, helping consumers to better understand those features, compare similar products or the same product over time, and hold the provider to account for its sustainability claims.
- **Detailed disclosures** will provide more granular information, which could be useful to institutional investors and a broader range of stakeholders. These will be located in pre-contractual disclosures, the sustainability product report and sustainability entity report.

Naming and marketing

The naming and marketing of financial products and services in the UK must be clear, fair, and not misleading and will specifically need to be consistent with the sustainability profile of the product or service i.e. proportionate and not exaggerated.

Further, for in-scope products provided to retail investors that do not qualify for and use one of the sustainable labels, the FCA is proposing to prohibit the use of certain sustainability-related terms e.g. ESG, climate, impact, green etc. The proposal codifies guidance set out in the Dear Chair letter referred to above.

What is the current timetable for implementation?

At the end of March 2023, the FCA announced that there would be a delay in publication of the final rules from end of H1 2023 to Q3 2023 and the proposed effective dates will be adjusted accordingly. The FCA is taking additional time to consider the feedback it received in response to the consultation, with particular focus on the following areas:

- approach to the marketing restrictions (including navigation to in-scope products that may not qualify for a label, but nevertheless have some sustainability-related characteristics)
- refining some of the specific criteria for the labels
- clarifying how different products, asset classes and strategies can qualify for a label, including multi-asset and blended strategies
- clarification of certain matters including that primary and secondary channels for achieving sustainability outcomes are not prescribed, and that independent verification of product categorisation is not required to qualify for a label.

The FCA may also be taking its time to consider and respond to the letter from the Treasury sub-committee on financial services regulations. It raised concerns that the cost benefit analysis of the proposals did not cover costs to the consumer, which could potentially be substantial, nor the potential risks to consumers and the funds industry were the FCA requirements to become too onerous for US or EU based funds to meet.

What are the next steps for fund managers?

Fund managers, if they have not already done so, should now be reviewing their sustainability-related claims about investment products as the proposed "anti-greenwashing" rule will come into effect from the date of publication of the new rule. In relation to the other proposed requirements, it is anticipated that fund managers will benefit from a one-year period for implementation.

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