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Sustainability Disclosure Requirements and Investment Labels

The FCA's proposed new labelling regime for UK investments

January 2023

Introduction

The FCA recently published its long-anticipated consultation paper on Sustainability Disclosure Requirements and Investment Labels (**CP22/20**).

CP22/20 builds on the FCA's previous work in this area, including its Discussion Paper (**DP21/4**) which is discussed in our podcast here and set out in our earlier briefing, available here. In this briefing we answer the following questions:

1. What is the background to the new proposals?
2. How does the regime differ from the EU's Sustainable Finance Disclosure Regulation (SDFR)?
3. What is the proposed scope of the new regime?
4. What are the proposed investment labels? Who can use them? What criteria must products meet?
5. What are the proposed new disclosure and reporting requirements?
6. What are the practical implications of CP22/20? What can firms do now to prepare for the new rules?

Background to the new proposals

The demand for environmental, green and social impact investments is on the rise. Many asset managers have, in recent years, launched sustainable investment products, or portfolios, aimed at consumers who wish to know that, as well as generating a financial return, their money is being invested with environmental or social considerations in mind.

However, as demand has increased, the FCA's concerns about greenwashing have grown. The FCA says that fears about exaggerated, misleading or unsubstantiated claims may already be eroding trust in the market.

In November 2021, the FCA issued discussion paper DP 21/4 in which it set out some ideas as to how it would help consumers navigate sustainable investments. This included the idea of a labelling system for consumer-facing products, as well as a suggested regime for additional disclosures.

In October 2022, the FCA revealed its proposals in a consultation paper, CP 22/20. The new proposals include:

- A general "anti-greenwashing" rule applicable to all firms.
- New investment labels to be used by funds and discretionary strategies who wish to market themselves to consumers as "green" or "sustainable".
- A requirement for new consumer-facing disclosures.
- Further reporting requirements, designed to enhance the new TCFD-aligned reporting requirements.

International context

The FCA have said that its proposed new Sustainable Disclosure Regime is designed to be compatible with the EU's Sustainable Finance Disclosure Regulation regime (SFDR), as well as proposals being developed in the US. However, firms must bear in mind that the FCA's emphasis on labelling marks a **clear departure** from the approach taken by other regimes.

Whilst the EU and US regimes categorise products principally to determine disclosure requirements, the FCA's policy rationale for categorising products is to help consumers identify sustainable investment products and navigate the market.

The UK's regime is designed to have a more consumer-friendly look and feel than SFDR. The UK's regime is also designed to combat greenwashing by setting a **high bar** for products that make sustainability claims. The FCA have deliberately set out very challenging standards for the use of these labels. Therefore, it will not be possible to simply "read across". A fund which is marketed in the EU as an "Article 8" or "Article 9" fund will not automatically meet the criteria for an investment label under the new UK regime. Asset managers will have to ensure that such funds also meet the UK's label-specific criteria.

Scope of the SDR and labelling regime

In scope **firms**

The new rules apply to firms conducting so called "sustainability in-scope business" in the UK in respect of "sustainability products".
The following types of firms are **in scope**:

- Firms carrying out portfolio management
- UK UCITS management companies
- ICVCs that are UCITS without a separate management company
- Full-scope UK AIFMs
- Small-authorised UK AIFMs

There are also certain rules for firms who distribute funds retail investors in the UK.

In scope **products**

In scope firms will need to apply the new rules when conducting activities in relation to so called "**sustainability products**". These are:

- Authorised funds (excluding feeder funds and funds in the process of winding up or termination)
- Unauthorised AIFs, including investment trusts
- Portfolio management services, including discretionary portfolios.

A product does not have to be sustainable in order to be a "sustainability product" under the new proposals. "Sustainability products" encapsulate all the products set out above, whether they are marketed as sustainable or not.

Territorial **Scope**

The current proposals do not apply to overseas products which are marketed in the UK. **However, the FCA does intend to follow up with an additional consultation paper concerning overseas funds in due course.**

In the meantime, the FCA proposes that distributors of overseas funds marketed into the UK (for example, under the Temporary Marketing Permissions Regime) which use sustainability-related terms in their name or marketing should be required to display a notice stating that the fund is based overseas and not subject to FCA sustainable investment labelling and disclosure requirements.

Investment Labels

The FCA have proposed three distinct “investment labels”. These are:

- “**Sustainable Focus**” - Products using this label must have a minimum percentage (70 per cent) of assets which meet credible sustainability standards.
- “**Sustainable Improvers**” - Products using this label may invest in assets which have the potential to become more sustainable over time.
- “**Sustainable Impact**” - Products using this label are expected to be “true” impact funds: they must aim to have a real-world sustainability impact.

The labels cannot be used by any authorised firm. They are reserved for in-scope firms (fund operators and discretionary managers) and are intended to be applied on a product-by-product basis to sustainability products which meet the stringent labelling criteria.

The use of labels will not be mandatory. No firm will be forced to use a label for a particular product. However, firms should note that:

- Before a firm is able to use a label in respect of a particular in-scope product, that product must meet the relevant criteria for the label, including specific requirements depending on the label, as well as cross-cutting criteria.
- If an in-scope firm decides not to use a sustainable label for a fund, that fund will not be able to use words implying sustainability characteristics in the naming or marketing of the fund. This means that sustainable terms such as “ESG”, “climate”, “sustainable”, “green”, as well as others, will not be permitted to be used by that fund in its name or marketing materials.

Therefore, firms that currently have products which they market as sustainable will be faced with the choice to apply a label or remove the sustainability references from the fund’s name and marketing materials.

Proposals for Discretionary Strategies

The FCA have included separate proposals for discretionary services which are marketed as sustainable.

Under the current proposals:

- A discretionary strategy will only be able to use a label if at least 90 per cent of the value of the products in which the strategy invests meets the criteria to use that same sustainable investment label.
- As an exception to the general naming and marketing rules applicable to funds, a discretionary strategy offered to retail clients can be marketed as “sustainable”, “green” etc without the use of a label, but only where 90 per cent of the total value of the products in which the portfolio invests themselves use a sustainability label.
- Discretionary strategies will not need to publish their own consumer-facing disclosures, but will need to instead provide a list of all the sustainability products in which they invest, along with details as to the underlying investments’ label and consumer facing disclosure.

There is a lack of clarity concerning the way that these requirements will apply to discretionary strategies. It is hoped that the FCA will provide further detail in their subsequent policy statement.

Criteria for use of an investment label

Firms must ensure that sustainability products meet a variety of stringent criteria before the product makes use of a label. The table below sets out some of the key criteria.

Principle 1: Sustainability Objective. A sustainable investment product must have an explicit environmental and/or social sustainability objective.

Sustainable Focus	Sustainable Improvers	Sustainable Impact
The sustainable investment objective must align with requirements to invest predominately (at least 70 per cent) in assets that meet a credible standard for environmental or social sustainability, and/or align with a specified environmental and/or social theme. A credible standard is one that is robust, independently assessed, evidence-based and transparent. The FCA suggests that aligning with the UK taxonomy when it is developed could be evidence of meeting a credible standard.	The sustainability objective must set out that the product will invest in assets that have the potential to become more environmentally and/or socially sustainable over time, including in response to active investor stewardship.	The sustainability objective must be to achieve a predefined, positive, measurable real-world environmental and/or social outcome.

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

Sustainable Focus	Sustainable Improvers	Sustainable Impact
At least 70 per cent of the product's assets either meet a credible standard of environmental or social sustainability, or align with a specified environmental and/or social theme. If the assets cease to meet the requirements above, the firm must take action, to restore compliance as soon as reasonably practicable, having regard for the interests of the firm's clients and consumers.	The firm must ensure that the product is invested in assets that have the potential to become more environmentally and/or socially sustainable over time, including in response to active investor stewardship.	The firm must specify: • a theory of change, in line with the product's sustainability objective, emphasising how its investment process aims to contribute to addressing either environmental and/or social problems • a robust method to measure and demonstrate that its investment activities have had a positive environmental and/or social sustainability impact • its escalation plan should the real-world outcome no longer be achievable, including potential divestment of assets

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Criteria for use of an investment label

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.

Sustainable Focus	Sustainable Improvers	Sustainable Impact
KPIs must include metrics that demonstrate the ongoing alignment of the product's assets with a target E and/or S sustainability profile, and the product's ongoing adherence to asset-level sustainability features in accordance with its investment policy and strategy.	KPIs must include metrics that demonstrate: • a clear and measurable target for improvements in the sustainability profile of the assets held by the product • the long-term sustainability profile of a product's assets • the extent to which improvements in the sustainability of a product's assets have been achieved over time, including through investor stewardship • how the firm's stewardship strategy has been applied to support improvements in the E and/or S sustainability of assets • the stewardship activities undertaken in relation to improving the sustainability profile of the product's assets	In specifying KPIs to assess performance of the product, a firm must apply enhanced impact measurement and reporting based on industry best practices.

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.

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What do the labels mean in practice?

Sustainable Focus

The FCA expects these products to be active, highly selective and to use extensive screening.

For example:
- A global equity educational achievement fund which focuses on investing in companies which improve young people's educational achievement through the use of technology and innovation.
- It uses screening to avoid companies with unsustainable business plans.
- It links its investments to activities that support Goal 5 of the UN Sustainable Development Goals.

Sustainable Improvers

The FCA anticipates that these products are likely to be invested across a broad range of sectors. These products pursue their sustainability goals through investor stewardship and also through portfolio construction and asset selection. These products must have clear sustainability KPIs and targets.

For example:
- An emerging markets sustainable finance fund which has an objective to provide capital growth by investing at least 80 per cent of the assets in financial institutions with significant exposure to emerging economies that have a strong commitment to improving sustainability.
- It uses stewardship to influence positive change and has an escalation policy in place if its stewardship is not achieving the intended improvements.

Sustainable Impact

To qualify for this label a product must aim to achieve a positive, measurable contribution to real world sustainability outcomes.

Sustainability goals may be met by directing typically new capital to projects and activities that offer solutions to environmental and/or social problems.

These products would be expected to have a stated theory of change, and to pursue a highly selective asset selection strategy aligned with that theory of change.

For example:
- A clean energy impact fund which finances the construction of wind farms.
- Its objective is to increase renewable use and access in emerging markets.
- It applies a proprietary scorecard to assess the non-financial performance of its investments.
- Environmental metrics tracked include the level of carbon emissions avoided.

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What do the labels mean in practice?

Using the labels

In addition to the requirements that a firm must meet in order to attach a label to a sustainable product, firms must also comply with further rules relating to the use of such labels.

Firms must:

- Use the relevant graphic when displaying the label.
- Publish the label in a prominent place on a relevant digital medium where the product is offered, eg on a webpage.
- Provide details as to where associated. consumer facing disclosure can be found
- Review the use of the label at least every 12 months.
- Keep records of the initial decision to use a label and each review.
- Give investors at least 60 days' advance notice where a fund ceases to use a label.

Approval by the FCA?

Although the FCA has stated that it will not specifically verify or approve the use of a label by an in-scope firm, a firm will be obliged to inform the FCA that it is using a label for its product within a month of starting to use the label.

However, authorised funds can expect scrutiny as to their proposed use of a label when applying to the FCA's fund authorisation team, either at the authorisation stage or when applying to the FCA to change the objective and/or policy as part of the implementation of the new rules.

Consumer-Facing Disclosures

The FCA are proposing to complement the labels with additional disclosures to help improve consumer understanding of the sustainability elements of these products.

The new rules will require both high-level disclosures, designed to increase retail consumer understanding, and more granular disclosures which are aimed at a broader range of stakeholders who want more information.

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Consumer-facing disclosures – high level disclosure	
Applies to	All in-scope products marketed to retail clients, even if these are not being marketed as sustainable. For those products that are not engaged in any sustainability-related strategies, the disclosure will be more limited.
Format of document, location	This disclosure is to be contained in a standalone document (maximum size two sides of A45), which is to be published alongside the KID. The disclosure must be made available in a prominent place on the relevant digital medium for the firm, ie the main product webpage.
Content	While the FCA has not specified a template for this document, there are form and content requirements, such as: • Basic information: firm name, product name, date etc • Product label: displayed prominently • Sustainability goal: product's sustainability objective • Sustainability approach: eg screening, stewardship approach etc • Unexpected investments: summary of types of investments that consumers would find "surprising" ie inconsistent with the sustainability objective • Sustainability metrics: relevant KPIs linked to sustainability objective • Signposting to other disclosures: hyperlink to further detailed information. For those products that are not engaged in any sustainability-related strategies, the disclosure will be more limited. For example, the label field must be marked with "no sustainable label," and other fields marked as "not applicable" or "N/A."
Portfolio managers	Do not need to provide this disclosure in respect of their discretionary strategies, but will be expected to provide an index of the underlying in-scope products, linking to their label and consumer-facing disclosure, as applicable.

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Pre-Contractual Disclosures

Pre-contractual disclosures – detailed product level disclosure	
Applies to	All products using a sustainable investment label. Also, products without a label which adopt sustainability-related features that are integral to their investment policy and strategy will be obliged to set out these features (including a sustainability objective, if any) and the investment policy and strategy in a proportionate manner to the sustainability profile of the product.
Format of document, location	These disclosures are expected to be in the fund prospectus of a fund product as set out in FUND 3.2. If the product is not required to have a prospectus, “Part A” of the separate sustainability product report should be used for this disclosure, which should be set out in a prominent place on the relevant digital medium, ie product webpage.
Content	No specific template for disclosure, but this disclosure must meet the obligations set out in: • Principle 1 – Sustainability objective • Principle 2 – Investment policy and strategy • Principle 5 – Stewardship
Portfolio managers	Not required to produce their own pre-contractual disclosures. However, they must provide retail investors with easy access (e.g. by hyperlinking) to the relevant disclosures.

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Ongoing sustainability reporting

In addition to disclosures set out above, the FCA is also proposing detailed product and entity level sustainability reports.

Ongoing sustainability product report/ “Part B” – detailed product level disclosure	
Applies to	All products using a sustainable investment label, except portfolio management services and unauthorised AIFs not listed on recognised exchange
Format of document, location	These disclosures, which build on TCFD reporting requirements, need to be set out in a dedicated sustainability product report, also known as a Part B report. This report must be published in a prominent place on the main website for the business of the firm, eg with a link from the homepage.
Content	These disclosures are designed to help clients and consumers assess a product’s ongoing performance and progress towards meeting its stated objective. The disclosure must meet the obligations set out in: • Principle 2 – Investment policy and strategy • Principle 3 - KPIs • Principle 5 – Stewardship There are further specific criteria for each sustainable label. In addition, the FCA proposes that the “Part B” disclosure should include additional information such as: • any other metrics that a client or consumer might find useful in understanding the firm’s approach to meeting the sustainability objective • contextual information alongside KPIs/metrics disclosed including how KPIs/ metrics should be interpreted • historical annual calculations on KPIs/metrics after the first year of reporting • any disclosures where the firm’s approach to a sustainability product materially deviates from the firm’s overarching approach disclosed in the firm’s sustainability entity report
Portfolio managers	Not be required to produce their own sustainability product reports. However, they must provide retail investors with easy access (e.g., by hyperlinking) to relevant disclosures
On demand reporting	Public disclosures are not appropriate in all client relationships, e.g., discretionary investment management clients. Where such firms use a label, the FCA is proposing that a client can make an on-demand request for the sustainability information on an annual basis, from 1 July 2025

Entity level disclosures

Entity level disclosures – detailed disclosures (building on TCFD entity level disclosures)	
Applies to	All in-scope asset managers with AUM of £5 billion or more (on a 3-year rolling basis) even if sustainable labels are not used.
Format of document, location	The report must be published in a prominent place on the firm's website. The report may either incorporate disclosures required under TCFD rules or hyperlink to the TCFD entity report, provided FCA cross referencing rules are followed.
Content	The FCA is planning to introduce core entity-level disclosure requirements based on the TCFD's four recommendations: • The governance around sustainability related risks and opportunities • The actual and potential impacts of sustainability-related risks and opportunities on their businesses, strategy, and financial planning, where such information is material • How the firm identifies, assesses, and manages sustainability-related risks • The metrics and targets used to assess and manage relevant sustainability-related risks, where such information is material.
Initial disclosure and updating requirements	Initial disclosures from largest in-scope firms (those with AUM in excess of £50 billon AUM) will be due provisionally by 30 June 2025, smaller in-scope firms due to publish their initial report by 30 June 2026 which aligns with the deadline for publishing TCFD entity reports. These disclosures are to be updated on an annual basis.

Anti-Greenwashing rule

A key element of the FCA's objective for the SDR and labelling regime is to reduce greenwashing. Therefore, the FCA is proposing a general anti-greenwashing rule which would require all regulated firms to ensure the naming and marketing of financial products and services in the UK is clear, fair, and not misleading, and consistent with the sustainability profile of the product or service, ie proportionate and not exaggerated. This will also apply to FCA-regulated firms approving promotions for unauthorised persons.

Distributors

The FCA are also introducing certain rules for distributors.

- Where distributors offer in-scope products that have a sustainable investment label to retail investors, distributors must display the label prominently in the relevant digital medium (eg product webpage) and provide access to the accompanying consumer-facing disclosures.
- Distributors must keep the relevant digital medium and marketing communications updated with any changes a firm makes to the labels and disclosures.
- In relation to overseas products (which are not currently in scope of the proposed SDR regime) which use prohibited sustainability-related terms, distributors of those products to retail investors must place a notice alerting retail investors that "This product is based overseas and is not subject to FCA sustainable investment labelling and disclosure requirements". This should be prominent on the relevant digital medium with a hyperlink to the FCA webpage, which will set out what the labelling and disclosure requirements are, for retail investors that wish to know more.

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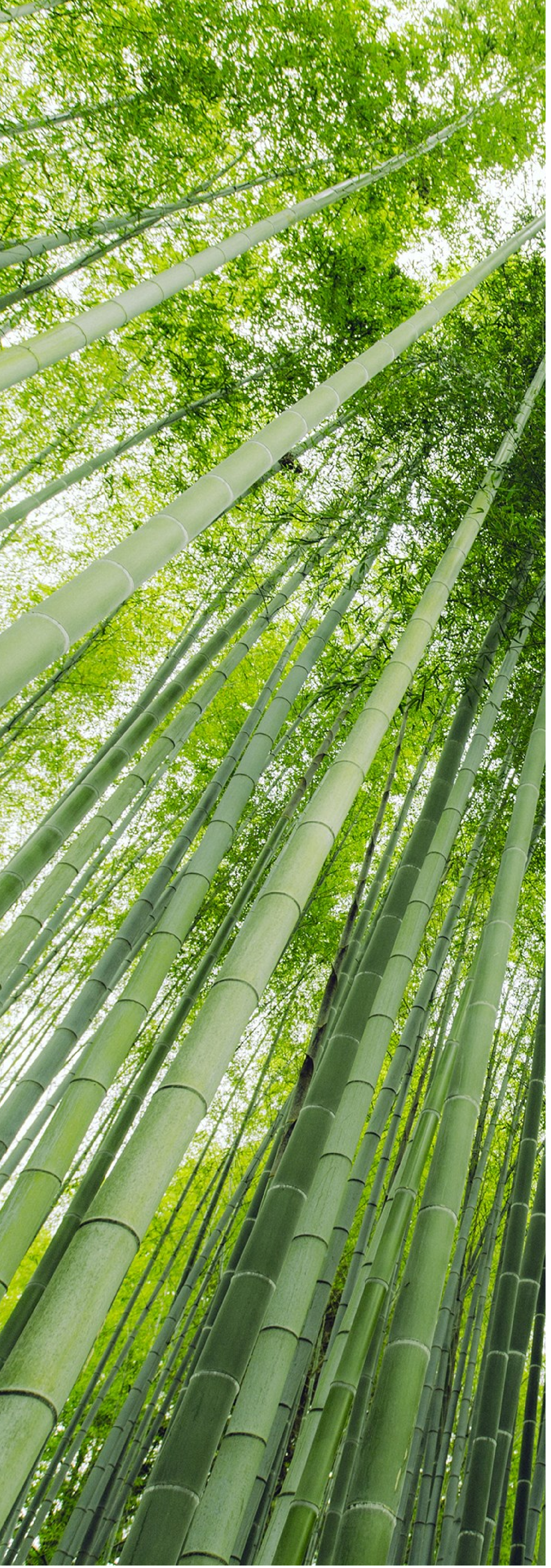

Implementation timeline

25 January 2023	Deadline for responses to FCA consultation
30 June 2023	Expected publication of Policy Statement including final rules and guidance. Proposed implementation of the general anti-greenwashing rule.
30 June 2024	Proposed date for: • the implementation of labelling, naming, and marketing rules • Consumer facing disclosures to be available • Pre-contractual disclosures to be available (Prospectus/Part A)
30 June 2025	Proposed date for the phasing in of first product and entity reports (Part B and entity reports).

Next steps: how should firms start to prepare?

Firms should be carefully considering how to deal with the incoming SDR and labelling regime. The FCA expects firms to engage with the consultation paper so that they are ready to start implementation as soon as the final rules are published in July 2023.

Firms should begin with a review of their current products to analyse products that are currently marketed as “sustainable” to see whether they could meet the criteria for a sustainable investment label.

The FCA expects that many products currently marketed as “sustainable” will need to be amended if they wish to qualify for a label. Firms can start this work now by asking themselves what changes will be necessary to the way that products are managed, monitored and marketed in order to meet the stringent label criteria.

Many sustainable products will need to be amended to include a sustainability objective. Firms should also consider whether they currently have the processes and people to enable them to monitor and report under the new rules. Many will be thinking about how they can use third party providers to demonstrate their products’ performance against their sustainability objectives.

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