XPS Investment

Investment briefing

December 2023

FCA finalises UK Sustainability Disclosure Requirements and adds a fourth sustainability label

In brief

- On 28 November 2023 the FCA issued the final Sustainability Disclosure Requirements (SDR) policy statement. This will apply to all FCA-authorised firms who make sustainability-related claims about their products and services.
- The key update is the addition of a fourth 'Sustainability Mixed Goals' label to go alongside the three other labels: Sustainability Impact, Sustainability Focus, Sustainability Improvers.
- The labelling regime will be supported by anti-greenwashing rules (which are out for consultation until January 2024) and naming and marketing rules, alongside disclosure requirements for asset managers.
- Together these requirements aim to assist investors in understanding the sustainability characteristics of their investments and reduce green-washing.
- The anti-greenwashing rules will come into force in May 2024, the labelling regime will come into force on 31 July 2024, before naming and marketing rules will apply from 2 December 2024.

Alex Quant summarises the key aspects of the final Sustainability Disclosure Requirements (SDR) policy statement and the implication for investors.

There is growing focus on investing sustainably by retail and institutional investors, and there is a range of preferred approaches as ESG / sustainability mean different things to different people. Therefore, it's important that investors get clarity from investment managers on the approach taken by a given fund so that investors can make informed decisions based on their preferences.

In October 2022 the FCA issued its draft Sustainability Disclosure Requirements (SDR) for consultation – this was an important step as part of the UK Government's Roadmap to Sustainable Investing. After consulting widely, the final policy statement has now been published in November 2023, along with a timeline for implementing the various aspects.

The overall aim of the SDR policy is to support investors when reviewing and selecting sustainable investment products, to provide clarity on the different approaches taken by different funds.

> SDR is a big step forward for UK investors, and well help to provide decision useful information on the sustainability approach of investment funds.
>
> **Alex Quant**
> Investment Consultant
> & Head of ESG Research

Key outcomes from the finalised SDR statement

1. **Labelling regime:** Total of four sustainability labels for UK managers to use depending on their approach. A fourth 'Sustainability Mixed Goals' label was introduced to go alongside the three labels proposed last year: Sustainability Impact, Sustainability Focus, Sustainability Improvers. There is no requirement for the use of a label to be externally verified.
2. **Threshold for asset inclusion:** Clarification that at least 70% of the fund's assets must meet the objective of the given label, requiring investments to be selected with reference to a robust, evidence-based standard that is an absolute measure of environmental and/or social sustainability.
3. **Anti-greenwashing, and naming and marketing rules:** Confirmation of an anti-greenwashing rule (which is out for consultation until January 2024), and naming and marketing rules, both aimed at protecting investors from greenwashing claims by managers.
4. **Transparency on conflicting objectives:** Investment managers must disclose the extent to which the sustainability strategy is likely to have a material impact on the financial return, and managers must identify and disclose if pursuing certain positive sustainability outcomes could result in other negative environmental and/or social outcomes.
5. **Reporting guidelines:** Product-level and entity-level disclosure requirements for firms using labels or sustainability-related terms within fund names. These will come into force from December 2025.

Key dates

Anti-greenwashing rules and guidance	Labelling regime	Naming and marketing rules
31 May 2024	**31 July 2024**	**2 December 2024**

Detail on the key aspects

Labelling regime

The final policy confirmed there will be four sustainability labels:

	Sustainability labels			
Category	**Sustainability Impact**	**Sustainability Focus**	**Sustainability Improvers**	**Sustainability Mixed Goals**
Overview	At least 70% of assets to achieve a pre-defined, positive, measurable environmental and/or social impact. Investing in assets that already focus on the sustainability of people and planet, delivering solutions to real-world sustainability problems.	To invest in at least 70% of assets that are environmentally or socially sustainable i.e. which already focus on the sustainability of people and/or the planet.	To invest in at least 70% of assets that have the potential to become more sustainable over time. These assets may not be sustainable now but aim to improve the sustainability of people or the planet over time, where the manager has high conviction and evidence to support this.	Managers can use this label when they invest in a mixed manner across the other labels. 70% of assets must meet one of the three other objectives.
Notable requirements to warrant the label	Must specify a 'theory of change' – how they expect their investment to achieve a positive impact. Evidence of a robust method for measuring and demonstrating the positive impact.	Must be clear on framework used to identify that an asset is sustainable.	Identify the time period for improvement. Set short and medium-term targets for improvement. Robust evidence to satisfy potential to improve.	Must identify the proportion of assets which are invested in accordance with each of the other labels.

The labels do not seek to provide any endorsement of a product's suitability for an investor and the FCA have continued to stress that there is no hierarchy between the labels – each label, which identifies a different style of sustainability investing, serves a different purpose and will meet the need of different investors.

Determining 'sustainability'

- Across the different labels managers must follow a 'robust, evidence-based standard that is an absolute (as opposed to a 'relative') measure of environmental and/or social sustainability'.
- Whilst the FCA define both 'robust' and 'evidence-based', as well as outlining potential standards for managers to use (e.g. EU Taxonomy, thresholds on greenhouse gas emissions for assets), managers are given discretion to determine the sustainability of an asset themselves using a proprietary framework or using a third-party.
- This will be a key area for asset manager disclosure to ensure investors can compare approaches and make informed decisions. There is a potential greenwashing risk that managers choose a 'weak' standard which allows them to classify non-sustainable assets as sustainable, although the disclosure requirements (see below), look to address this.

Anti-greenwashing rules

- To ensure sustainability-related claims about products and services are fair, clear and not misleading, and are consistent with the sustainability characteristics of the product or service. These will be an integral part of ensuring firms are delivering what they claim to be. The FCA is consulting on these rules and the supporting guidance until 26 January 2024.

Naming and marketing

- The FCA has also clarified rules to ensure the naming convention of funds accurately reflects the sustainability characteristics of the fund.
- A key requirement to use sustainability-related terms within naming convention is that the sustainability characteristics 'should be material to the product i.e. at least 70% of the product's assets'.
- In addition, the terms 'sustainable', 'sustainability' and 'impact' can only be used for funds which use one of the four SDR labels.

Disclosures

- The FCA also outlined product-level and entity-level disclosure requirements for firms using labels or sustainability-related terms within fund names. Product-level sustainability information must be disclosed annually and an entity-level sustainability report (which builds on the TCFD report) must be also published annually.

How XPS can help

In 2019 XPS recognised that there was no clear definition of sustainable funds. We therefore developed our Sustainable Designation for funds which meet our high standards of ESG integration, construct portfolios tilted towards sustainable practices and demonstrate strong active ownership.

In 2023 we also developed our Impact Designation which goes further to identify funds which pre-emptively target, measure and monitor real-world outcomes to generate positive environmental and/or social impact, alongside financial returns.

Unlike the FCA labels, our Sustainability and Impact designations represent an endorsement of a fund or strategy backed by our research view.

Our sustainable research framework broadly aligns with the FCA's proposals. More generally when recommending any fund, sustainable or not, we require minimum levels of ESG integration and therefore will not recommend funds which do not take a responsible approach. This is consistent with the ethos communicated by the FCA that consideration of ESG risks, opportunities and impact are increasingly considered to be integral to an investor firm acting in accordance with its fiduciary duty.

Conclusion

In summary, the SDR is a significant milestone in the UK fund management industry. It will increase transparency, help protect investors from green-washing and lead to a more efficient allocation of capital, all of which should aid the transition to a more sustainable future.

Investors will still need to undertake careful due diligence to ensure their investment manager is delivering what they claim, and that the approach is in line with their preferences and broader objectives. It is critical that the sustainability assessments and disclosures supporting a given label are a fair reflection of a fund's true credentials.

To discuss any of the issues covered in this edition, please get in touch with Alex Quant.

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