Proposal for U.K. Sustainability Disclosure Rules Will Apply to Investment Managers

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The United Kingdom's Financial Conduct Authority (FCA) has issued proposed rules to establish a U.K. sustainability disclosure regime (SDR) providing a U.K. take on a topic many investment managers have been dealing with in preparation for the European Union's (EU) Sustainable Finance Disclosure Regulation (SFDR)[1], the proposed disclosure rules by the U.S. Securities and Exchange Commission (SEC) relating to environmental, social and governance (ESG) issues, and other proposed regulations.

The rules are subject to consultation until January 25, 2023, but are expected to require both manager-level and product-level disclosures, introduce a fund labelling regime and set out anti-greenwashing guidance. The rules are expected to be finalized by the end of Q2 2023, with disclosure rules applying from 2024 and reporting commencing in 2025. The current proposals apply to certain FCA-regulated firms. The below focuses on examining key impacts on UK investment managers. Read on for further details.

Background

Further to the U.K. Government's Roadmap to Sustainable Investing published in October 2021, the FCA has issued a consultation paper (CP 22/20) on its proposed regime of sustainability disclosure rules. CP 22/20 builds on responses to the discussion paper on sustainability disclosure requirements and investment labels and furthers the FCA's anti-greenwashing initiatives. Relatedly, the proposal is aimed at increasing transparency regarding the sustainability of investment products and facilitating like-for-like comparisons, particularly for retail investors.

Summary of key proposals

At a high level, the FCA's proposals introduce:

- **Sustainable investment labels (SILs)**, used at the option of in-scope firms selling in-scope products, provided that they meet the requisite criteria. These criteria are

[1] EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector.

intended to substantiate claims of sustainability by setting clear, explicit objectives and requiring additional reporting on performance against these objectives on an ongoing basis[2]. The FCA has proposed three mutually exclusive SILs: (1) sustainable focus, (2) sustainable improvers and (3) sustainable impact.

- **Product-level sustainability disclosures**, being pre-contractual disclosures for sustainable products, as well as pre-contractual consumer-facing disclosures applicable to all products (including those without a sustainability focus). On-demand disclosures are also to be provided to investors seeking additional information, while more detailed product-level sustainability reporting is required for certain firms.
- **Firm-level sustainability disclosures** applicable to firms with £5 billion or more assets under management (AUM), in the form of an annual sustainability entity report focusing on governance processes surrounding sustainability risks and opportunities.
- **Requirements for distributors** (including platforms and advisors) of in-scope products to retail investors, to ensure that product-level information, including any SILs, is made available.
- **Naming and marketing rules rules** restricting the use of certain sustainability-related terms (e.g., "ESG" and "green") in marketing in-scope products to retail investors where the product does not have a SIL[3].
- **A general "anti-greenwashing"** applicable to all managers, specifying that sustainability-related claims must be clear, fair and not misleading.

Scope

While the anti-greenwashing rule is applicable to all FCA-authorized firms, the remaining proposals apply to U.K. Markets in Financial Instruments Directive (MiFID) portfolio managers, Undertaking for Collective Investment in Transferable Securities (UCITS) management companies of U.K. UCITS and U.K. Alternative Investment Fund Managers (AIFMs) in respect of authorized and unauthorized funds (including investment trusts) and certain portfolio management services, as well as distributors of those products. They apply principally with respect to strategies and products that are focused on sustainability or ESG, but some requirements apply to all managers, even those without any sustainability or ESG focus.

Extraterritorial Application: The FCA has noted that it intends to seek further consultation on the applicability of the proposed rules to non-U.K. investment managers at a later date.

When will the rules take effect?

The FCA intends to publish the rules in a policy statement by the end of the first half of 2023, with the anti-greenwashing rule becoming effective immediately upon publication. The SIL regime, additional consumer-facing and pre-contractual

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[2] Where a firm is in-scope by virtue of its role as a portfolio manager (see "Scope" below), 90 percent of the assets in the portfolio must use the relevant SIL in order for the portfolio itself to be eligible for that SIL.

[3] Portfolio managers with a portfolio consisting of 90 percent of assets using a SIL are exempt from these restrictions, provided the terms used are not misleading.

disclosures, naming and marketing rules, and requirements on distributors would take effect 12 months later. This would be followed by the ongoing product- and entity-level disclosures, which are expected to take effect 24 months after publication of the rules, subject to some exceptions[4].

The FCA notes that the product-level disclosures may be further updated to align with the U.K. Green Taxonomy, once developed.

Interaction with SFDR requirements and SEC proposals

The FCA has described how it considers the SFDR requirements and the SEC proposals to interact with the SDR. In particular, the FCA highlights that although there is some overlap between the SILs and Article 8 and Article 9 products under the SFDR, there will likely be some Article 8 products that will not meet the criteria for any SIL. However, the FCA's disclosure requirements under the SDR are less technical and data-focused, and do not apply the "do no significant harm" test. CP 22/20 also includes tables comparing the entity- and product-level disclosure requirements under the SDR against the SFDR and the SEC proposals.

We have set out a more detailed discussion of the proposals in the Annex below. We continue to follow the development of the proposals.

[4] For portfolio managers, the proposals in respect of consumer-facing disclosures and the naming and marketing rules would come into effect after 18 months.

"On-demand" sustainability reporting requests (see the Annex for further detail) could be made following the effectiveness of the ongoing product-level disclosures, using data from preceding year or the start of the investor's relationship of the firm (whichever is later).

Entity-level disclosures are to implemented in stages, with firms managing £50 billion or more in AUM being subject to the requirements from 24 months, while firms within the threshold (see the Annex for further detail) but managing less than £50 billion in AUM being brought in scope from 36 months.

Annex[5]

Applies to	Proposed Rule	Description
(A) Sustainable Investment Labels (SILs)		
Firms electing to use a SIL in respect of an investment product[6]	**Sustainability Principles:**	
	1. Sustainability objective (SO)	The product must have an explicit environmental and/or social SO as part of its investment objectives. The SO must be clear, specific and measurable, with a plausible and credible link to an environmental and/or social outcome. Firms may refer to the standards produced by the Sustainability Accounting Standards Board in determining the SO, but are not required to do so.
	2. Investment policy and strategy aligned with the SO	The product's investment policy and strategy must be aligned with the SO, with investments made accordingly. Asset-level selection criteria should also be defined in specific and measurable terms. For index-tracking products, the firm must be satisfied that the index provider's methodology aligns with the SO and retains responsibility for ensuring this continues to be the case. Firms must identify any investment which may reasonably be considered in conflict with the SO or investment policy, and must have adequate processes in place to monitor performance against the SO and report on an ongoing basis.
	3. Key performance indicators (KPIs)	The firm must specify credible, rigorous and evidence-based KPIs, monitored on an ongoing basis, which are relevant to, and aligned with, the SO.
	4. Resources and governance; stewardship	The firm must apply and maintain appropriate resources and arrangements for delivering the SO and the product's investor stewardship strategy (particularly relevant to products labelled as "sustainable improvers"), as applicable.

[5] This Annex is in relation to the U.K. FCA's proposed U.K. sustainability disclosure regime applicable to U.K. MiFID portfolio managers, UCITS management companies of U.K. UCITS and U.K. AIFMs, in respect of authorized and unauthorized funds (including investment trusts) and certain portfolio management services.

[6] There is no obligation on firms within the scope of this proposal to use a SIL in respect of eligible products, and the labelling of products with SILs comes with additional, more detailed disclosure and reporting requirements. However, products which do not have a SIL but purport to be sustainable or to adopt sustainability-related features in their investment strategy are subject to restrictions on how they are named and marketed (see (D) below).

Applies to	Proposed Rule	Description
	Additional criteria in respect of each SIL:	
	“Sustainable focus”	At least 70 percent of the investment portfolio must consist of assets that meet a **credible** standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme. This may include index-tracking strategies which track selective benchmarks reflecting the SO. A “credible” standard needs to be robust, independently assessed, evidence-based and transparent, but, at this stage, the FCA has not specified further.
	“Sustainable improvers”	The product invests in assets which have the potential to become more environmentally and/or socially sustainable over time, including in response to investor stewardship. The SO must be clear and measureable, with KPIs setting out targets for improvement, the long-term sustainability profile, and the extent to which improvements are attributable to stewardship.
	“Sustainable impact”	The product has a SO that aims to achieve a pre-defined, positive and measurable environmental and/or social impact. The firm must develop a theory of change emphasizing how the investment process aims to contribute to addressing environmental and/or social issues, as well as robust methods for measuring and demonstrating the impact of the investment on those issues (with a related contingency plan in the event the anticipated real-world impact is no longer plausibly achievable). KPIs must have enhanced impact measurement and reporting based on industry best practice.
	FCA Notification:	The firm must notify the FCA within one month of the date on which it starts to use a SIL in relation to a product. Where a new SIL is used, the FCA must be similarly notified within one month of the change.
(B) Sustainability Disclosures		
All firms with retail investors	Consumer-facing Disclosures	This should be a summary document (approx. 2 pages) setting out the key sustainability-related features. It should be digitally accessible in a prominent place, such as the website the product is offered on. The disclosures should include (clearly signposted) the SO and investment strategy, how these may impact financial returns, details of any progress towards them, as well as any investments held which are inconsistent (with an explanation of why these are held). Where the product has a SIL, it should also set out the FCA-specified descriptor applicable to that SIL or, if there is no SIL,

Applies to	Proposed Rule	Description
		note “no SIL”. Finally, there should be a summary of the relevant metrics and KPIs, together with details of where other disclosures (where relevant) can be accessed. Portfolio managers managing a portfolio with a retail investor base can satisfy this obligation by publishing an index of the underlying products of the investment portfolio, including any SIL, with links to those products’ individual disclosures. ***Review:*** These disclosures should be reviewed and updated every 12 months, and should also be updated as required to reflect any changes to the product. Investors should be notified of any proposed revisions to the disclosures at least 60 days prior to them taking effect, and the revisions should be published within 60 days of their effectiveness.
Firms electing to use a SIL in respect of an investment product	Pre-contractual Disclosures	This should be made in any offering documentation or, where no pre-contractual materials are prepared, in Part A of a public product-level sustainability report. The disclosures include the SIL, SO and investment strategy, how these may impact financial returns, details of the link between the SO and purported environmental and/or social outcome, specifications of asset-level selection criteria, details of monitoring and reporting, and information on stewardship and resources. If the product is index-tracking, disclosures should also be made in relation to how the index methodology aligns with the SO. There are additional requirements for products labelled as “sustainable improvers” or “sustainable impact”. Portfolio managers managing a portfolio with a retail investor base can satisfy this obligation by publishing an index of the underlying products of the investment portfolio, including any SIL, with links to those products’ individual disclosures. ***Review:*** These disclosures should be reviewed and updated every 12 months, and should also be updated as required to reflect any changes to the product. Investors should be notified of any proposed revisions to the disclosures at least 60 days prior to them taking effect, and the revisions should be published within 60 days of their effectiveness.
Firms with sustainable investment	Pre-contractual Disclosures	This should be made in any offering documentation or, where no pre-contractual materials are prepared, in Part A of a public product-level sustainability report. The disclosures include the specific sustainability characteristics of the investment product, any SO, and the relevant investment policy and strategy.

Applies to	Proposed Rule	Description
products, but no SIL[7]		Portfolio managers managing a portfolio with a retail investor base can satisfy this obligation by publishing an index of the underlying products of the investment portfolio, including any SIL, with links to those products' individual disclosures. ***Review:*** These disclosures should be reviewed and updated every 12 months, and should also be updated as required to reflect any changes to the product. Investors should be notified of any proposed revisions to the disclosures at least 60 days prior to them taking effect, and the revisions should be published within 60 days of their effectiveness.
Certain firms electing to use a SIL in respect of an investment product[8]	Sustainability Product Report (SPR)	This builds on the public Task Force on Climate-Related Financial Disclosures (TCFD) product report, and is also referred to as Part B of a public product-level sustainability report. It should be digitally accessible in a prominent place, such as the website the product is offered on. Where a firm is required to prepare a public TCFD product report, it should include this (or a link) in the SPR. The SPR must include the SIL, SO and investment strategy, details of any deviations from the overarching investment approach, progress towards the SO and KPIs (and/or other relevant metrics) and, where stewardship is a significant part of the investment strategy, related KPIs and outcomes. As above, there are additional requirements depending on the SIL. ***Review:*** The SPR should be reviewed as required to ensure it remains consistent with the SIL used and other disclosures required. Where other disclosures are updated, the SPR should be updated as appropriate as well.
All firms[9]	On-demand Reporting	Firms (in particular, those providing portfolio management services or U.K. AIFMs managing unauthorized AIFs that are not listed on a recognized exchange) are required to provide equivalent information as set out in the pre-contractual disclosures and SPR (as applicable) on demand to clients. This is limited to one request per client per reporting period, in respect of each product, and the firm must respond within a reasonable time.

[7] "Sustainable investment products" are those with sustainability characteristics as part of their investment strategy or policy, but which don't meet the criteria for (or elect not to use) a SIL.

[8] This does not apply to firms providing portfolio management services or U.K. AIFMs managing unauthorized AIFs that are not listed on a recognized exchange.

[9] This applies in respect of all investment products, regardless of whether they use a SIL, or have sustainability characteristics.

Applies to	Proposed Rule	Description
All firms with £5 billion or more of AUM (on a 3-year rolling average)	Entity-level Disclosures	These disclosures should be digitally accessible in a prominent place, such as the main website for the business of the firm. They should include the approach to governance with respect to sustainability risks and opportunities (including how these are identified, assessed and managed, together with associated metrics), actual and potential impacts of these risks and opportunities on the business, its strategy and financial planning, and how its strategy has influenced decision making. TCFD-aligned disclosures must also be clearly identifiable (e.g., included by link). Where the firm manages products which have a SIL, the report should also describe arrangements and resources in place to support the achievement of the SO(s) and any resources, governance and organizational arrangements that support the delivery of those SO(s) and related investment strategies. Firms may rely on group reporting to the extent it is relevant to the firm and covers all in-scope products under management. Any group reporting will also need to make use of suitable cross-referencing. ***Review:*** Entity-level disclosures should be updated annually.
(C) Requirements for Distributors		
All firms (including platforms and advisors) with retail investors	Distribution Obligations	All firms (including platforms and advisors) that distribute products to retail clients must ensure that those investors are provided with access to the related consumer-facing disclosure and that the relevant website (or similar) and marketing materials are kept updated. Where the product has a SIL, the firm must display that SIL (and no other) in a prominent place on the webpage or other digital medium where the product is offered. Firms that distribute recognized schemes (including exchange-traded funds (ETFs) that are recognized schemes) must, where terms that would otherwise be prohibited by the naming and marketing rules are used (see (D) below), specify that the product is based overseas and is not subject to FCA sustainable investment labelling and disclosure requirements.
(D) Naming and Marketing; Anti-greenwashing		
All firms	Anti-greenwashing Rule	Must ensure that any reference to the sustainability characteristics of a product or service are consistent with their sustainability profile and are clear, fair and not misleading.

Applies to	Proposed Rule	Description
Firms electing to use a SIL in respect of an investment product	Naming and Marketing Restrictions	If a product is labelled as “sustainable focus” or “sustainable improvers”, it may not use the word “impact” in the name of the product.
All firms with products that don’t use a SIL	Naming and Marketing Restrictions	Firms are restricted from using certain terms in naming or marketing materials, such as “ESG” (or any component thereof), “climate”, “green” and any other term implying sustainability characteristics. Portfolio managers are exempt from this restriction, provided that 90 percent of the total value of products in the portfolio use a SIL and the terms which would otherwise be prohibited are not used in a misleading way.