UK SDR Consultation Paper 22-20

FSI Consultation Responses

Company overview

First Sentier Investors is a global asset management group focused on providing high quality, long-term investment capabilities to clients. We offer a comprehensive suite of active investment capabilities across global and regional equities, cash and fixed income, infrastructure and multi-asset solutions. Today, across the First Sentier Investors group, we manage US$134.4 bn* of assets on behalf of institutional investors, pension funds, wholesale distributors and platforms, financial advisers and their clients. (*As of 30 September 2022). First Sentier operates offices in both London and Edinburgh.

#	Question	FSI Response
1.	Do you agree with the proposed scope of firms,products and distributors under our regime? If not, what alternative scope would you prefer, and why?	FSI generally agree with the proposed scope, products and distributors under the regime. Overall, we believe the regime could consider further fungibility with other regional regulations such as EU SFDR and the proposed US Securities and Exchange Commission sustainability rules. We note a further consultation is expected regarding overseas products once the overseas fund regime (OFR) is finalised. There also needs to be clarity around those funds that use ESG or sustainability-related names in the EU but that do not qualify for a label as per SDR (e.g. a SFDR Article 8 fund with 50% sustainable investment commitment that uses ‘sustainable’ in its name but does not qualify as a Sustainable Focus fund in the UK). We would recommend the removal of the requirement to identify both a primary *<u>and</u> a* secondary investor contribution mechanism by which a product achieves a positive environmental or social outcome. Separately, section 4.76 of the paper refers to the use of a label being a ‘significant event’ as described under COLL 4.3 - the changes will require many products to update their investment objectives. We would ask the FCA to consider whether a grandfathering approach could be adopted to allow managers to update the investment objectives without formal notice to investors when changes to the investment profile, risks, leverage, and asset types are unchanged. Lastly, we would like to understand more clearly the FCA’s intention to expand the requirements to portfolio management services aimed at institutional clients.

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2.	Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?	We note the proposed timeline as set out in the consultation paper with labels, consumer-facing and pre-contractual disclosures, and naming and marketing rules to apply 12 months after the publication of the Policy Statement (PS). We believe this is a relatively short timeframe to implement the required changes, including possible re-authorisation of funds, for those funds seeking a sustainable label. The timeline will include the need to conduct a deep-dive review of the final PS. Of particular concern, would be the proposed requirement to have independent assessments of credible standards where managers use in-house proprietary systems and metrics to define sustainable investments. Such independent assessment would require a substantial time commitment engaging with the limited number of third-party assessors that may provide such services. We would welcome clarity on when asset managers should have proprietary systems assessed i.e in advance of June 2024 or afterwards. We would also flag the continued lack of reported data from investee companies required to demonstrate funds are achieving sustainable investment objectives. Many asset managers operate global and emerging market strategies where corporate disclosures continue to lag more developed corporate regulatory reporting regimes including those in the EU. This will invariably impact on the ability to align assets with credible standards. In addition, many funds will require updates to fund documentation, including investment policies and objectives, to reference both financial objectives as well non-financial / sustainable objectives. These changes will require post authorisation applications, or re-authorisations, to the FCA which could possibly lead to challenges with the 12-month application post Policy statement.
3.	Do you agree with the proposed cost benefit analysis set out in Annex 2. If not, we welcome feedback in relation to the oneoff and ongoing costs you expect to incur and the potential benefits you envisage.	We agree that the benefits of the sustainability disclosure requirements outweigh the costs of implementation. Whilst our requirements for labels and product-level disclosures will be applied on a fund-by-fund basis, we estimate costs on a firm-by-firm basis to reflect that asset managers who manage multiple funds are likely to be able to benefit from economies of scale, I.e. applying our rules to one fund should facilitate applying them to other funds and thus lower the per-fund costs of compliance. The requirement to produce consumer facing product level disclosures with prescribed fields for all retail funds, regardless of whether they have sustainability characteristics, will lead to all firms with retail clients incurring costs. Separately, section 15 of the CBA annex refers to firms benefiting from the economies of scale when updating fund material. We would highlight that

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		firms will have ongoing costs and time required to maintain additional disclosure documents on a fund level.
4.	Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why.	We strongly support the approach for a product to identify a sustainability objective alongside demonstrating intentionality. This will distinguish sustainable investment products from products purely focused on financial objectives. However, we note the lack of a clear definition of the term 'sustainable investment' in the CP. As we have seen with EU SFDR, a lack of definition of a sustainable investment has caused a significant level of uncertainty for the asset management industry. Each label does however seem to offer a different approach to sustainable investing. Nevertheless, it would be beneficial for the FCA to provide a clear definition going forward. We do agree with the overall approach to include a non-financial objective or sustainability objective alongside a financial objective. We do agree with the 3 identified investor contribution channels by which an investor may plausibly contribute to positive outcomes for the environment and/or society, namely – (i) Active Investor stewardship & engagement, (ii) Influencing asset prices and the cost of capital, (iii) Seeking a positive sustainability impact by allocating capital to underserved markets or addressing market failures. As previously noted, we would challenge the requirement to identify a primary and a secondary channel for each label to measure investor contribution. As an example, we would highlight the difficulty for fixed income strategies to demonstrate stewardship outcomes given the lack of voting rights for bond holders at company annual general meetings. We also believe asset selection should play a more important role as a channel by which an investor contributes to positive outcomes. Furthermore, it seems the terms 'channels' and 'mechanisms' are used interchangeably throughout the paper. We would suggest identifying the more relevant term and removing reference to the other. Finally, we would look for enterprise contribution i.e the outcomes contributed by the issuer of the asset, independently of actions by the investor, to play a more prominent role alongside the investor contribution in the attainment of the sustainability objectives of the product.
5.	Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?	We agree with the overall intention and approach to the labelling and the classification system including the intention to achieve a product's stated objective i.e intentionality. However, we would urge a level of fungibility for differing standards between SDR and other global sustainable finance regulations including the EU SFDR. Many global fund managers, including First Sentier Investors, operate strategies across multiple countries and regions. Divergence of regulatory standards poses challenges whereby a particular investment strategy/fund could obtain a sustainable categorisation in one region i.e under EU SFDR, and possibly not meet

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		the criteria for a label under SDR where the intention is to 'raise the bar'. This may require a change of investment processes depending on the region and associated disclosure obligations. As previously noted, we would also draw attention to the limitations resulting from corporate data disclosures. The CP does recognise that sourcing ESG-related data remains a major challenge for the industry. We would ask the FCA to provide guidance on the use of proxy or estimated data and how this data could be considered in the absence of reliable reported data. Separately, from our experience from implementing the EU SFDR we believe that the approach will require a substantial uplift in fund documentation including offering documents, marketing materials and indeed the consumer-facing disclosures. We believe the paper and approach underestimates the time and resources including third-party assistance from legal firms.
6.	Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on:	
6a	Sustainable Focus: whether at least 70% of a 'sustainable focus' product's assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?	We are supportive of setting a threshold for a percentage of assets meeting a credible standard of environmental and/or social sustainability. We would advocate for the FCA to present the rationale for selecting 70% as the lower bound. In our view, the threshold should be raised further closer to sustainable investment requirements under the EU's SFDR Article 9 requirement i.e all investments to be considered sustainable other than for cash and cash equivalents. We believe a threshold of 70% will dilute the benefits of the label given the broad range of strategies that may avail of the label in its current form We would also question how the FCA will define whether a particular company is considered sustainable i.e use of a look-through approach to proportion of revenue, opex, capex as defined in SFDR/EU Taxonomy or utilise the proposed UK Green Taxonomy. *CFA UK comment: The majority of our members believe the 70% assets threshold for the 'Sustainable Focus' category to be too low and insufficiently well defined*

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		We note the CP refers to use of a taxonomy, such as the UK Green Taxonomy, as a potential way of demonstrating that assets meet a credible standard of sustainability. Given the delays to the UKGT, it would be important to understand whether third party data providers could provide a credible standard or whether proprietary sustainability criteria and systems would suffice. We strongly urge the FCA to support independent assessments of proprietary sustainable criteria and systems. In addition, will the FCA's planned Code of Conduct for ESG data and rating providers provide for an agreed consistency of methodologies between providers? Finally, independent third-party assessment of credible standards will require a not insignificant cost outlay for managers running multiple strategies and/or labels.
6b	Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?	We agree with the distinguishing features of the label namely the aim to invest in assets that have the potential to deliver measurable improvements over time, and that stewardship should be a key feature. As a signatory to the FRC Stewardship code, we are required to report annually on stewardship outcomes. We would note that asset managers will be challenged to provide a causality link between individual engagement or stewardship activities and changes in company behaviours. We would also question what role an asset will play once it improves or transitions its business towards being considered a sustainable asset/business over time. Should this asset be sold as it is no longer contributing to the objective? We note that the FCA should give further consideration to what it defines as stewardship under the new Rules and Handbook, and the extent to which this draws upon the existing definition within the FRC's Stewardship Code. Section 4.35 refers to the metrics disclosed as part Governments Transition Plan Taskforce could form part of KPI's used to measure progress. Similar to the UKGT, we note this has yet to be implemented.
6c	Sustainable Impact: whether 'impact' is the right term for this category or whether should we consider others such as 'solutions'; and the extent to which financial additionality should be a key feature?	We do agree that the label should be named Sustainable Impact as "Impact" in relation to impact investment is a well-recognised term throughout the industry and appears to be the intent of this label. We believe the concept of 'additionality', particularly for listed equities, will prove challenging to demonstrate. In particular, we would argue that additionality through stewardship will be very challenging to evidence and question the premise that minority shareholders can "claim" their activities have specifically generated an impact. In addition, the label would typically require investment in primary or private capital. Again, a challenging

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		concept for listed equity strategies operating in secondary markets. We would also note that retail investors generally do not invest in private markets. For these reasons, we believe there will be a select number of funds applying for the impact label and that this label if not clear in its criteria runs a high risk of greenwashing. We do, however, agree with the requirement to articulate a 'theory of change' i.e : a comprehensive description and illustration of how and why a desired change is expected to occur in a particular context .
7.	Do you agree with our proposal to only introduce labels for sustainable investment products (ie to not require a label for 'non-sustainable' investment products)? If not, what alternative do you suggest and why?	We agree with the suggested approach. We would recommend that non sustainable products be required to disclose a statement that "the investment product does not meet the minimum requirements for a sustainable label".
8.	Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider: • whether the criteria strike the right balance between principles and prescription • the different components to the criteria (including the implementing guidance in Appendix 2) • whether they sufficiently delineate the different label categories, and; • whether terms such as 'assets' are understood in this context?	We broadly support the balance between principles and prescription. We are generally supportive of the qualifying criteria outlined in the paper namely, the five overarching principles, key cross-cutting considerations and the category specific considerations. We understand criteria for each label must be met in full and on an ongoing basis. We would welcome any information regarding the frequency of ongoing assessment and whether a breach of thresholds or criteria, either inadvertent or advertent, would incur notification to the FCA. Similarly, where a product does not meet a key performance indicator (principle 3), how should managers disclose same. It would be useful to further define the term 'as soon as reasonably practicable' in the below sentence from the CP. *'If for reasons beyond the firms' control, the assets cease to meet the requirements above, the firm must take action to restore compliance as soon as reasonably practicable, having regard to the interests of the firm's investors (i.e. clients and consumers).'* The non-handbook guidance section of the CP requires firms to advise on a time horizon for the sustainability objective to be met or attained. Would this require a specific time-horizon or could this include a possible range in years?
9.	Do you agree with the category-specific criteria for: • The '**Sustainable focus'** category, including the	Sustainable Focus – category-specific criteria

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	70% threshold? • The ‘**Sustainable improvers’** category? Is the role of the firm in promoting positive change appropriately reflected in the criteria? • The ‘**Sustainable impact’** category, including expectations around the measurement of the product's environmental or social impact? Please consider whether there any other important aspects that we should consider adding.	We broadly agree with the category-specific criteria for the Sustainable Focus category. As noted in our answer to Q. 6, we believe the 70% threshold should be raised further to a minimum of 90%. Furthermore, clarity on how the threshold should be applied i.e should the threshold apply over a reference period or at a specific snapshot. Sustainable Improvers - category-specific criteria With regards to the key-performance indicators, we would have the following comments; - ‘*a clear and measurable target for improvements in the sustainability profile of the assets in which the product invests’.* Should targets be specific to each asset/company or common across a portfolio? We understand metrics will be required in reporting disclosures such as those related to voting outcomes. - ‘*the changes (if any) in the sustainability profile of the product’s assets over time, distinguishing between any improvement or deterioration in the sustainability profile of individual assets and changes arising from asset rotation’.* We would ask for further clarity on the timescale for reporting on stewardship outcomes. Stewardship outcomes are often the result of a long-term partnership approach with an investee company. Furthermore, positive stewardship outcomes are often collaborative industry efforts and/or the result of a range of efforts from within and outside the industry which will prove challenging to demonstrate each investor contribution. Sustainable Impact – category-specific criteria We agree that products in this label should demonstrate a pre-defined, positive, measurable real-world outcome. This is in line with the industry understanding of impact investing. We also agree with the requirement to define 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.
10.	Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?	We are supportive of the approach to not introduce a mandatory requirement for firms to seek independent verification of their labelling at this stage. This would be consistent with the approach taken by the European Commission. However, we have seen fast-track application processes particularly in Ireland and Luxembourg where managers self-categorised under SFDR. Firms’ internal product design, product governance, disclosure and compliance procedures should be robust in ensuring appropriate classification and labelling. A requirement for firms to seek independent verification would significantly increase the costs

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		and burden on firms. Nevertheless, we would support the introduction of a verification process after a period of 3 years.
11.	Do you agree with our proposed approach to disclosures, including the tiered structure and the division of information to be disclosed in the consumer facing and detailed disclosures as set out in Figure 7?	We agree with the need for managers to provide decision-useful information in product pre-contractual disclosures in line with the 5 principles overarching principles. We do support aligning SDR requirements with existing TCFD-aligned product and entity level disclosures, including the flexibility to utilise, or cross-refer, to disclosures made at group level.
12.	Do you agree with our proposal to build from our TCFD aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?	Yes, we agree with the proposal as outlined reporting aligned with IFRS/ISSB standards is potentially helpful and efficient if the reporting is streamlined. However, we note the importance of providing meaningful disclosure on social objectives and issues and environmental objectives and issues beyond climate change.
13.	Do you agree with our proposals for consumer facing disclosures, including location, scope, content and frequency of disclosure and updates? If not, what alternatives do you suggest and why?	We would disagree with the requirement to produce a consumer-facing disclosure document for funds without a sustainability label. Likewise, we would disagree with the requirement to include a list of 'unexpected investments' in the disclosure document. We believe consumers will have their own views on what could be considered an unexpected investment. Furthermore, consumer facing disclosures are an additional documentation overhead combining pre-contractual information with reporting on progress which is an unusual approach in the industry (pre & post information). The label should be the simplest flag showing a client the high-level degree/style of sustainability. Pre-contractual and reporting can then offer additional detail.
14.	Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?	Should the consumer-facing disclosure requirement remain in the final Policy Statement, we would suggest that the FCA or industry provide a standardised template.
15.	Do you agree with our proposals for precontractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on	Yes, we are supportive of the requirement for pre-contractual disclosure I.e disclosures should be in the prospectus and in a section clearly dedicated to a funds sustainability qualities and how it achieves them. Noting the FCA have identified several areas of common deficiency for ESG/sustainability products and the required disclosures, we would anticipate a large body of

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	the scope, format, location, content and frequency of disclosure and updates.	work will be required across the industry to bring offering documents in line with SDR standards. We would suggest removing reference to 'Part A of the report' which seems to suggest this is a report rather than pre-contractual disclosures.
16.	Do you agree with our proposals for ongoing sustainability related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.	We support the proposal to mandate ongoing sustainability-related performance disclosures with the detail to be disclosed in section 5.67. We suggest the report could be presented as an appendix to the annual financial statements, similar to SFDR periodic disclosures, rather than a further standalone sustainability report on a firm's website.
17.	Do you agree with our proposals for an 'on demand' regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?	Section 5.74 of the CP suggests the date can be negotiated between fund and client. This could become quite a commitment if clients request on-demand reporting not aligned with the fund year end. The paper is not entirely clear on whether the on-demand reporting solely applies to discretionary mandates / segregated mandates or indeed also applies to fund investors.
18.	Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.	We recognise the importance of entity-level reporting and agree with building on the TCFD reporting requirements for asset managers, which is in line with recommendations from the International Organisation of Securities Commissions (IOSCO). However, we note that climate-related data and information is generally more available than sustainability-related data such as social-related data. We would like clarity on the requirement for entity level reporting where the asset manager only has a proportion of its products subject to FCA oversight.
19.	Do you agree with how our proposals reflect the ISSB's standards, including referencing UK adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?	

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20.	Do you agree with our proposed general 'Anti greenwashing' rule? If not, what alternative do you suggest and why?	We support the anti-greenwashing rule applicable from the date of publication of the policy statement. Reiterating existing rules (i.e adding to the ESG sourcebook), will ensure sustainability-related claims remain clear, fair and not misleading in the period prior to pre-contractual and consumer-facing disclosures becoming effective. We would also like to see alignment of the anti-greenwashing provision with the standards set by other jurisdictions as this issue is not unique to UK investors.
21.	Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?	We are supportive of the principle of the naming rule. We have some reservations regarding the non-exhaustive list of prohibited terms in section 6.12 of the paper. Whilst naming proposals are generally consistent with similar proposals from ESMA on fund names using ESG or sustainability-related terms, we believe including a list of specific terms is unworkable. In particular, the term 'Responsible' is widely used in the industry. Many of these funds would integrate ESG factors and consider other sustainability issues and metrics, and we believe there is sufficient demand from retail and institutional investors to support this type of product However, given the high-bar, certain funds will be unable to achieve a label. We would also question why the term 'governance' is included as a prohibited term without a label.
22.	Do you agree with the proposed marketing rule? If not, what alternative do you suggest and why?	We fully support that it is not acceptable for funds to make unverifiable or meaningless sustainability claims in marketing material, however, we note the absence of a clear definition as to what constitutes marketing activity in the paper. We believe the marketing rules are overly prohibitive on the use of certain terms which are used across investment strategies and are not limited to specific sustainable portfolios. We also note that ESMA's consultation paper on funds using ESG terms is *not* proposing to restrict such terms in marketing materials.
23.	Are there additional approaches to marketing not covered by our proposals that could lead to greenwashing if unaddressed?	
24.	Do you agree with our proposals for distributors? If not, what alternatives do you suggest and why?	We do believe that distributors have a role to play in disseminating fund materials with sustainable disclosures including the proposal to display sustainable labels prominently on fund platforms. Similar to our comment regarding the proposal for non-sustainable funds (those without a label) to create a consumer-facing disclosure document, we would question the requirement for distributors to make this document available to investors.

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		We note that distributors should not be held accountable for any additional disclosures for overseas funds distributing in the UK, in the absence of specific rules for such funds under SDR.
25.	What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?	We believe that pension products which are available for self-selection on DC platforms including the default option, should also carry sustainable investment disclosures and be subject to the same key principles as this consultation. We would support this being phased in after the implementation of this CP.
26.	Do you consider the proposed naming and marketing rules set out in Chapter 6 to be appropriate for pension products (subject to a potentially lower threshold of constituent funds qualifying for a label). If not, why? What would be an appropriate threshold for the naming and marketing exemption to apply?	Pension products should be subject to the same key principles as outlined in this CP.