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7th January 2022
Gwil Mason
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12 Endeavour Square
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Sent via email to dp21-04@fca.org.uk

Dear Mr Mason,

ShareAction response to *DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels*

I am writing to respond to your discussion paper *Sustainability Disclosure Requirements (SDR) and investment labels* on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors.[1] We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the view of clients, beneficiaries and pension scheme members.

Q1: What are your views on the tiered approach set out in Figure 2 (pg 10)? We welcome views on any concerns and/or practical challenges.

We would welcome additional entity level disclosure for consumer labels as the credibility of sustainable products are supported or weakened by the processes taking place at a firm level, in the same way that a firm's business model should affect its ability and pricing of a (green) bond. For financial market participants, a client should also be able to see the investment approach of the firm e.g. in terms of active and passive approaches and its commitment to stewardship. We think that entity level disclosures are important for institutional investors and consumers in the context in which the Government is introducing the labels for the following reasons:

- The impact of an investor providing a "sustainable" financial product can be directly undermined by that investor's wider non-sustainable products and activity. For example, as the Government has recognised in its 2021 Green Finance Roadmap, stewardship by investors is critical to the transition. However, stewardship linked to sustainable products can be undermined or cancelled out if, at an entity level, the house voting and stewardship policies contradict those of the sustainable product.

[1] https://shareaction.org/

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- The point of disclosures is to avoid greenwashing. It seems very likely that consumers will assume that the sustainability credentials at the product-level are mirrored at the entity level. If this is not the case – or if there are no disclosures to demonstrate whether this is the case – this opens the door to greenwashing and undermines the policy intention.
- Some will no doubt say that all that matters is that there are sustainable products, but if the Government wants to live up to its ambition for the UK to be the first "net zero financial centre", it needs to incentivise financial market participants that are transitioning their overall business models and not to simply encourage more green products.

This is not to say that entity level disclosures need to be the same as product-level disclosures. For example, the TCFD's Governance and Strategy-level disclosures could be used as a basis for entity level disclosures. And disclosures could be made about issues such as whether there is sustainability expertise on the board, whether remuneration is linked to sustainability targets, Stewardship Code status, whether there is training on sustainability, and how sustainability considerations are integrated at a portfolio level across the organisation.

The FCA should also be explicit about where and how this information is published, whether within a written prospectus or digitally displayed - as is stipulated in the SFRD/CDSR reporting guidelines. Having this information in the same format, and being able to locate it easily will be important for clients in their consideration of products.

Q2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of product than for others, please provide examples.

To enable good alignment and stop a race to the bottom in fulfilling minimum requirements, we would advise that the SDR reflects the SFDR in its scope. SFDR has a broad scope (financial market participants are defined as investment firms, including asset managers which offer portfolio management services, pension providers and insurance-based investors, as well as qualifying venture capital and social entrepreneurship activities), with additional requirements for large investors, with over 500 employees. In relation to the firms that should be covered, we would push for the broadest scope possible, with fall back option to have certain provisions only apply to the larger firms.

In terms of the products in scope, we would advise a particular focus on longer term investment products including pensions, retail investment products including real estate and infrastructure and insurance policies to be covered. We don't believe that there are products that do not require or would benefit from such labelling. However, given the magnitude of capital flows between asset owners and asset managers, labelling should prioritised on products targeted at them. Segregated mandates, which we understand to be those into whose mandate clients will have had greater input would also benefit from information on sustainability.

While a primary function of these standards should be to stop greenwashing, there should be an equal focus encouraging portfolios to de facto take material sustainability criteria into account, as part of risk management and fiduciary duty, if they are not doing so already. As such we believe there to be a strong case for calling out or identifying products that aren't sustainable, through clear labelling and with clear language – and indeed the use of colour coding on certain funds were applicable.

To this end, we would strongly discourage the term 'responsible' for products that merely account for the impact of material sustainability factors on financial risk and return, as we believe this to be basic duty of care for investors in managing their clients' money (see our response to Q.4 for more detail).

Q3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable and impact) and how best should we engage with them?

We agree that the organisations and initiatives identified (i.e. CFA Institute, the IA, TISA, BSI and IOSCO) should be consulted when defining key terms used in the SDR. These reputable and longstanding organisations have already laid the groundwork for many of the topics under consultation and a strong degree of alignment is warranted. In addition to the ones mentioned above others could include:

- Global Sustainable Investment Alliance[2]
- Impact Investing Institute
- The PRI
- The UK Sustainable Investment and Finance Association
- Academia - Smith School, Cass business school, Said business school, Cambridge Institute for Sustainability Leadership, Grantham Institute, University of Zurich Centre for Sustainable Finance and Private Wealth.

Q4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.

We broadly welcome mapping onto SFDR and splitting out Article 8 funds. Research by the Netherlands' financial regulator (AFM) shows that a lack of clarity over Article 8 funds may have caused incorrect fund self-categorisation by firms.[3] Splitting this category into distinct buckets could help UK firms in this regard and also provide more clarity on the sustainability ambition of a fund for consumers. Three of the fund classifications (transitioning, aligned, impact) are part of a broader "sustainability" classification. This could lead to further confusion for consumers. For example where a fund invests in assets with high potential to transition, but are therefore not currently considered sustainable. We recommend the FCA removes any overarching classification for these funds.

The Transitioning category is welcome especially given issues in the EU around Article 8 funds, however more information is needed on the timescales involved and it is critical that there are clear and robust criteria for what can count as "transitioning", otherwise this category will be used to cover all manner of funds, assets and net zero targets even when they are not robust or science-based, and may allow for weak stewardship. For example, the following need to be clear: How long does a fund/asset have to transition? A client may be frustrated where assets in fund have not transitioned after e.g. 10 years. What happens when an asset is felt to have transitioned

[2] http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf

[3] https://www-afm-nl.translate.goog/nl-nl/professionals/nieuws/2021/september/beleggers-beter-informeren-duurzaamheid?_x_tr_sl=nl&_x_tr_tl=en&_x_tr_hl=nl

and becomes sustainable? Does the holding get taken out of the transition fund and put into an aligned fund? Does the fund classification change from transitioning to aligned when a majority of its holdings are considered "aligned"? In addition to providing clarity on these questions, the FCA should take steps to avoid a situation where funds sit in this category indefinitely.

However the FCA must also make clear the fund categories are not exclusively focussed on "E" factors, but across all ESG themes. Clients may expect "transitioning" to mean transition to net zero but the discussion paper notes a "transition to a more sustainable future". A client may be surprised to find a "sustainable transitioning" fund covers climate change but ignores wider E factors and S factors. The EU is expected to publish the final report for its draft social taxonomy soon, which may be useful in considering the UK's own approach. At the very least, given its important interrelations with climate change, biodiversity loss should be included as an E theme from the launch of the UK's framework.

We also have some concerns with the first two classifications, "Not promoted as sustainable" and "Responsible". On the former, the FCA should look beyond how the product is promoted and focus on funds that are actively harming the environment and society. The framing of this category is important and this work should be as much about steering investors and savers away from harmful products as it is about steering them towards sustainable products. We recommend this classification be renamed "Harmful" (I.e. non-Taxonomy aligned and also non-transitioning).

We also note that this category is based on whether or not the product is "promoted" as sustainable, whereas the "Sustainable" categories (and, to a lesser extent, the "Responsible" one) are intended to be based on an objective criteria – including e.g. alignment with the Taxonomy. We wonder whether this could lead to some practical confusion for investors when categorising products as "Not Promoted" could end up covering products that are similar to the Sustainable products, but just happen not to be promoted as sustainable.

We are concerned with the criteria for the "Responsible" classification, which the discussion paper states is the "impact of material sustainability factors on financial risk and return". This is the legal minimum for institutional clients under the Occupational Pension Scheme (Investment) Regulations 2005. The name of the fund classification may suggest to clients that the fund goes beyond the legal minimum when this is not the case. It could lead to a situation where higher prices are charged for funds that are 'business as usual' and ultimately not provide strong enough incentives to invest more sustainably where a fund's impact is proactively considered. It is also likely to mislead consumers who assume that there is something "special" in relation to sustainability about the label "Responsible", when this is not the case – the consultation document states that these products have "no specific sustainability goals".

The FCA will also need to consider fund naming standards following the new classifications. There will be many funds that call themselves sustainable which will not meet the new criteria, potentially leading to even more confusion/greenwash.

Q5: What are your views on 'entry-level' criteria, set at the relevant entity level, before products can be considered 'Responsible' or 'Sustainable'? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for 'Sustainable' products. We also welcome feedback on potential challenges with this approach.

We support the proposal that there be a baseline of "entry-level criteria" at entity level for the reasons set out at Q1 above. Given the FCA's minimum criteria for the responsible classification is that the fund considers the impact of sustainability factors on financial risk and return – the legal minimum expected of most UK pension schemes – we would expect entry criteria for those funds currently labelled sustainable to be more stringent. In particular, we think as part of 'entry-level' sustainability criteria for transitioning, aligned and impact categories, entities should be required to:

- Develop voting policies explicitly committing to support shareholder resolutions on ESG issues on a 'comply or explain' basis;
- Publish voting policies and voting rationales in a manner that is timely and user-friendly;
- Commit to voting at all AGMs, regardless of geography or the level of holdings;
- Pre-declare voting intentions for particularly key ESG resolutions;
- Consider filing shareholder resolutions at companies failing to make sufficient progress on ESG issues.
- Ensure there is sustainability expertise on the board;
- Requiring ESG and sustainability targets are linked to executive remuneration;
- Put into place mandatory training on sustainability, and how ESG and sustainability considerations are integrated at a portfolio level across the organisation.

As we have outlined in our answer to Question 4, we are concerned about how the transitioning classification will work in practice. In particular we are keen to avoid a situation where this category could cover all manner of funds and assets, net zero targets even when they are not robust or science-based, and the risk this could allow for weak investor stewardship. To curb these risks, the FCA should require that at fund level in the transitioning category:

- Products have clear timeframes over which products should have transitioned;
- Firms have detailed stewardship strategies and annual reports on transition progress related to those products;
- Transition plan reporting, with specific criteria that are timebound;
- Alignment with science-based pathways to incentivise continued improvement to fully green activities
- Firms develop and publish escalation policies where there is a lack of progress amongst holdings in relevant products;

Q6: What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

In balancing principles and prescription we advise the FCA to reflect on the feedback given to the SFDR as it stands currently. Overwhelmingly it is felt that the SFDR requirements would be more effective if they were, among other things, more defined and included the appropriate thresholds

to quantify negative impacts. This has been the experience amongst investors in the EU.[4] Eurosif in particular has called for greater clarity in terms of definitions and performance metrics.

From reading the discussion paper, we were unclear about whether a firm would be able to apply several classifications to the same fund. This would lead to more confusion and potential greenwash. Classifications should be mutually exclusive and the FCA should make this clear in its response.

The forthcoming UK green taxonomy would be a useful framework against which funds can evidence how they meet the fund classification criteria. However, it should not be the only metric. For funds with "S" objectives a green taxonomy will not be useful and the FCA should consider what other criteria could be used - including whether strong alignment with the EU's proposal for a social taxonomy - is warranted. Another route for investors with a specific focus on workforce and social issues could be to commit to a voluntary initiative for engagement and/or disclosure, like ShareAction's Workforce Disclosure Initiative (WDI). The WDI is supported by a growing coalition of investor members, pushing for systemic change in the way that companies report on, and are held accountable to their workers. The annual survey aims to deliver the first robust standardised and comparable data set on companies' workforce practices and could represent a useful way of evidencing how firms meet "S" criteria.

Separately, ShareAction has recently called on the Government to provide a long-term vision for its Levelling Up agenda, including setting out expectations on investors for incorporating health into ESG frameworks. As with climate change, companies and institutional investors need clear policies and frameworks for their practices to benefit health. Armed with this, institutional investors can use their stewardship activities to support government ambitions in relation to health.

We are calling on HMT to endorse and embed the framework developed by ShareAction and Business for Health which advocates for business and investors to consider health using an approach similar to that used in climate reporting. The framework includes three pillars or 'scopes':

- Worker health,
- Consumer health (via products and services produced),
- Community health (via impacts on the local environment).

This should set-out clear expectations of industry to enhance its health-related disclosures and further regulation to encourage this reporting and ensure its quality and consistency. We have called on the Government to work with investors, companies, health experts, and civil society to provide best practice guidance on disclosures with a view to moving to mandatory disclosures. We see a clear opportunity for HMT to integrate this framework now, as it considers how the implement new Sustainability Disclosures Requirements. Should the Government accept our proposals, the FCA could consider investors' use of such a framework as evidence of funds meeting the above classifications vis a vis public health.

[4] https://capitalmonitor.ai/institution/investment-managers/calls-get-louder-for-sfdr-overhaul-as-eu-fails-to-provide-clarity/?utm_source=pardot&utm_medium=email&utm_campaign=cm_newsletter_0308

Q8: What are your views on our treatment of transitioning assets for: a: the inclusion of a sub-category of 'Transitioning' funds under the 'Sustainable' label? b: possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?

See above comments on the labelling system. We would encourage the FCA to remove the overarching category of "sustainable". All 5 classifications should be individual categories not collated under one banner, which is very confusing and will not help consumers to identify whether their preferences are met by a certain investment product.

Minimum criteria are essential, especially for this category. This is not a static label, so improvements need to be made within certain timeframe against very clearly defined criteria. The criteria for this label should be strengthened over time. We recommend the FCA introduces a review cycle to ensure the labels are appropriate and in consumers' interest every 3 years.

Q9: What are your views on potential criteria for 'Responsible' investment products?

As previously stated, we take the view that the responsible label, as applied in this way is misleading. Sustainability factors can affect the price of underlying assets, which is why integration of material ESG factors by pension schemes is required by law.

If properly labelled, under 'responsible investment' there should, at the very least there be a strong focus on do no harm systems in place, focussed on doing no harm to human rights and the environment and with a low threshold for taxonomy alignment e.g. 25%. We would also expect to see active stewardship of responsible assets by firms including voting and engagement.

Q10: Do you agree that there are types of products for which sustainability factors, objectives and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?

No. Sustainability factors can affect all products, whether they happen to be marketed as sustainable or not. Equally, all products will have an impact on the environment and society, both positive and negative, and those marketed as "not promoted as sustainable" are most likely to have the worst impacts. In the context of the UK striving to become the world's first net-zero financial centre the FCA should carefully consider whether it should introduce a regulatory regime where firms can essentially ignore sustainability altogether.

Q15: What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?

We would encourage the FCA to build on strong elements of SFDR, such as:

- Financial institutions should disclose on an annual basis which actions have been taken to address the adverse impacts per indicator.
- Firms should explain how they follow-up when investee companies fail to take action to minimize the negative impacts on which their engagement policies are focused, after more than one reference period.
- The FCA should review the effectiveness of Principal Adverse Impact indicators, but also consider broader scope for mandatory disclosures. For example, include more metrics on "S" and "G", and make sure social metrics are aligned with the OECD's Guidelines for Multinational Enterprises.

I hope our views are clear, but please do not hesitate to contact us at fergus.moffatt@shareaction.org if you have any questions.

Yours sincerely,

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