January 2023

# CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels

ClientEarth response

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# About ClientEarth

1. ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid, Beijing, Luxembourg and Los Angeles, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.
2. ClientEarth's Accountable Finance initiative analyses the legal duties of a wide spectrum of actors in the financial system – including companies, investors, banks, insurers, pension schemes and asset managers – to consider, manage and report their risks and impacts associated with climate change and the environment.
3. This paper sets out ClientEarth's response to the proposals set out by the FCA in Consultation Paper CP22/20 on the proposed UK Sustainability Disclosure Requirements (SDR) framework and investment labels (the "**CP**"). Please contact Dan Eziefula (deziefula@clientearth.org) and Megan Clay (mclay@clientearth.org) if you wish to discuss anything contained in our response. Our previous response to the FCA's Discussion Paper DP21/41 on SDR (the "**DP**") is available on our website[1].

# Top Lines

4. ClientEarth welcomes the opportunity to respond to the CP. We are supportive of the FCA's proposal to introduce a regime for sustainability disclosures and the labelling of sustainable products, and we consider that the proposals are a positive step towards providing consumers with the information they need to make informed choices on sustainable investment. In particular, we welcome the changes made to reflect the concerns expressed by us and others in response to the DP. Although we are broadly supportive of the proposed SDR and labelling regime, we have several high-level concerns that we believe must be addressed in the design of the new regime in order to ensure that it is robust, understandable to consumers and does not inadvertently facilitate or formalise greenwashing.
5. Our top line comments are:
    a. **"Sustainable" label could be misleading**: Our most fundamental concern with the current proposals is that they risk giving consumers the misleading impression that labelled products are more sustainable than they really are. Consumers may assume that a product labelled as *"sustainable"* is *"wholly sustainable"*. In particular, consumers are likely to infer that *"sustainable"* products are consistent with international climate goals (including limiting warming to 1.5°C) and other planetary boundaries. However, labelled products only need to target a single sustainability objective, and may be unsustainable in other ways (for example, not being aligned with climate goals). In order to remedy this, we propose that the label descriptors (and potentially the labels themselves) should clarify whether the product sustainability objective relates to climate change, environmental issues (other than climate change) or social issues. See our response to question 6 below. In addition, we propose a *"do no significant harm"* principle, as set out below.
    b. **Do no significant harm principle**: The current proposals would allow products to obtain sustainability labels due to their connection to a specific sustainability objective, even where

[1] https://www.clientearth.org/media/pbopi1ps/clientearth-response-to-fca-dp21-4.pdf

they cause significant harm to other sustainability issues. This is likely to mislead consumers (who may assume that a product labelled as *“sustainable”* is *“wholly sustainable”*) and would undermine the purpose of the regime by allowing harmful products to be labelled as sustainable. We therefore propose at question 6 that products should be required to do no significant harm to sustainability issues as a criteria of labelling (in line with the approach of the EU’s Sustainable Finance Disclosure Regulation).

c. **Criteria for “sustainable focus” and “sustainable improver”**: We propose that the criteria for the sustainable focus and improver labels should be tightened. For sustainable focus, we propose that suggested criteria for assets to *“align with a specified environmental and/or social sustainability theme”* should be removed. For sustainable improver, we propose that it must be credible that the assets will become more sustainable over time in response to the firm’s actions (such as stewardship) or investment. See our response to question 9 below.

d. **Double materiality**: It is essential that the entity and product sustainability reports required under SDR capture both: (1) the financial impact of social and environmental factors on the products or firm; and (2) the impact of the products or firms on society and the environment (referred to as double materiality). This is crucial for investors and consumers to understand the impact associated with their investments and the firms they choose to do business with. On this basis, we also strongly support the inclusion of a robust set of mandatory sustainability impact metrics in the SDR regime. See our response to questions 16 and 18.

e. **Anti-greenwashing rule**: We welcome the introduction of an anti-greenwashing rule. However, we propose that the rule should be amended to expressly clarify that firms must: (1) not omit or hide important information relevant to any statements they make about sustainability characteristics; and (2) be able to substantiate their claims with credible, science-based evidence

f. **Enforcement**: The SDR and labelling regime must be underpinned by effective monitoring and enforcement from the FCA. This is particularly important given that firms self-certify labels under the regime, based on intentionality. See our response to question 10.

# Consultation Question Responses

**Q1: 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?**

6. We welcome that the FCA is committed to review the scope (and potentially lower asset under management linked thresholds) after three years of disclosures and emphasise the importance of keeping the scope under review.

7. We suggest that the draft Handbook wording should be clarified to ensure it clearly reflects the FCA’s intended scope for consumer facing disclosures. The FCA intends that all firms marketing sustainability products should make consumer facing disclosures, regardless of whether they use sustainability labels. We therefore suggest that ESG 4.2.1 should expressly state that a firm should make consumer facing disclosures *“regardless of whether it uses a sustainability label in relation to a sustainability product”* (following the language used in relation to sustainability entity reports at ESG 4.4(1)(b)).

**Q2: Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?**

8. We consider that the SDR and labelling regime should be introduced as soon as possible. It is vital that capital is rapidly redirected towards sustainable activities, including in order to meet the UK's emissions 2030 Nationally Determined Contribution under the Paris Agreement and its 2035 carbon budget emissions target under the Climate Change Act 2008. As the FCA's Financial Lives Survey data shows, the majority of adults would like their money to do some good as well as make a financial return, and the SDR and labelling regime provides the opportunity for people to better understand how this can happen in practice.

9. We strongly support the FCA's proposal for the immediate introduction of the anti-greenwashing rule. However, given that (as the FCA acknowledges) firms should already be ensuring the information they communicate to clients is clear, fair and not misleading under PRIN 2.1, Principle 7, and COBS 4.2.1, we urge the FCA to ensure that it does not wait for publication of the policy statement to take enforcement action in respect of misleading sustainability claims.

**Q4: 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.**

<u>Secondary channel for sustainable improvers</u>

10. For sustainable improvers, the CP envisages that improvement can be achieved through the primary channel of investor stewardship, or through the secondary channel: *"Portfolio construction and asset selection in 'sustainable improvers' products would be geared towards identifying those assets that are best-placed to improve their sustainability profile over time"*.

11. We consider that this secondary channel is too broad and vague. In particular, it could be deemed to include investments in companies that have not aligned their businesses with sustainable goals, but which the firm nevertheless considers may improve in future. This is too unclear and subjective a standard, as it is unclear how firms should (absent their own positive action on stewardship) identify assets that are best-placed to improve their sustainability profile over time under this secondary channel. In particular, investments in companies that have implemented policies to align their business with sustainable goals (for example, fully implementing credible emissions targets into their corporate strategy) will already qualify for the sustainable focus category.

12. The FCA should therefore issue guidance on this secondary channel, to help firms understand the kinds of investment that fall within this category. For example, investments in sustainability-linked bonds that have credible KPIs with associated step-up coupon incentives could be appropriate. As set out more fully in our response to question 9 below on the criteria for sustainability improvers, products should only qualify for the sustainable improver label where it is credible that the improvement will be (at least in part) in response to the firm's actions or investment.

<u>"Sustainable" label could be misleading</u>

13. See question 6 below in relation to the use of the term *"sustainable".* As set out in that question, labelling an investment as *"sustainable"* on the basis that it targets only a limited sustainability objective

could mislead consumers and facilitate greenwashing, as products could be labelled as *“sustainable”* where they are not aligned with climate goals and/or do not respect planetary boundaries.

**Q6: 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:**

**a. 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?**

**b. 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?**

**C. 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?**

<u>“Sustainable” label could be misleading</u>

14. We have serious concerns that the three proposed categories for sustainable investments would (under the current proposals) mislead consumers as to the overall sustainability of products and facilitate widespread greenwashing. The labelling of investments as *“sustainable”* (either for focus, improvers or impact) is likely to give consumers the overall impression that the product is sustainable, despite the fact that the product may target only a single narrow sustainability objective. In particular the term *“sustainable”* is likely to give the impression to consumers that the product is consistent with all planetary boundaries, and in particular that it is aligned with climate goals (including aligning with 1.5°C, in accordance with the goals of the Paris Agreement). However, the product’s sustainability objective may be limited, and may not include any climate or environmental objectives.

15. For example, a product which uses a *“sustainable focus”* label due to a sustainability objective in relation to limiting plastic waste and plastic pollution could nevertheless entirely invest in companies whose activities conflict with the climate transition (such as the new production of coal) and/or destroy ecologically significant habitats (such as the clearing of primary forests in the Amazon). Such a product would not be <u>*“sustainable”*</u> in any meaningful sense. The proposed guidance clarifies that products should not undermine their stated sustainability objective, but crucially this permits labelled products to undermine other sustainability matters outside of their specified sustainability objective (which may be narrow).

16. The specific sustainability objectives of the product will be clarified in consumer facing disclosures and pre-contractual disclosures. However, this would not remedy the problem, as:

    a. There is a significant risk that consumers will be misled by the label titles into assuming that the product is *“wholly sustainable”*, and many consumers may not review the underlying disclosures in sufficient detail to dispel this impression and fully understand the implications of the limited scope of the product’s sustainability objective. In practice, many consumers’ investment decisions may be influenced by the sustainable label itself, and not by the underlying detail of the accompanying disclosures.

b. The current proposals for consumer-facing disclosures do not make clear that the product may not be *"wholly sustainable"* (and in particular may undermine other sustainability objectives).

c. Firms could make misleading claims about the proportion of their products that are *"sustainable"* based on the number of their products with sustainability labels, in circumstances where many of those products target only narrow sustainability objectives and are not aligned with climate goals and/or do not respect planetary boundaries (contrary to consumers' preferences and expectations).

d. The labelling system as a whole could be undermined if firms widely apply sustainability labels to products that target narrow sustainability objectives and which undermine other sustainability objectives (such as climate change), as it will be difficult for consumers to readily identify which products are genuinely sustainable.

17. As a result, the current proposals for sustainability labels may give consumers a misleading impression of a fund's sustainability credentials, could facilitate greenwashing by firms which market products as sustainable based on narrow sustainability objectives, and could result in the whole regime being undermined by harmful products being labelled as sustainable.

18. Our concerns are supported by the FCA's own research in its Occasional Paper 'Matter of fact-sheets: improving consumer comprehension of financial sustainability disclosures',[2] which found: that

> *"For some participants, the incoming perception was that products marketed as sustainable were 'wholly sustainable'. Some were not aware that investments marketed as sustainable could vary significantly in terms of their sustainability credentials and continued to struggle with the concept that there could be different approaches to sustainability*." (page 5)

19. Our concerns are also supported by the experience of EU in relation to Sustainable Finance Disclosure Regulation ("**SFDR**"). There are concerns that the Article 8 SFDR category (for funds that promote environmental or social characteristics) is so broad that it leads to greenwashing, due to the wide range of fund strategies labelling themselves as Article 8.[3]

20. We consider that the above concerns represent a significant and fundamental issue with the current proposals for SDR and labelling which could seriously undermine the integrity of the whole regime. We therefore ask that the FCA considers in depth options for remedying these issues in the final rules. As set out below, we propose: (a) the introduction of a *"do not significant harm"* principle; (b) improving the label descriptors and requiring their disclosure alongside the label; (c) the FCA should consider alternative options for the term "sustainable" in the labels.

*(a) Do no significant harm*

21. As set out above, the current proposals would allow products to obtain sustainability labels due to their connection to a specific sustainability objective, even where they cause significant harm to other sustainability issues.

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[2] fca.org.uk/publication/occasional-papers/occasional-paper-62.pdf
[3] See 'SFDR: 'Vague' Article 8 definition increases risk of greenwashing' (ETF Stream, 9 August 2021). Although the classification of funds under Articles 8 and 9 of SFDR is intended to trigger specific sustainability disclosure obligations, rather than to serve as a fund labelling regime, large numbers of European funds have sought to classify as either Article 8 or Article 9, and these classifications have become de facto investment product labels for EU funds – see 'How have fund managers been interpreting the Article 8 label under SFDR?' (Portfolio Adviser, 23 September 2021) and 'SFDR: Four Months After Its Introduction' (Morningstar, 27 July 2021).

22. We propose that FCA should require (at least for the sustainable focus and sustainable impact labels) that the product should not significantly harm other environmental or social objectives as a qualifying criteria for labelling.

23. We suggest that the FCA uses the EU's approach to the *"do no significant harm"* principle in the Sustainable Finance Disclosure Regulation ("**SFDR**")[4] and EU Taxonomy for Sustainable Activities to inform its development this rule. In particular, we suggest that:

    a. The SDR labelling regime should specify the main sustainability issues that products must not significantly harm. This could be informed by the approach of the EU Taxonomy, which provides that sustainable activities should not significantly harm six environmental objectives (being climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems) and should at a minimum align with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.[5] In addition, the FCA should issue guidance on the thresholds for applying the do not significant harm principle to these areas, which could be informed by the technical standards for the EU Taxonomy.[6]

    b. Firms should be required to disclose their principal adverse impacts on sustainability matters (in line with the approach of the SFDR) in order to demonstrate that they meet the qualifying criteria of doing no significant harm to environmental and social matters.

24. We recognise that introducing a *"do no significant harm"* criteria for the sustainable improver label may involve difficulties. It may be appropriate for a product to obtain a sustainable improver label where it invests in companies that are not currently sustainable, but which may improve over time (subject to our comments on the improver category and descriptors below). We emphasise the importance of disclosing the impacts products have on sustainability issues (see our response to question 16 below on double materiality).

*(b) Improving label descriptors*

25. The CP proposes that the descriptors at ESG 4.2.2(5) be included in the consumer facing disclosures, in order to help explain to consumers (in a concise way) what the relevant sustainable label means. In view of our concerns that the use of labels describing products as *"sustainable"* could be misleading (as outlined above), it is important that the descriptors provide consumers with the additional information they need to understand that their product may not be *"wholly sustainable"*. In view of the significant information asymmetry between firms and investors, it is important that the descriptors adequately convey the meaning of and limitations to the label. We therefore propose that:

    a. The descriptors for sustainable focus and sustainable improver should be amended so that they do not give the misleading impression that the product is *"wholly sustainable"*, and to clarify where the product relates only to a limited sustainability objective. The CP proposes that the

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[4] See SFDR article 2(17) on *"do no significant harm",* SFDR articles 4 and 7 on disclosing principal adverse impacts, and SFDR Annex 1 setting out a Template principal adverse sustainability impacts statement.
[5] See articles 3, 9, 17 and 18 of the Taxonomy Regulation (Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088).
[6] See: European Supervisory Authorities, Final Report on draft Regulatory Technical Standards (February 2021); and EU Technical Expert Group on Sustainable Finance, Taxonomy: Final report of the Technical Expert Group on Sustainable Finance (March 2020).

descriptor for sustainable focus should be *"invests mainly in assets that are sustainable for people or the planet"* and for sustainable improvers should be *"invests in assets that may not be sustainable now, with an aim to improve the sustainability of those assets for people or the planet over time"*. Both of these descriptions are likely to exacerbate the impression that the product is *"wholly sustainable"* and/or is targeting improvement in all aspects of sustainability. We propose that, instead of using the generic term *"sustainability"*, there should be alternate versions of the descriptor wording which should state if the sustainability objective is limited to one or more of: (1) climate change, (2) other environmental goals; or (3) social issues. In addition, the descriptors should explain that the product could have negative impacts on other sustainability issues (unless a *"do no significant harm"* principle is included in the rules)

b. The descriptors should be required to be disclosed in all client communications that refer to the label, as they contain necessary information for consumers to understand what the label means. Without the descriptors, consumers may have a misleading impression of the meaning of the label, and in particular may misunderstand that the product is limited to certain sustainability objectives. As the descriptors are high-level single sentence descriptions, it should be feasible to include them in all such client communications.

26. See also our below section on the sustainable improvers label, which proposes amendments to the descriptor for that label in order to clarify that it does not necessarily imply a certain level of performance in relation to the sustainability objective.

*(c) Potential removal of term "sustainable"*

27. We suggest that the FCA considers options for removing the term *"sustainable"* for products that are not aligned with international climate targets and other planetary boundaries (see paragraph 23.a above on key environmental objectives).

28. One option would be to identify in the label where the product's sustainability objectives are limited to either: (1) climate change; (2) environmental goals (not climate-related); or (3) social issues. This approach would introduce more categories of labels, but would avoid the risk of misleading consumers and would significantly reduce the risk that the labelling regime would be used for greenwashing. In addition, it would better align with the approach of the Competition and Markets Authority, which discourages the use of generic terms such as *"sustainability"* without appropriate clarifications.[7]

<u>"Improvers" label is potentially misleading</u>

29. We have serious concerns that the use of the term *"sustainable improvers"* for products that have sustainable stewardship policies will mislead consumers, as it will give the impression that improvement is guaranteed and/or highly likely. Stewardship is a vitally important tool for incentivising sustainable action by companies, but its effects are far from guaranteed. The risk of misleading consumers on this category is high, given that the FCA's own research found that consumers were likely to misunderstand the nature of stewardship and to misunderstand the category:

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[7] See CMA, <u>Guidance: Making environmental claims on goods and services</u> (September 2021), which states: *"Broader, more general or absolute claims are much more likely to be inaccurate and to mislead. Terms like 'green', 'sustainable' or 'eco-friendly,' especially if used without explanation, are likely to be seen as suggesting that a product, service, process, brand or business as a whole has a positive environmental impact, or at least no adverse impact."*

> *"Overall, although sustainable fact sheets increased consumer understanding, qualitative research found that some consumers often remain unfamiliar with important concepts such as 'stewardship', as well as the fact that there are different approaches to investing sustainably."* (summary page)
>
> *"People also tended to overestimate the sustainability credentials of the 'Transitioning' (now called 'Sustainable Improvers') labelled product, incorrectly believing that it invested mainly in companies or assets that maintain sustainable characteristics."* (p.3)

30. We therefore propose that:

    a. The descriptor for the label should be amended to more clearly explain that improvement on sustainability is not guaranteed. The descriptor states that the product "*invests in assets that may not be sustainable now, with an aim to improve the sustainability of those assets for people or the planet over time"*. Consumers may understand that this means that the targeted improvement is likely. In addition, as set out at paragraph 25.b above, the descriptor should be included in all client communications that refer to the label.

    b. The FCA should consider alternative names for this label category that better illustrate that the product is only targeting improvement. See also the above section on potentially removing the term *"sustainable"* from the labels.

<u>Removal of "Responsible" label</u>

31. We note and welcome the removal of the *"Responsible"* label that was proposed in the DP. The integration of material sustainability risks in investment decisions and risk management is required for the managers of all funds (including those not promoted as sustainable) to meet their legal and fiduciary duties. Introducing a *"Responsible"* label for funds that meet these existing legal requirements is unnecessary. In addition, it could give the misleading impression to consumers that *"Responsible"* funds have adopted a more pro-active sustainability approach, when in fact they merely integrate consideration of sustainability risks in its normal processes in line with their legal duties.

**Q7: 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?**

32. The DP proposed a *"not promoted as sustainable"* label. This has been removed from the CP. We consider that products that are not promoted or marketed as sustainable should be labelled as such, because:

    a. Highlighting where products are *"not marketed as sustainable"* (or an alternative label) would make clear to consumers where a product does not hold itself out as sustainable. This would present a counterpoint to the three *"sustainable"* categories, and we believe it would help consumers more easily distinguish between sustainable and non-sustainable products This could serve to increase investment in sustainable labelled products, and further incentivise firms to design sustainable labelled products.

    b. There would be minimal cost or administrative burden for firms to label products that are not marketed as sustainable.

**Q9: Do you agree with the category-specific criteria for:**

**• The 'Sustainable focus' category, including the 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.**

Sustainable focus: 70% threshold

33. We propose that the sustainable focus label criteria should require that 100% of the product's assets meet the standards specified at ESG 3.2.6(1). This is because:

    a. The sustainable focus label is designed to identify products that are aligned with sustainability goals. Consumers will therefore be entitled to expect that, where funds are marketed with the sustainable focus label, all (or the vast majority) of the investments are aligned with sustainability goals. We consider that 70% is too low a threshold to meet consumers' legitimate expectations, and that a 100% requirement would better meet consumer expectations and preferences.

    b. There is no equivalent threshold for the sustainable improver category (the criteria for the sustainable improver label requires that all of the assets should be meet the standard at ESG 3.2.7(1)). In our view, there is no good reason to have a lower standard for the sustainable focus label (by allowing only a proportion of the assets to meet the qualifying criteria) than the sustainable improver label.

    c. The European Security and Markets Authority is proposing that funds marketed as sustainable should have at least 80% of their investments aligned with environmental or social goals.[8] The introduction of the SDR regime is an opportunity for the UK to introduce a world-leading regime for sustainability disclosure that ensures that gives the highest level of investor confidence. We therefore suggest that the SDR regime should, at a minimum, not fall behind in this regard.

34. If the FCA nevertheless includes a threshold for the sustainable focus label, it is important that both:

    a. a new requirement is added that the assets falling outside of that threshold do no significant harm to sustainability issues (see our response to question 6 above for more detail); and

    b. double materiality disclosures are made, so that consumers can fully understand the impacts of their products on sustainability issues (see our response to questions 16 and 18).

35. These additions are required to ensure that consumers are not misled into believing that a sustainable focus product is *"wholly sustainable"*, when in fact some of investments may have material negative sustainability impacts.

Sustainable focus: alignment with environmental or social sustainability themes

[8] ESMA, Consultation Paper: On Guidelines on funds' names using ESG or sustainability-related terms (November 2022).

36. Products may qualify as sustainable focus under the proposed ESG 3.2.6(1) where 70% of their assets either:

    *"(a) meet a credible standard of environmental and/or social sustainability, in accordance with ESG 3.2.6R(2); or*

    *(b) align with a specified environmental and/or social sustainability theme."*

37. We agree with the criteria to meet a credible standard of environmental and/or social sustainability, in particular in light of the ESG 3.2.6(2) requirement that the credible standard must be *"robust, independently assessed, evidence-based and transparent"*.

38. However, the criteria to "*align with a specified environmental and/or social sustainability theme"* is too broad and vague, and should be removed. There is no guidance (in the Handbook or accompanying guidance) on what alignment with an environmental or social sustainability theme means, and so it is unclear what standard firms should apply. In particular, there is no requirement for any supporting independent evidence (and it therefore appears to be a far lower standard that meeting a *"credible standard"* of sustainability). As a result, firms could adopt a low standard for determining whether a product is aligned with a sustainability theme (given that the labelling regime is self-certifying), which would result in unsustainable products being misleadingly labelled as *"sustainable focus"*. This would undermine the regime as a whole, as firms may prefer to use the *"sustainability theme"* criteria over the *"credible standard criteria"* in light of its lower and more ambiguous standard.

<u>Sustainable improvers: credibility of improvement</u>

39. The CP proposes that products qualify for the sustainability improvers category where they are *"invested in assets that have the potential to become more sustainable over time, either environmentally and/or socially, including in response to investor stewardship."* We consider that a self-certifying label based on *"the potential to become more sustainable over time"* is too broad and vague, and could result in firms classifying products as sustainable improvers that are in fact unsustainable (including in relation to the specified sustainability objective) and have little prospect of improving.

40. We consider that the criteria should be amended and clarified to limit the category to where all of the following apply: (a) the firm commits to use investor stewardship; (b) it is <u>credible</u> that the assets will become more sustainable over time; and (c) it is credible that the improvement will be (at least in part) in response to or influenced by the firm's actions or investment (either through investor stewardship or otherwise).

<u>Do no significant harm</u>

41. Asset out in our response to question 6 above, we propose the inclusion of *"do no significant harm"* criteria.

**Q10: 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?**

<u>Enforcement</u>

42. The discussion of monitoring and enforcement is notably absent from the CP. As the labelling regime is self-certifying and does not require independent verification, it is essential that the FCA monitors and robustly supervises and enforces sustainable labelling and disclosure standards, in order to ensure the effectiveness of the new regime and prevent greenwashing. The FCA must consider how it will monitor, supervise and enforce compliance with the new regime, and what the consequences of failure and breach will be. We call on the FCA to publish a clear road map for enforcement, covering:

    a. when and how the criteria for investment product labels will be tested, including at the point of award and periodically throughout the life of a fund;

    b. the consequences of failing to meet labelling criteria, including loss of label (as part of ongoing monitoring and supervision), investigation, public statements, fines and other disciplinary action;

    c. how quality sustainability disclosure under SDR will be monitored, supervised and enforced; and

    d. how the FCA will ensure it has adequate resource and expertise to deliver these oversight and enforcement requirements.

**Q11: 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?**

**43.** We support a tiered system of disclosure. The needs of retail consumers, institutional investors and other stakeholders may differ, and agree that it would be helpful for consumer-facing disclosures to include a simplified and streamlined element to help less sophisticated users identify and compare key product-level information, with more detailed disclosures in product and entity level sustainability reports and pre-contractual disclosures.

**Q12: 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?**

44. We agree with the approach of building from TCFD product and entity reports, so that new disclosures can be included within firms existing processes for TCFD disclosures. We also agree that the disclosure requirements should be updated over time to reflect current best practice under the ISSB standards. However, as set out in our response to question 19, the FCA may should be willing to introduce rules that go further than ISSB standards, where appropriate (for example, in relation to double materiality).

**Q13: 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?**

<u>Impact on sustainability issues</u>

45. The current proposals for consumer facing disclosures in the CP do not explain that the product may have negative impacts on sustainability issues. ESG 4.2.2(7) provides that firms should disclose where any of a sustainability product's investments are inconsistent with its specified sustainability objective. However, this does not cover any material impacts of the product on other sustainability issues (outside of the sustainability objective).

46. In order to ensure that consumers are not mislead into believing that sustainable labelled products are *"wholly sustainable"* and have no negative sustainability impacts, the consumer facing disclosures should explain that the product could have negative impacts on other sustainability issues outside of the sustainability objective (unless a *"do no significant harm"* principle is included in the rules).

47. See also our response to questions 16 and 18 below on double materiality in the product and entity-level sustainability reports.

<u>Products without sustainability labels.</u>

48. The draft Handbook wording for consumer facing disclosures should be clarified to explain the disclosures that need to be made for products without sustainability labels. In particular, the requirements at ESG 4.2.2(4) and (6) to (8) refer to sustainability objectives, which are only required for products with sustainability labels. It is therefore unclear what standard is to be applied for products that do not have sustainability labels.

49. We suggest that the Handbook wording should clarify what disclosures that should be made *"where a sustainability product has sustainability characteristics as an integral part of its investment policy or strategy but does not meet the criteria under ESG 3.2 to use a sustainability label"* (this mirrors wording from the proposed ESG 4.3.4(R) in relation to pre-contractual disclosures).

**Q16: 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.**

<u>Double materiality</u>

50. The CP proposes that Part B of the product-level sustainability report includes details of the firm's progress in meeting the sustainability objective specified for the product, including its performance against key performance indicators relating to that specific objective (ESG 4.5.7). However, this is limited solely to performance in relation to the product's specified sustainability objective. The CP does not propose any information be included on the products impact on (or performance in relation to) sustainability issues more generally.

51. We consider that the SDR labelling regime should enable investors and consumers to fully understand the environmental and social impact associated with their investments. In order to achieve this, firms need to disclose their products' performance on sustainability issues that fall outside of the product's specified investment's sustainability objective. For example, an investor in a sustainable focus label product which has a sustainability objective in relation to plastic waste and pollution should also receive information on the product's performance in relation to other issues such as climate change and the protection and restoration of biodiversity and ecosystems.

52. It is therefore essential that the disclosures required in the sustainability product reports capture the impact of the product on society and the environment (referred to as double materiality). Such information is crucial for sustainability-conscious consumers and investors who want to make investments that do not undermine environmental and social issues.

53. We therefore propose that the product report should include:

    a. Narrative disclosure of the relevant product's impacts on environmental and social impacts.

    b. Mandatory sustainability impact metrics for the relevant product, in order to provide consumers and investors support with comparable and credible information to assess the degree of impact of the product on environmental and social impacts. We recognise that (outside of climate-related metrics included within the FCA's TCFD regime), metrics for sustainability impacts are a developing area, and that the SDR requirements may need to be updated over time as industry practice and capability for such metrics develops. In the first instance, we suggest an initial set of sustainability metrics based on the SFDR 'principal adverse impact' indicators and metrics. We note that omitting such metrics would result in the UK regime falling behind the EU in the quality of sustainability-related disclosures.

**Q18: 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.**

<u>Double materiality</u>

54. As set out in our response to question 16 above, the SDR regime should enable investors and consumers to understand the environmental and social impact associated with their investments and with the firms which they choose to manage their investments.

55. The disclosures required in the sustainability entity report should therefore capture both: (a) the financial impact of social and environmental factors on investment products and firms; and (b) the impact of financial products and firms on society and the environment (referred to as double materiality). Such information is crucial for sustainability-conscious consumers and investors who want to make investments that do not undermine environmental and social issues.

56. The CP proposes that the sustainability entity report disclose only sustainability risks and opportunities (ESG 4.6.1(1)(b) requires disclosure on *"the actual and potential impacts of any material sustainability-related risks and opportunities on the firm's business, strategy and financial planning"*) as well as disclosures on process (i.e. governance, strategy and risk management). It does not include a requirement to assess and disclosure the firm's impacts on the environment and society (where they do not impact the firm's financial return).

57. We therefore propose that the entity report should include:

    a. Narrative disclosure of the firm's impacts on environmental and social impacts.

    b. Mandatory sustainability impact metrics at an entity level (aggregating impact of the firm's products), in order to provide consumers and investors support with comparable and credible information to assess the degree of impact on environmental and social impacts. We recognise that (outside of climate-related metrics included within the FCA's TCFD regime), metrics for sustainability impacts are a developing area, and that the SDR requirements may need to be updated over time as industry practice and capability for such metrics develops. In the first instance, we suggest an initial set of sustainability metrics based on the SFDR 'principal adverse impact' indicators and metrics. We note that omitting such metrics would result in the UK regime falling behind the EU in the quality of sustainability-related disclosures.

**Q19: 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?**

58. We support the reference to ISSB's standards at ESG 4.6.2, including referencing UK adopted IFRS S1. However, it should be clarified that firms' obligations to make disclosures under the FCA's regime are not limited to the standards set by the ISSB, and that disclosing in accordance with ISSB standards therefore does not necessarily imply compliance with the regime. For example, the ISSB standards may not include reference to double materiality, which (as set out in questions 16 and 18 above) we propose should be expressly included in the FCA's regime.

**Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?**

59. We strongly support the inclusion of an express anti-greenwashing rule. However, we consider that the proposed rule does not significantly increase or clarify the standards for claims about sustainability issues beyond the existing requirements under COBS 4.2 (which require client communications to be clear, fair and not misleading). The proposed rule requires firms to ensure that references to sustainability characteristics *are "consistent with the sustainability profile of the product or service"* and *"clear, fair and not misleading"*.

60. In order to make sure that firms which make claims in relation to sustainability characteristics do not greenwash, we suggest that the greenwashing rule should make clear that firms must:

    a. not omit or hide important information relevant to any statements they make about sustainability characteristics, and in particular should not refer to benefits without referring to relevant negative impacts; and

    b. be able to substantiate their references to sustainability characteristics with credible, science-based evidence.

61. We note that our above proposals reflects the approach of the Competition and Markets Authority in its Green Claims Code.[9] In addition, the FCA may also consider issuing accompanying guidance to help firms understand how to comply with this greenwashing rule and avoid making claims in relation to sustainability that may be misleading. We suggest that this guidance should be consistent with (and could be informed by) the CMA's approach in its Green Clams Code.

**Q21: Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?**

[9] CMA, Guidance: Making environmental claims on goods and services (September 2021).

62. We support the proposed prohibition on terms related to sustainability for products that do not have sustainable labels. In addition to the terms listed in the CP, we suggest that the FCA include the term *"GSS"* (i.e. green, social and sustainability), which is commonly used in relation to sustainability-linked bonds.

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