Response to DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels

The EIRIS Foundation is a research, advice and advocacy charity that focuses on pioneering the next steps in sustainable finance.

Since 1983 we have been involved in the development of retail green and ethical funds and our former research subsidiary, the Ethical Investment Research Service provided the research that underpinned many of the first steps in this field, and often worked alongside them in creating those products. Each year we publish an analysis of the market, most recently in 2021 when the value of such funds nearly doubled. In 2020 we undertook some research into the funds (alongside pension funds and banks) for UKSIF's Good Money Week looking at the extent to which they could offer individuals the opportunity to contribute to building back better. This gave us useful experience of the challenges facing someone who was trying to look into the marketplace and we drew up a series of recommendations and conclusions as a result.

We have also recently undertaken our own investment procurement for a £1 million growth fund which gave us some useful insights into this marketplace and the experience of consumers in seeking responsible and sustainable investment, and in the process of thinking through our own responsible investment policy and clarifying the key dimensions of that approach.

For over 30 years our research subsidiary was a leading ESG research agency and so we bring the experience of researching issuers on ESG issues for investors on the basis of what they make public and what they're willing to share in response to further questions. In 2015 we merged that subsidiary with Vigeo to create Vigeo Eiris which has since become part of Moody's ESG Solutions. Our CEO represented Vigeo Eiris in the BSI PAS 7341 discussions, but we are now independent entities.

Introductory remarks

We welcome the DP21/4 discussion paper and many of the ideas put forward to tackle this important agenda. Product labelling and associated disclosures have the potential to greatly improve the consumer's experience and the sustainability impact of what you rightly describe as an increasingly diverse and growing market.

We also welcome the approach you have taken in seeking alignment with the various other projects that have addressed the same agenda and that will be very important in moving this field forward without adding to any potential confusion.

Some general observations that apply throughout our responses would be:

1. Wherever it is possible to refer to international standards in defining sustainability (social or environmental) and when it comes to disclosure by companies and requirements upon investors, this has considerable alignment benefits and avoid fragmentation when many of the portfolios and a good number of the fund managers operate beyond the UK. We welcome the steps you are taking in this direction.
2. The "dear chair" letter to authorised fund manager chairs contains a lot of useful principles which should be worked into the detail of disclosure requirements in the next phase of the process.

3. The main insight behind a lot of our responses is that the proposals are not yet clearly enough focused upon the practicalities of what a funds provide to consumers (as distinct from some of the philosophy behind that which also remains important). The main function of a retail fund is to provide the consumer with a portfolio of investments, and the fund manager may also undertake stewardship activities on behalf of that fund. But this means that the key “value add” of a fund to the consumer can be seen in three areas:
    - The exposure they offer to particular positive themes amongst issuers: products, practices, or the underlying purpose of the issuer. Here the issue is how the fund stands out compared with the market in general, what is the particular focus or bias of its portfolio.
    - The exposure they offer to the chosen market without investing in things that the consumer wish to avoid through negative screening in relation to products, practices or breaches of norms.
    - The participation on behalf of the consumer in stewardship activities including engagement and voting (which tends to be at firm level), which may go beyond responsible investment to pursue particular sustainability goals also.

    So through our response we refer to these key building blocks of positive focus, negative screening and stewardship as the key distinctions that need to be clear.

Responses to the questions raised

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

It is a good idea to distinguish between simple higher-level disclosures and more detailed ones. It would be important to test “disclosure layer 1” particularly with focus groups and surveys over time to make sure that the disclosures were well understood by their target audiences. They should not mislead in the sense of giving people an impression which would not be supported by more detailed examination.

However, the distinction is not necessarily between consumers and institutional investors. Those providers of ethical and green products who have encouraged their consumers to engage in stakeholder meetings or correspondence have often discovered that financial consumers can be much more knowledgeable about some ESG issues than the institutional fund managers providing these products. It remains the case that distinguishing between those who don’t have much time or inclination to look into the detail on the one hand and those who want the full story on the other is valuable.

It is also important to minimise the extent to which information is hidden behind any sort of regulatory firewalls or filters, leaving some of those who are seeking it unable to access it (or just making it hard to find). For example, putting detailed ESG information behind a filter for sophisticated financial investors would be a mistake.

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.

It is a good idea to think of labelling requirements in terms of their specific audience. On the other hand there are several reasons for caution around narrowing the scope of the scheme in general:

a. When the first green or ethical fund was launched in the UK in 1984, "ethical" or "responsible" investment was all about equity investment. But over time ESG considerations have expanded to nearly all asset classes step by step, and that process has accelerated greatly in recent years. So any restriction on labelling by asset class or distinctions like active and passive management will be likely to be quickly overtaken by events if it is not already missing the boat.

b. It is true that segregated mandates or products targeted at specific institutional clients can provide their clients with different opportunities to engage with the provider in pursuit of information. Such investors may also be deemed to require less protection from other points of view. But there is also considerable pressure from institutional asset owners and from more sophisticated investors generally for much better and clearer ESG information about the products that they buy. And a good (consistent) fund labelling system might well be better information than they presently receive. Such institutions may also be providing products to retail markets or reporting on their activities to their own stakeholders/members and if they are going to report on a comparable basis themselves, they will need the same type and nature of data as inputs on the products they buy to build their own portfolios. Also, in many cases, the level of sophistication in ESG matters and access to information for pension fund trustees or others within the institutional fund market (whatever their financial expertise) would mean that straightforward clear two-tier disclosure about financial products would also be of great benefit to them in any case. It is, however, necessary to have a clear portfolio to analyse for a fund labelling scheme and that might limit the applicability of this approach to some other situations.

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?

You have identified a number of useful initiatives which are all relevant.

The BSI PAS 7341 (which include representatives of a number of the other bodies you refer to) has attempted a particularly clear distinction between responsible and sustainable investment which encourages clarity of thinking about the particular sustainability objectives that the user of the standard is adopting. See particularly requirement 4.1.10, which lists a range of possible frameworks and sustainability standards you might adopt. This choice of sustainability objective is then used throughout the rest of the PAS to help specify the differences, and how they should be put into practice. This PAS is focused on the firm level, but many of the principles may be helpful to the operation of a particular fund as well, even if the whole firm didn't want to operate within the "sustainable investment" requirements. This is particularly true of the stewardship elements as they tend to be at firm level. So it would be good to work closely with their plans for a fund level PAS, and to align with this work where possible.

In the EIRIS Foundation's own procurement of investment management services for its £1m growth fund, one of the two fund managers we appointed recently was Snowball, an impact investment manager. They have significant experience of assessing impact offerings from others that would be appropriate for their fund, so we commend their expertise to you. And the Impact Investing Institute was also created to advance the growth and effectiveness of impact investing and has in their staff, supporters and partners a wide range of valuable expertise in this area.

In general, it's very important that the labelling system serves the needs of consumers and those advising them (as well as the policy objectives that you refer to), particularly in any case where those interests may diverge from the interests or convenience of fund providers. We are aware that you've been informally consulting with networks that can help to bring that perspective, and we welcome the opportunities we've had to contribute to those discussions. You mention Fund EcoMarket elsewhere in the document and your advisory group has a number of others with long-term commitment to this marketplace or representing stakeholders within it.

We encourage you to continue sharing your thinking with such groups: to test out solutions on those with experience of running ethical funds to identify the likely practical impact on product design and development and the evolution of the market; and also with those who have long term experience of advising consumers in this field to understand how the labelling approach is likely to affect the advice process and how they will be understood and used by financial consumers.

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.

The sort of distinction you are making between Responsible Investment and Sustainable Investment makes sense and aligns quite well with the previous BSI work and with the other frameworks you quote. The further distinctions of Transition, Alignment and Impact are all good ways to describe important elements the approach/philosophy a fund manager or the issuers they invest in may take to ESG issues.

On the positive side, understanding the philosophy or intention of a fund is important because the ESG characteristics of a portfolio or an of each underlying investment might otherwise be just co-incidence.

However, the idea of grouping funds according to the further distinctions – transition, alignment and impact - doesn't work well when set against what funds are actually offering the consumer: the selection of a portfolio of investments and the exercise of voting and engagement opportunities.

The challenges would include:

a. The products or practices in a diversified portfolio will almost always contain a mixture of transition, alignment and potentially high impact investments. Setting thresholds is going to be arbitrary (and likely subject to the way a particular provider defines those categorise as well, unless the regulation is going to be very prescriptive on many levels). You would need rules to sort out the classification of portfolios that were 50% high impact, 40% in transition and 10% not even transitioning, v. those that were 30% high impact 50% aligned and 20% transitioning for example.
b. The need for some sort of promotion/relegation arrangement to prevent borderline cases flipping too and fro on each valuation (particularly as some client mandates or fund of funds processes may take a view based on the labelling scheme outcomes).

c. Individual issuers may have high impact products or services, but only “transitioning” practices. Both could be important to consumers, and to policy. For example, the discussion of just transition has established that tackling climate change is not just about decarbonising the energy services sector (and many others), it is also about how that shift may affect people and communities at risk of being left behind.
d. Stewardship activities by the fund manager can also be viewed on the same sort of transition, alignment & impact scale, but some funds may have more impactful stewardship with rather transitional portfolio selection and they need to be understood separately, rather than just averaged.

It would be better aligned with consumers interests to show them how much and what sort of positive portfolio exposure/bias, negative screening and stewardship activity they were being offered, more in the style of “food labelling” than a hierarchical grouping of funds. That would also encourage providers to understand and address demand and the policy priorities in each of these areas, rather than focus exclusively on the minimum required to get into the top bracket to the exclusion of all else.

Your discussion paper expresses concerns about subjective medals or traffic lights, but happily the work you have done has identified the potentially useful transitioning-aligned-impact framework which can be used at least for the positive portfolio exposure/bias and stewardship dimensions, although negative screening would need to be treated somewhat differently. This is partly because of the diversity of possible negative screens (and their motivation) and because there is no obvious way to rank different approaches, except in the mind of the individual consumer who knows what they wish to avoid.

A possible approach which is developed further in subsequent sections is set out below.

<table>
<tr><td></td><td colspan="3">Responsible</td><td colspan="3">Sustainable</td></tr>
<tr><td>Fund objectives</td><td colspan="3">Protecting portfolio from ESG risks, pursuing ESG opportunities and reducing any negative ESG impacts over time</td><td colspan="3">Pursuing stated E/S sustainability objectives/norms in addition to financial return</td></tr>
<tr><td>Products or practices?</td><td colspan="3">Stewardship is mainly about practices, but portfolio selection could be about the ESG consequences of either if the manager judged them to be material.</td><td colspan="3">Some sustainability objectives may more about products and others more about practices, but the fund would need to set which products or practices it saw as relevant to advancing their chosen sustainability goals and then disclosure against that choice.</td></tr>
<tr><td>Fund mechanism</td><td>+ve focus</td><td>-ve screening</td><td>Stewardship</td><td>+ve focus</td><td>-ve screening</td><td>Stewardship</td></tr>
<tr><td>Impact</td><td rowspan="3">Not a requirement, but should be able to explain how stocks included in the portfolio fit with the firms understanding of the financial implications of ESG risks, opportunities and impacts</td><td rowspan="3">Not a requirement, but should be able to explain where stocks have been omitted or holdings reduced because of ESG risks opportunities or impacts</td><td>Deliberate (measurable) action to address systemic risks or reduce SDR impacts</td><td>Entities with E/S improvement at their core</td><td rowspan="3">Not a requirement, but may identify products or practices or potential norm breaches that conflict with chosen sustainability goals</td><td>Seeking E/S change through measurable strategic/ cultural shifts</td></tr>
<tr><td>Aligned</td><td>Maintaining/ supporting good governance practices for long-term wealth creation</td><td>Taxonomy product or good practices compliance</td><td>Maintaining/ supporting good practice (re the chosen goals)</td></tr>
<tr><td>Transitional</td><td>Working on identified governance failings</td><td>Entities in transition</td><td>Working on those not exhibiting good practice</td></tr>
<tr><td colspan="7">Any -ve screening disclosures not linked with the choice of any sustainability objective</td></tr>
<tr><td>Purpose/ philosophy</td><td colspan="2">Explain any starting points or rationale behind the screens</td><td>Disclosure detail of any</td><td>Products avoided</td><td>Practices avoided</td><td>Breaches of norms avoided</td></tr>
</table>

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 make further comments on the entry-level for responsible investment in response to the detailed questions. On the entry-level criteria for sustainable products we believe the key step is to require funds to set out clearly the particular sustainability objectives or norms that they are pursuing. They then need to be clear about how they are defining alignment with those standards (and potentially transitioning towards them). This needs to be done in a manner that makes clear to the investor what the positive bias or exposure of the fund will be; what, if anything, it is assuring the consumer it will not invest in; and how it will leverage its voting, engagement another stewardship work in pursuit of those goals or norms.

A number of historic products were created before current sustainability norms (for example the Paris agreement or the UN Guiding Principles on Business and Human Rights). But in those cases the criteria they applied could still be seen as general responsible business norms, and many are now reflected in those internationally agreed standards.

ISO26000 provides a valuable framework that integrates many of these approaches to responsible business.

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.

You refer already to the diversity of this marketplace and a lot of that is welcome innovation. If anyone had set down in stone the principles behind the first ventures in this field in the form of a regulatory labelling system then much that has followed might never have taken place.

In our view you protect the potential for future innovation by allowing funds to make their own choice of sustainability goals and norms. But you protect consumers by insisting that they define very clearly how portfolio investments will be judged as meeting or not meeting those goals and norms. It will likely be necessary to issue guidance in that area in the light of developments in much the same way as the Stewardship Code has a regular process of steering disclosures over time.

You can also make policy driven or consumer survey driven decisions that certain elements must be included or that a fund must include or explain the omission of particular goals. For example a sustainable fund that pays no attention to climate change might be something you did not want to label in this way. And once the UK taxonomy exists you might at least want each fund to explain their attitude to it (see our comments on regulated disclosures here)

Q7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics:

- ***intentionality***
- ***return expectations***
- ***impact measurement***
- ***additionality***
- ***other characteristics that an impact product should have***

These are generally helpful elements.

In thinking about impact investing, it may be helpful to separate the impact of the fund manager on the issuers invested in, and the impact of the issuers themselves. And then to consider those in relation to the relevant dimensions of fund contribution (positive exposure, negative avoidance and active ownership) referred to already.

When choosing investments, a fund manager may look for opportunities in

(a) entities that have social or environmental improvement built into their purpose, governance and operation (such as social economy enterprises: housing associations for disadvantaged groups, B corporations etc). Or they may look for
(b) enterprises in public or private markets which have products or business models and practices which are, by design, tackling some generally recognised social or environmental challenge with the potential to make a significant contribution over time.

So it makes sense to treat these as the "top end" of a positive focus/bias in a portfolio. These are the issuers aiming, deliberately, to make a social or environmental difference and who can be expected to measure and report upon that impact over time.

But when looking at the fund manager (rather than the issuers in the portfolio), there can also be measurable and deliberate impact generated by active ownership. Here the measure is not the impact of the issuer at the start of the engagement, but rather the change in issuer activities that the manager is seeking to bring about. It is a different sort of impact, but if a manager has a clear strategy with deliberate and measured social and environmental improvement goals and can measure their success over time, it also makes sense to treat this sort of impact as "top end" Stewardship activity.

We think this example further demonstrates the case for focussing on positive exposure, negative avoidance and active ownership, rather than trying to group together two very different sorts of impact: "issuer impact" and "manager impact" in a single fund category. Particularly when consumers may view these two differently.

Rather than separating "impact" funds from others we believe that all funds being labelled should disclose:

(a) What proportion of their portfolio is invested in companies they judge to have
   i. social or environmental improvement built into their purpose, governance and operation
   ii. products, services or business models designed to address recognised social or environmental challenges

   and any portfolio targets or ranges that they have set it that regard

(b) What Stewardship activities they are undertaking
   i. To address systemic risks (for example, as described in the Stewardship Code) or to reduce, mitigate and remedy any impacts of portfolio companies identified under SDR
   ii. To achieve measurable social or environmental change through changes to business models and strategies or cultural change (for example as described in PRI's Engagement 2.0 framework)

   And what proportion of the fund portfolio is the subject of such initiatives, where appropriate, and any targets or ranges they have set in that regard.

(c) The definitions (including external frameworks) that they have used in making these assessments; how they are measuring impact over time; and their progress to date.

Additionality is hard to measure, but disclosure of involvement in new issues of shares or bonds, involvement in private as well as public markets, concessional finance or support for collaborative initiatives designed to help attract other new funds to relevant enterprises would be of interest to those attracted to the concept of impact investment.

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?

Before commenting on transitioning, we'd like to support the concept of alignment with the UK taxonomy or other sustainability criteria when it comes to products invested in. Attempts to define products and services that are green are to be welcomed for this purpose. Alignment with the EU taxonomy and emerging other global taxonomies (particularly since many funds invest globally) would be very helpful in practice.

Where there are differences between such approaches, simple differences that can easily be applied (like including on excluding particular categories of taxonomy compliant activities) rather than re-creating similar but different detailed definitions, would be enormously helpful to issuers and to directing effort to tackling the very serious sustainability crises we face, rather than creating reporting burdens for issues, and analysis burdens for the rest of the chain.

We think there is an equally good case for alignment with sustainability ***practices*** (for example the UN Guiding Principles on Business & Human Rights, and models of engagement with and responding to the needs of stakeholders and communities such as set forth in ISO 26000.

And we think the EU's draft approach to a social taxonomy on ***products*** (seeking to highlight business activities that widen the provision of essential products to underserved communities while meeting appropriate quality and affordability criteria) is also very attractive here.

It is clear from the above that funds will need to be clear which sustainability objectives they are seeking to pursue and then the relevance of particular products or practices to those goals in order to disclose what proportion of their portfolio can be seen as aligned with their sustainability objectives.

But to return to your answer on transitioning: the starting point is that it is a useful concept.

The shift to a sustainable economy is going to involve a lot of transitioning by enterprises that are not yet sustainable. Particularly if we are to achieve a just transition which does not leave behind those who have devoted their working lives and careers to date to unsustainable enterprises. So when measuring the positive focus of a portfolio it is a good idea to have a category of investments that are "on the journey" or "assisting the journey" towards the sort of enterprises that it is envisaged will qualify for the UK Taxonomy or make other contributions to sustainability.

For practices, too, there is merit in identifying separately those enterprises that are "on the way" to implementing practices like human rights due diligence but are not yet fully aligned with the sustainability practices identified by the UN Guiding Principles on Business and Human Rights, for example.

Similarly, in the active ownership area, engagement and voting on individual stocks where there is not yet alignment with good practice cannot always be expected to deliver results, but deserves recognition as "work in progress" or "transitioning" even so.

As argued previously, rather than trying to set up rules to decide which whole funds are "transitioning" and which are "aligned", the goal should be for each fund to disclose:

a. The sustainability objectives it is seeking to address (see, for example, those listed in PAS 3741, 4.1.10)
b. What products and practices it views as essential to the achievement of these objectives and therefore how it defines "aligned" and "transitioning", including which external and recognised frameworks it will depend upon for that purpose
c. What proportion of its portfolio falls into the "aligned" and "transitioning" headings for each of the sustainability objectives set analysed by both product and processes, where applicable). It is important to say that the portfolio aggregation of exposure needs to be approached differently as between product and practices. In relation to products/services.

The consumer is going to want to know what proportion of the portfolio is invested in companies that are providing ***one or more*** of the list of products/services that align with the sustainability objective. In relation to practices they are going to want to know what proportion of the portfolio aligns with ***all of*** the practices identified (albeit that a fund may seek some practices only in relation to certain business models or sectors). But the fact that a company aligns well with human rights practices is not going to mean that they are unconcerned about their pollution or recycling approach if a fund included all these in their sustainability goals or norms.

d. Any portfolio targets or ranges they have set in this regard
e. What governance practices they would see as aligned with their sustainability goals and what governance shortcomings they would regard as still (or not yet) transitioning and requiring further stewardship dialogue or engagement
f. How stewardship activities can also support the achievement of alignment amongst portfolio holdings whose products or practices are still (or not yet) transitioning.
g. What proportion of the fund portfolio has been the subject of stewardship activity and with what result in terms of the alignment goals set.

Negative screening

One specific problem with the model presented is treating negative screening only as one of the elements of "transitioning" (so it can help to move you from "responsible" into "sustainable" but can play no further role in changing your label to "aligned" or "impact" investments).

From a consumer perspective, negative screening requires clarity about the screens being applied and any thresholds used so that people would not be surprised by any negative characteristics of any investments included in the product if they were to be aware of them. This should include clarity about any limitations (a common issue is whether they apply to indirect holdings), or if they apply to the production of a particular product, but not the sale of the same product. We can understand why there might be a desire to avoid the general suggestion that "the more negative screens the better" in the design of the labelling scheme, although the very helpful recent letter to chairs of authorised fund managers rightly suggests that a minor exclusionary screens on its own should not qualify a product to use certain ESG labels.

Negative screens can also be separated into product, process and breaches of norms and funds could helpfully set out any negative screens by reference to each of these for clarity.

You can imagine products that only qualify as "responsible" (in the sense that they have not decided to pursue any particular sustainability objectives) but which still offer consumers certain negative screens. But once a fund has decided to pursue a sustainability objective it would also be helpful to be clear whether they see any particular products, process or breaches of norms as something to be avoided as undermining the chosen sustainability objective.

In short, transparency on negative screens should be separated from the responsible-sustainable-transitioning-aligned-impact scale and disclosed instead against product, practices and breaches of norms.

As well as explaining whether they have adopted any negative screens in order to avoid undermining a chosen sustainability objective, it may also be helpful to consumers to ask funds to disclose the rationale for their choice of other negative screens: for example if they have adopted a general "do not harm" principle, or are seeking to implement a particular religious or other ethical approach, or whether their screens have been “stakeholder driven” in response to client feedback/engagement or surveys of clients.

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

They are rather thin. Taking Stewardship seriously (for example by being a Stewardship Code signatory as you discuss) and being able to explain how your ESG integration work makes a difference to your investment management decisions should really be a minimum alongside the “capability” criteria you propose. These could be evidenced through PRI signatory status, or levels of reporting within the PRI reporting and assessment framework, for example. PAS7341 has a much wider range of requirements for responsible investment and there should be more alignment here, particularly because responsible investment as discussed here will tend to be at the level of the firm, rather than the fund, and the PAS was designed for firms.

But since this is a fund labelling proposal, funds could usefully be required to disclosure how the managers ESG integration work had affected the portfolio construction and choice of individual investments in the fund. They can also disclosure how the SDR risks, opportunities and impacts framework relate to the investments in the portfolio of the fund and any responsible investment action taken as a result.

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?

It is a good idea that any product which does not include responsible investment approaches or sustainability goals/norms should be clearly labelled as such. The way in which this marketplace is developing (and the degree of coverage of responsible investment issues in the financial and personal finance press) will lead to the risk that consumers assume such practices are in place when they may not be. A few phrases about being a responsible fund manager may trigger that assumption.

But in the model you proposed the left most box is actually neither sustainable nor responsible, and that should be made clear in whatever disclosures are required.

Q11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

Tackling Climate Change (although the Paris agreement refers to other sustainability objectives as well) should be treated as a sufficient sustainability objective to get into the sustainable zone.

Q12: What do you consider the role of derivatives, short- selling and securities lending to be in sustainable investing? Please explain your views.

People engaged in securities lending need to be clear about whether that impacts their stewardship capabilities.

Some investors will feel that short-selling and derivatives are themselves practices they do not wish to support. So fund should be clear about whether they use these techniques. But others will be happy to see the principles behind responsible and sustainable investment beings applied to these market practices as well and so they should be included within the scope of these proposals. They may need to be some clarity about portfolio aggregation of ESG characteristics in the case of short-selling.

Q13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

It is a good idea to build the framework on other existing disclosure wherever possible.

Q14: What are your views on consumer-facing disclosures, including the content and any considerations on location, format (eg an 'ESG factsheet') and scope?

The items you list are useful but there is a danger of slightly boilerplate answers to some of these questions which might leave the investor unclear about the distinctions in practice. That was very much our experience in looking at the top level statements by funds in our own research. The "dear chair" letter sets a number of helpful principles in this regard.

As we have argued elsewhere, funds should be explicit about the sustainability standards they're using, where possible referring to established international standards. The test for this section of the proposals is whether it will give readers sufficient clarity on

a. the positive bias of the portfolio that is being offered,
b. the types of assets that will be avoided (if any) and
c. how the stewardship approach is going to support the sustainability objectives/norms that have been identified**.**

Part of that will be including clear statements about what products and practices will be considered to be aligned or transitioning in relation to the goal set (if the framework we proposed earlier were to be adopted).

In general, you are also right to be prescriptive about the provision of certain information. In our experience of studying the existing funds (which included assessing the ESG performance of the fund managers) some of the clearest disclosures were around gender pay gaps, and that is very obviously because there is a clear regulatory requirement. In many other areas people making up their own frameworks for disclosure or just not disclosing at all meant that it was very difficult to get comparable information.

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

We won't repeat here the specific disclosure proposals we made in response to Q6 & Q8 which is where we've developed those requirements in the context of impact alignment and transition. The principal impact disclosures undress SFDR are potentially very useful (once the information flows exist) and alignment with those where possible would only be helpful.

Fund should also disclose and email address for any ESG questions from consumers and any other communication channels available to them. For example, newsletters available to consumers who may not be clients of the fund manager, but have invested through intermediaries. A link to a full portfolio listing (desirably with ISINs and similar identifier) should also be part of the top level disclosure.

Q16: What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?

We found that entity level information was very important in researching the funds in several respects:

a. for stewardship activities it will typically be the firm that has the capability rather than the fund, although obviously engagement and voting can be distinguished in pursuit of particular sustainability objectives, or more generally around the inclusion/exclusion border for a particular fund
b. Some of the most useful stewardship practices we identified were collaborative engagement efforts and initiatives like the climate champions net zero work. These are almost inevitably firm level commitments although it may be that the staff associated with particular retail funds are in fact those leading the work. Consumers might be pleased to hear that the capability organised to provide their fund (and to which they contribute through management fees) is able to have wider impact.
c. We believe the consumer is interested in the responsible business conduct of the fund manager as well as the particular fund. Many will be seeking funds that make investments in companies they can believe in run by manager who shares their ESG outlook.

Q17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.

As you have already acknowledged in your paper many firms operating across borders. They invest in companies that operate across borders or are based in other jurisdictions. The sustainability goals that people will adopt are typically global in nature. So the maximum degree of global alignment across your proposals is very important for the ultimate achievement of the aims you set out.

We should also see good ideas that are created in this process as being something we would want to export, in much the same fashion as the UK pensions disclosure legislation at the beginning of the century, and UK stewardship practices generally have been taken up much more widely. This can only be helpful for UK financial services as well as making all markets more sustainable. But we also need to learn from good ideas elsewhere. Other jurisdictions from time to time offer platforms or other collaborative opportunities. We should be seizing those opportunities and seeking to play a significant role within them. We may also be able to provide capacity building support to other markets. There is a history of emerging markets, for example, moving very fast on some disclosure initiatives which could be built on.

Q18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain? 32 DP21/4 Annex 1 Financial Conduct Authority Sustainability Disclosure Requirements (SDR) and investment labels

Financial advisers and other intermediaries have always played a very important role in this market both negatively and positively. Those who have the expertise and capability have made it possible for consumers to identify investments that met their needs at a time when the information was often very hard to come by. On the other hand, those who didn't ask clients about their requirements or discouraged consideration of green and ethical products, or platforms that didn't tackle the issue, have almost certainly delayed the development of this marketplace. So an obligation on anyone offering financial advice to align their recommendations with client requirements in this area and for platforms to make relevant data readily available would facilitate the various objectives you have set out.

One of the helpful aspects of the EU SFDR is the proposal that where funds use a benchmark to report on their own financial performance they need to align that benchmark with any sustainability objectives that restrict or focus the choice of investments. Otherwise, there is an unhelpful pressure within the investment management process to ignore the sustainability approach set out for the clients in order to match the benchmark. And also because reporting against a benchmark that disregards the universe actually available to the fund manager does not properly measure the value they have added through their investment management process. That would be unhelpful to advisers and the ultimate client.

It is true that ratings and index providers may claim intellectual property challenges in allowing their clients to pass on information to their own consumers. However, there is no real case for this at the level of portfolio-aggregated information, and the direction of travel appears to be strongly towards much wider disclosure of methodologies and other approaches by such agencies precisely because other actors in the chain need to appreciate what is being done on their behalf if their analysis is to add real value.

Q19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?

Third party verification can provide important assurance to users of the information and (possibly more importantly in practice) learning opportunities for the organisations undergoing the verification. There would need to be proper consideration of the potential costs and perhaps a pilot study in order to clarify the potential benefits and any disincentives to innovation that might result. Such concerns might be addressed by requiring it only once a fund reached a certain size and/or on a rolling basis (for example every three years), although smaller funds might then choose to adopt it as part of marketing their product.

At the same time two other approaches to verification and assurance for users of the information could be worth exploring:

a. A number of funds have established independent committees to advise on the criteria and approach and sometimes even individual portfolio choices of green and ethical funds. In the long history of this sector some of these groups have been very influential in the development and promotion of particular funds. So such committees (where they exist) could be given a formal role in approving the disclosures, and adding any qualifications that they felt necessary. It might be necessary to give them (at least collectively) the right to seek independent advice when fulfilling such a role. If third party verification was adopted more generally, the use of a funds own independent committee might still be retained as an alternative option for fund providers.
b. Clarifying the responsibility for internal sign-off of the disclosures within firms which might include internal compliance functions and a high level of senior sign-off, potentially with some requirements for ESG competence or training for those involved in such internal verification.

On the same broad topic, establishing good use of customer feedback would be another good way of improving the quality of these products and their relevance to their consumers. Firms might be required to provide clear communication channels to investors to raise any ESG matters/concerns, encouraged to provide annual meetings or Zoom calls for interested clients to hear more about the product and ask questions, and required to publish an annual summary of the matters raised by clients and the responses given. In the past such exchanges have been very helpful to enhancing manager understanding of the views of those on whose behalf they were investing, as well as raising matters that subsequently became part of the criteria adopted by funds, that might otherwise have been overlooked.

Q20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine- readable format to better enable data collection and analysis?

Machine-readable disclosures that are not hidden behind any particular regulatory filters would facilitate the provision of good advice to consumers and also the generation of analysis and comment by third parties. Both of these would make an important contribution to the success of this initiative.

Measures of success should include:

- regular consumer and adviser research to establish whether the disclosures are well understood by the target audiences, and how that evolves over time.
- an analysis of the growth of funds in the different categories of the labelling system, the sustainability goals chosen by funds and the proportion of portfolios that were assessed as meeting impact, alignment or transitioning thresholds. A comparison of those figures should be made with consumer expressed desire for such investments and approaches and any policy objectives in the same areas.
- the extent of uptake of (and alignment with) similar regulatory initiatives in other jurisdictions

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