SDR and labels policy
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

25th January 2023

Dear Colleagues,

We are pleased to take this opportunity to respond to this important initiative.

The EIRIS Foundation is a research, advocacy and advice charity pioneering the next steps in sustainable finance. Through our former subsidiary EIRIS which we sold in 2015, we played a significant role in creating and providing research for a number of long-term ethical and green funds since 1984. We also provided a variety of guides to explain their approaches and the difference between them in the early years to help retail investors understand what was on offer. And for many years we have a provided an annual update on the total assets under management (AuM) of green & ethical funds in the UK, with some commentary of the evolution of the market.

So from our point of view there is a lot to welcome in the proposals in CP22/20:

a. They highlight three very important elements of sustainable finance: Creating portfolios of companies contributing to a more sustainable future ("Sustainable Focus"); improve the sustainability quality of existing assets ("Sustainable Improvers") and putting money to work in new ways that can deliver real world sustainability outcomes ("Sustainable Impact").
b. The emphasis on the need to be clear about the sustainability objective of a fund and deriving what follows from there.
c. Generally introducing a lot more rigour into the marketing and disclosures of green and ethical funds and careful thought where disclosures should appear which may help to address our previous experience of considerable difficulty and inconsistency in how funds present their offers.
d. The focus on evidence-based assessments of how consumers understand disclosures in practice and the matching encouragement to firms to take the same approach in developing their own communications to consumers.
e. The work to align with and learn from the EU SFDR where possible, and to look for future alignment with ISSB and other emerging standards.
f. The detail and rigour of the implementation guidance and associated principles.

But we should also highlight some omissions and challenges:

1. **It is not obvious what is gained by making the three labels mutually exclusive and requiring fund providers to choose between them.**

   We do not believe that many investors are looking for one of these elements (focus, improvement and impact) at the expense of the others, even if different people may seek a different balance. Indeed people may want to combine these approaches for financial reasons as well as sustainability ones: to lower the risk of very focused funds, and to increase diversification or to increase a particular exposure without going "all in".

   It is not always sensible (particularly over time) to suggest that consumers should arrange their own portfolio to that end and the rules proposed may prevent a fund of funds that seeks to provide a combination from being labelled at all under the 90% label alignment rules. If the investment is linked to pensions, insurance or other financial products it may not be possible for the consumer to combine individual funds anyway.

   Mutual exclusivity will actively discourage individual funds from combining these elements for the consumer and may even deny such a fund the use of any of the labels in some circumstances.

   Some practical examples:

   (a) With the growth of impact investing options, it is increasingly possible for public market funds to put some of their cash or bond exposure into investment delivering real world outcomes related to their sustainability objective, or to make use of collective equity vehicles with such impacts. This is not the same as a fund devoted to impact, but would represent increased "sustainability value" for some (and possibly many) investors compared to a fund that did not do this. But it is proposed that focus or improvement funds will be barred from talking about impact in their communications when a more appropriate solution would be to require a clear statement of the percentage of the portfolio meeting whatever emerges as the impact requirements.

   (b) A focus fund emphasising low carbon infrastructure may find that many such assets have not attended to human rights associated with land use or raw materials sufficiently. But rather than excluding such assets, retail investors might prefer to see a combination of social improvement with environmental focus. Our work with the Business & Human Rights Resource Centre in researching their most recent Renewable Energy benchmark highlighted exactly this dilemma as part of the accelerating conversation on Just Transition. Asking a manager to choose between labelling such a fund as focus or improver will only add to confusion for consumers. Especially when they might view the combination as a more valuable way to advance their sustainability objective than either approach individually.

   (c) An Impact fund that cannot commit 100% of its assets at any one time to illiquid investment may have good reasons to invest in public markets with either a focus or improvers approach to sustainability and may be better regarded by investors than would be the case if they were to invest their current uncommitted assets in less sustainable assets. Such investors deserve to know whether that part of their portfolio would qualify for a label (viewed separately) and to benefit from the proposed related disclosures.

It would be better to allow funds to adopt more than one label if they wish to do so, and where appropriate to segregate assets and declare the proportion of their portfolio that meets the requirements for each label if their whole portfolio does not.

2. **Although there are a number of references to "what the fund invests in and what it does not" there is no attempt to address the green washing challenges of negative screening, which remains a significant part of the existing market.**

   Challenges that should be addressed include:
   (a) references to topic (for example tobacco) without clarifying the criteria applied: production or sale; nicotine in any form or just cigarettes; whole products or major components suppliers; or whether a turnover threshold is applied and what that might mean in practice by means of straightforward examples: in this case the effect of the criteria on supermarkets for example.
   (b) References to screens without clarity about whether those screens apply to any indirect holdings in other funds or just to directly held assets. Particularly important for funds of funds, but there are many products that mix direct holdings with funds for exposure to particular markets or themes.

   Some of this could be seen as related to the proposals for disclosing unexpected investments. If a typical consumer would be surprised to know the details of actual holdings having read any published negative screens, then there is a greenwashing problem.

3. **The fact that no equivalent of the EU SFDR requirement to disclosure principal adverse impacts has been identified is unfortunate:**
   (a) This means that consumers, including those investing in unlabeled funds will be denied information on exposure to a number of potential ESG risks that could have financial implications even if the consumer is not interested in sustainability.
   (b) It also means that an important lever to advance sustainable finance, and to help develop the UK as a marketplace with greater capacity to identity and then prevent, reduce, or mitigate ESG risks is not being deployed.
   (c) For labelled funds, this may be particularly important for social factors, especially if the main focus of the fund is environmental. Consumers might be surprised to know that holdings involve violations of social standards, but if the sustainability objective was expressed in purely environmental terms, such things might not have to be disclosed as "surprising investments" at all under the present proposals.
   (d) The analysis of such impacts can also contribute to a benchmark or starting point against which to understand the "sustainability add" of a particular focus or improver fund. For example a fund that says that part of its focus is to keep investment in controversial weapons below a given threshold, but one that is already many times that of the market exposure is clearly adding nothing at all in that regard.

We would be very happy to discuss these and the attached more detailed points further if that would assist in your important work.

Yours sincerely,

Peter Webster
CEO
EIRIS Foundation

Our responses in more detail to selected questions

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?

In principle consumers deserve the same clarity and protections when investing for their pension as for any other purpose, and so we look forward to the further proposals in that area.

We would like to be assured that the approach proposed applies to common investment funds for charities (see our guide to these funds and their approaches to responsible and sustainable investment). A specific additional requirement for charity funds would be asking fund providers to be clear about the alignment between the sustainability objective adopted by the fund and the various charitable purposes that different charities are registered under to help trustees to align their investments with their missions.

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

It would be helpful to have both "can" and "must" dates (with the proposed dates as "must") to encourage first movers to adopt the labels early and the gain experience of the models. This would depend upon any and all supporting material being ready by the "can" dates.

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.

Strong support for defining the sustainability objective up front and the definitions of how the objectives might be achieved are helpful.

The fact that they tend that they tend to differ only in terms of the priority of different approaches, plays into our argument that the hard mutual exclusivity of labels will not work so well in practice, and we summarise in our introductory remarks some of the ways this will add new and unhelpful pressures into the market (even as it tackles some of the challenges arising from the EU SFDR categorising on funds)

It would also be helpful to encourage fund providers to refer to existing and emerging international standards in defining their sustainability objectives, rather than making up such objectives for themselves. The BSI standard for Responsible and Sustainable Investment Management takes this approach. So as well as the Paris agreement and the SDGs, managers should be encouraged to consider SA 26000 (social responsibility and stakeholder impacts), The UN Guiding Principles for Business and Human Rights, the OECD Guidelines for multinational enterprises (and their work on responsible business conduct) and the ILO Core Labour Standards (recently expanded to include health and safety). Such an approach will facilitate global interoperability in this field as well as being appropriate for those offering global funds.

Q5: Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?

Yes (subject to comments made elsewhere)

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?

Yes, with a couple of caveats. And Yes without caveats to the 70% requirement.

There should be space in this category for objectives that relate to responsible business conduct in general as a necessary condition for the shift to a more sustainable economy, as long as the standards adopted are sufficiently ambitious (so represent a change to business as usual) and are clearly defined. While specific products, services or practices can help to achieve specific sustainability goals (for example those set out in the Sustainable Development Goals) businesses which have clear approaches to meeting the needs of all stakeholders, maintain high labour and consumer standards, act as good neighbours, are careful to respect the rights of those with whom they are linked through business and are well governed are also advancing the sustainability of the economy in general, and particularly social sustainability.

It should not be a requirement that such funds are narrowly focussed. More than one “theme” should be permitted as long as it is clearly defined and properly disclosed to consumers.

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?

Yes to Investor stewardship as a key feature. But there needs to be an equivalent of the 70% requirement to measure the seriousness with which engagement is being approached. The manager should have a clear improvement plan that covers at least the majority of the investments (50%), and, say 75% of all those they have identified as “high risk” or “most greatly in need of improvement”. The idea of KPIs that capture the desired improvement over time is certainly a helpful guiding star for this activity.

But if there is not some threshold of activity it would be perfectly possible for a fund manager to identify a KPI which they believe was likely to improve overtime anyway through the actions of others (one might suppose increases in energy efficiency or numbers of women on the board, for example), and then declare all their funds to be sustainability improvers on the basis of the activities applicable to the assets in the fund that arose from their general entity level stewardship activities (which might indeed be valuable activities). But this would not be the same as a clear plan to use the ownership rights attached to the assets in the portfolio and the engagement opportunities they offer to make serious progress on a given sustainability objective.

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?

There is a need to clarify the extent to which improvement or engagement activity should be considered as part of impact, or whether this category should focus more exclusively on putting money to work in ways that generate new business or economic activity with real world impact.

The challenge is that the more rigorously one defines the improvers category (which is very important for the total sustainability impact of this policy initiative) the more potentially confusing it becomes to try to define a kind of "high end" Stewardship approach as part of sustainability impact.

There also needs to be clarity about whether the impact approach has to relate to all the assets in the fund or some percentage (as with focus). There will at least be the issue of uncommitted funds here, and possibly the desirability of some diversification as well in some circumstances.

Perhaps a way of resolving the dilemma would be to say that the majority of the fund (at least 50%) had to be devoted to the primary channel that you identify (putting money to work to achieve new things), but that there should also be a rigorous and intentional stewardship strategy for the remaining part of the assets. In practise the primary channel may provide unique opportunities for stewardship as well.

Q7: Do you agree with our proposal to only introduce labels for sustainable investment products (ie to not require a label for 'nonsustainable' investment products)? If not, what alternative do you suggest and why?

There should be sustainability disclosures for all funds. We refer to the desirability of an alternative form of principle adverse impact disclosure in our introductory remarks. It should at least be a requirement for any fund that does not choose to be labelled to make clear somewhere suitably prominent that they have chosen not to do so, and provide a link to some general FCA description of the labelling arrangements so that consumers are aware of what they may be missing. If they wish the manager might also be encouraged to provide links to other labelled products that they offer those who want them.

Q8: Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider:

- whether the criteria strike the right balance between principles and prescription
- the different components to the criteria (including the implementing guidance in Appendix 2)
- whether they sufficiently delineate the different label categories, and; whether terms such as 'assets' are understood in this context?

These are generally very strong, and will provide a considerable enhancement to market practises if properly followed through by all parties.

We have referred in Q4 to the benefit of encouraging managers to refer to international standards wherever possible in defining their sustainability objectives, and we listed candidate standards there.

This section does refer frequently to adopting a single sustainability objective for the fund, but it would be entirely reasonable for a fund to be pursuing multiple SDGs at the same time, for example, and the same point would apply to a wide range of social standards.

We've argued elsewhere that funds should be able to pursue more than one sustainability objective as long as they remain clear about how each is to be pursued, and also that the pursuit of responsible business conduct (as long as clearly defined) should also be part of this framework as a means to advance sustainability and particularly social sustainability.

Philosophically, frameworks like the SDGs are deliberately interconnected and so to focus exclusively on one individual objectives (or worse, to pursue one at the expense of others) is to misunderstand their role in advancing both social and environmental sustainability. But also from consumer or a fund performance view it would not be helpful if the labelling regime was to tend to drive people into very narrowly focused funds with high risk and low diversification.

Finally this section refers again to the idea of mutual exclusivity between the labels and advances the argument that this arises because the primary and secondary channels are defined differently in each case. So if you know which is the primary contributor to the achievement of the objective, you know which label applies. But if one thinks through the practical business of running a particular fund, this distinction will often not hold up in practice. While referring back to our introductory remarks on this point, it may be worth tackling this argument directly here as well.

1. The framework of primary and secondary means to achieve sustainability objectives under the different headings is a great framework for thinking about focus, improvement and impact, three very important aspects of sustainable finance. It will help consumers and fund providers to clarify their thinking on the means to be deployed in order to achieve a given objective and to improve upon product design. It will also help to reduce confusing communication to consumers.
2. However if a provider decides to deploy both asset allocation and stewardship in a particular product in pursuit of the objective(s) (as most will) it then ceases to be meaningful to try to determine whether the asset allocation or the stewardship is most important to achieving the objective purely for the purpose of determining which label should apply. It will often be a mix in practice; it will vary over time; it may vary by different aspects of the sustainability objective or objectives, and they are seriously incomparable contributions to a given objective in principle anyway.
3. A blended strategy will often be the best for the consumer, and the most attractive to the manager as a product and a labelling system devoted to preventing greenwashing and advancing wider sustainability policy goals should focus on the extent to which the fund intends to do each task and how well it then delivers on the basis of the excellent criteria and process proposals advanced in this proposal.
4. In other words, rather than attempting to determine the balance of asset allocation (or types of asset allocation) and of stewardship to decide which label a fund should use, the purpose of the scheme should be to help the consumer and their advisors understand the balance of focus, improvement and impact offered by a given fund as the means to deliver the sustainability impact they are seeking to advance.

Q9: Do you agree with the categoryspecific criteria for:

- The ‘Sustainable focus’ category, including the 70% threshold?

Yes

- The ‘Sustainable improvers’ category? Is the role of the firm in promoting positive change appropriately reflected in the criteria?

As argued earlier there should be a requirement that there is a clear improvement plan for at least 50% of the assets and 75% of those judged “high risk” or “most in need of improvement”

- The ‘Sustainable impact’ category, including expectations around the measurement of the product's environmental or social impact?

As argued earlier there should be a requirement that 50% of the assets an invested in the primary channel as you define it. Putting money to work in ways that create new business or economic activity

Please consider whether there any other important aspects that we should consider adding.

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?

It is important that disclosure both short and detailed are not hidden behind online paywalls or regulatory walls that make them hard to access for consumers

It is also important that consumers and their advisers have easy access to a full portfolio listing, and that a contact is provided (both phone and email) for further questions about the sustainability approach being adopted.

EIRIS Foundation

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