International
Capital
Market
Association

25 January 2023

Response to the FCA's consultation on Sustainability Disclosure Requirements (SDR) and investment labels

The International Capital Market Association (ICMA) welcomes the opportunity to provide feedback on the FCA's consultation on Sustainability Disclosure Requirements (SDR) and investment labels.

ICMA is a membership association, headquartered in Switzerland, committed to serving the needs of its wide range of members. These include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms and others worldwide. ICMA currently has over 620 members located in 66 jurisdictions. See www.icmagroup.org.

This feedback is given on behalf of ICMA and its constituencies. We would like to note that ICMA does not specifically cover retail investors.

The response below has been directly submitted to the email address provided in the comments section on the FCA website.

Yours faithfully,

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ICMA welcomes the FCA's consultation paper (CP) on its proposed sustainability disclosure requirements and investment labels. We agree that the financial services sector has an important role to play in helping the UK economy adapt to the transition to net zero and a more sustainable future. Relatedly we welcome the FCA's initiative to propose new rules helping consumers navigate the landscape of products offered to them by the financial services sector. We also think that the rules set forth in CP 22/20 will provide clearer guidance to asset managers on how to label and market their funds.

Greenwashing

We understand that tackling greenwashing is a core regulatory priority for the FCA. This is in line with what we observe in other jurisdictions, for example, the European Union. In the absence of an agreed definition of "greenwashing" in the financial services space, we think that regulatory guidance, such as the proposed sustainability disclosure requirements and investment labels, can prevent alleged greenwashing that happens unintentionally. Moreover, we can see how the option to challenge firms and take enforcement action against them as appropriate under the proposed "anti-greenwashing rule" could function as a deterrent against greenwashing. It would be good to better understand how the FCA intends for supervision to work in practice and what kind of action would be taken if poor conduct is observed.

<u>The biggest challenge that retail investors face when it comes to current sustainable investment labels is that they often do not fully understand and, as a result, can misinterpret a label which may primarily refer to "ESG integration</u>" i.e., the consideration of ESG risks, opportunities and impacts that may be material to the future financial performance of a company, rather than the (real economy/real world) impact that the company is having on the environment and wider society. This is not immediately obvious to non-professional investors, but also does not imply any intentional greenwashing by the fund manager.

Sustainable Investment Labels – General

The newly proposed sustainability labels can help address this issue by considering consumers' intentions. Importantly, the three labels "sustainable focus", "sustainable improvers" and "sustainable impact" seem to all have a link to real world impact (although it is only explicitly mentioned for the third one) by classifying and labelling a product based on "how the fund may plausibly achieve a positive outcome for environmental or social sustainability". That said, when it comes to sustainable fixed income products, we would like to point out that most green bond funds could fall under all of the three proposed categories.

At the same time, funds which include assets that focus on "ESG integration" (as defined above) or funds that employ strategies such as "exclusion/negative screening" or basic "ESG tilts" would not qualify as sustainable investments because of the lack of positive outcomes or objectives. As a result, many products that are currently labelled as ESG or sustainable may have to either lose the label, reclassify and/or adjust their sustainability strategy. Taking this into account, <u>we think the FCA should consider creating a fourth label for funds focusing on the consideration of ESG risks, opportunities and impacts material to the issuer, rather than on sustainable outcomes or improvements.</u>

Sustainable Investment Labels – Specific

<u>In our opinion, the product category "Sustainable Focus" is not sufficiently clear</u>. Is this intended to cover for instance, investments in companies with low carbon emissions but that are not clearly making an additional contribution to the net-zero transition, as highlighted in the "Dear Chair letter" referenced?

Saying that these funds must invest in assets where at least 70% meet a credible standard or align with a specified environmental and/or social theme, leads to three questions:

1. Are there any rules regarding what the remaining 30% or less can be invested in?

2. Could the FCA provide more examples for what constitutes a credible standard beyond the proposed definition referring to one that is "robust, independently assessed, evidence-based and transparent"?
3. Could the FCA provide more examples for what constitutes an environmental or social theme beyond the sustainable development goals (SDGs)?

For funds that are invested in sustainable bonds, we would like to add that a credible standard would be, for example, ICMA's Principles (including the Green Bond Principles and the Social Bond Principles). The Principles provide the global voluntary issuance standard and encourage, among other, issuers to provide information on the alignment of projects with official or market-based taxonomies. Similarly, an environmental or social theme could include green or social bonds aligned to the Principles. ICMA also provides guidance documents on mapping the SDGs to eligible green or social projects which is often incorporated by issuers in their bond frameworks.

We are supportive of the category "Sustainable Improvers" which we consider important for progress towards achieving the goals of the Paris Agreement as the label covers assets in transition to becoming more sustainable. Questions that come to mind here are:

1. How will a firm assess the potential for the sustainability profile of assets to improve over time and how ambitious will the improvement have to be?
2. More specifically, how will a firm assess whether KPIs are ambitious?
3. What happens with the assets and the fund, if KPIs are not reached? For example, the sustainable impact category suggests potential divestment of assets.

For funds that are invested in sustainable bonds, this product category could be investing in transition related sustainability-linked bonds (SLBs) aligned with the Sustainability-Linked Bond Principles (SLBP). The SLBP already clarify what makes a KPI ambitious, how progress should be reported and what happens if targets are not reached. Furthermore, any bond (green, social, SLB) would gain additional credibility if aligned with ICMA's Climate Transition Finance Handbook which, among other, provides guidance on recommended disclosures.

Finally, we mostly agree with the category of "Sustainable Impact" but we consider the additionality condition to be unworkable for investing in a large portion of the sustainable bond market. This is because refinancing of sustainable projects would likely not quality while green and sustainability bonds are regularly issued, for example by banks, development institutions and sovereigns, for this purpose. The current proposal would therefore have the consequence to significantly constrain permitted investments, for example towards private equity and private debt, which are typically not liquid enough to be suitable for a product sold to retail investors.

It is important to underline that funds invested in sustainable bonds aligned with the ICMA Principles already contain impact reporting based on guidance from the Harmonized Frameworks for Impact Reporting.

We also have some further questions:

1. Could the FCA provide examples for a robust method to measure and demonstrate the positive real-world impact?
2. How often will the impact have to be demonstrated?
3. How can firms demonstrate that unintended negative environmental or social impact has been avoided?

UK SDR and EU SFDR

Overall, we note that the proposal is different to the EU's Sustainable Finance Disclosure Regulation (SFDR)'s Article 6, 8 and 9 classifications, which relate to disclosure requirements and are not intended to be used as product labels. The FCA also underlines that there is no hierarchy between its proposed labels, which contrasts with SFDR where Article 9 funds are perceived to be the most ambitious, and therefore likely to be more attractive to responsible investors. As a result, asset managers initially favoured marketing their funds as Article 9 products, only to reclassify many of them following clarification from the European Commission (EC) in June 2022 that Article 9 funds should only contain 100% "sustainable investments" as defined by Article 2 (17) in the SFDR.

<u>The FCA proposal may be comparatively easier to implement.</u> This is further aided by SDR not requiring the disclosure of principal adverse impacts (PAIs) of investment decisions on sustainability factors, and the labelling regime not applying the concept of "do no significant harm" (DNSH). However, this makes the definition of a "sustainable investment" quite different to its characterisation under SFDR.

We see the emphasis on active stewardship in all three labels as a positive feature, as the engagement will allow asset managers to monitor and push for progress, especially with the improvers and impact funds.

We note that this CP published in October is focusing only on funds and portfolio management based in the UK. ICMA intends to also respond to the future CP which will detail how the same proposals may be applied in respect of overseas funds. Comparing and contrasting the UK SDR with the EU SFDR will be even more important then.

Connecting the dots with existing frameworks and legislative initiatives

<u>We appreciate the proposal making reference to existing frameworks and legislative initiatives such as TCFD, TPT and ISSB,</u> which will not only be helpful to connecting the dots but mean that market participants will already be familiar with certain elements related to the proposed disclosures and avoid duplication where disclosure based on other initiatives are already mandatory.

That said, ISSB currently only focusses on integrated risk as it impacts the enterprise value of a company, so referencing UK-adopted IFRS S1 at least initially appears less relevant to providing the data required for the three outcome-oriented fund labels. Both ISSB and TCFD will however be helpful in this respect through their required disclosures of Scope 1-3 greenhouse gas emissions.

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