SDR Labels Report

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SDR: Sustainable Disclosure Requirements

The ESG market has been rapidly moving, leaving behind a cloud of misunderstanding in the absence of universal ESG taxonomies. To help prevent greenwashing and help investors ravigate ESG investing, the FCA have proposed three new labels to distinguish between different types of responsible investing. These were proposed in their October 2022 consultation paper and its labels will be provisionally available to UK investment products from 30th June 2024, with the policy statement expected to be released in Q3 2023. The FCA have stated that there will be guidance in the near future regarding rules for financial advisers on how to handle sustainability matters in their investment advice.

Sustainability related claims must be clear, fair, and not misleading. Therefore, there are specific requirements for a product's acquisition of the new labels.

The FCA has stated that these labels are mutually exclusive and do not have a hierarchy; they simply offer different sustainability approaches. The descriptions below are drafts, and may change when released – particularly the 'Impact' label.

Sustainable Focus

Products that aim to invest in assets that are environmentally and/or socially sustainable.

Sustainable Improvers

Products that aim to invest in and engage with assets that can improve their sustainability profile over time.

Sustainable Impact

Products that aim to invest in assets that provide positive sustainability outcomes, sustainability solutions, and/or real-world impact.

Sustainable Focus

This label indicates that investments are made in assets that many investors would consider as environmentally and/or socially sustainable.

- Sustainability Objective

The product will have a stated goal to invest in assets that meet a credible standard of environmental and/or social sustainability that is evidence-based, independently assessed, and transparent. The product may align with a specific environmental and/or social sustainability theme, such as climate change or biodiversity. A minimum of 70% of the product's assets must meet either one of these criteria.

- Primary Channel for Sustainability Outcomes

The product pursues its sustainability goals by influencing asset prices, which reduces the relative cost of capital of sustainable economic activities and/or projects.

- Secondary Channel for Sustainability Outcomes

As well as the above, the product will usually pursue the ongoing improvement of its assets' sustainability performance through stewardship/engagement activities.

Sustainable Improvers

This label indicates products that are not currently objectively environmentally and/or socially sustainable but have the potential to measurably improve.

- Sustainability Objective

The product has an objective to deliver measurable improvements in the quality of its assets' sustainability over time. This involves investor stewardship and engagement.

- Primary Channel for Sustainability Outcomes

The product will achieve its sustainability goals through investor stewardship i.e., engaging with its assets to encourage improvements in their sustainability profiles.

- Secondary Channel for Sustainability Outcomes

Asset-picking and allocation is determined by the potential for assets to improve their sustainability profile over time. This can be aided by influencing asset prices and, therefore, the cost of sustainable economic activities and/or projects.

Sustainable Impact

This label indicates products that aim to achieve a positive contribution to sustainability outcomes. Sustainable Impact Funds differs from the other two labels in that it seeks to deliver and report on the products' positive sustainability outcomes, i.e., its impact.

- Sustainability Objective

The product will have a goal to achieve a positive environmental and/or social impact that is measurable.

- Primary Channel for Sustainability Outcomes

The product aims to direct new capital to projects and activities that offer ESG solutions (i.e. to environmental or social issues). The product may look for underserved areas of markets and/or failing areas of markets. The product's asset selection strategy is likely to be highly selective and assess assets on a 'theory of change' i.e., how its investment process aims to help address environmental and/or social issues.

- Secondary Channel for Sustainability Outcomes

The product encourages change through stewardship i.e., engaging with its assets to encourage improvements in their sustainability profiles.

Five Key Considerations

The FCA has specified that products that do not have a sustainability objective and only use ESG integration strategies will not qualify for a label. Such product is likely to only be considering the sustainability-related risks and opportunities associated with their investment decisions.

Under draft guidance, products that do not qualify for any of the sustainable labels above will not be allowed to use sustainability-related terms such as 'ESG', 'Sustainable', 'Responsible', 'Green', or 'Climate' in their product name and marketing materials. This may change when guidance is officially released, potentially with weaker requirements. Tracker funds that follow an ESG-titled benchmark must disclose their use of the benchmark in their pre-contractual or consumer-facing disclosure reports.

To qualify for a label, the product must meet five overarching principles, several key considerations, and the category-specific key considerations relevant to the label in question above. This is to standardize the profession, as previously there has been different definitions and qualifying criteria used by different firms for sustainable products.

These key considerations include:

1. Sustainability objective
2. Investment policies and strategies
3. KPIs
4. Resources and governance
5. Investor stewardship

Sustainability Objective

To be a sustainable investment product, there must be an explicit environmental and/or social sustainability objective that is clear, objective, measurable, plausible, purposeful, and credible. This objective must be linked to an environmental and/or social outcome. The firm must be able to compare its product's performance against its pre-established sustainability objective, which must be reported to investors.

Investment Policy and Strategy

The firm's investment policy and strategy for the product must align with its sustainability objective, ensuring that the product is invested in accordance with such policies. The firm's asset selection process/criteria must aid its targeted environmental and/or sustainable profile, with clear and measurable terms as to know this is assessed and reported upon – including the assessment criteria for when assets may no longer meet their targets.

For index products, the firm maintains responsibility for ensuring that the index provider's construction methodology aligns with their sustainability objectives and policies. The firm has the responsibility to continuously monitor this alignment and ensure compliance with label requirements. They must report this measuring and monitoring to investors and disclose any policy/objective-conflicting assets that may be held by an index provider.

Impact-labelled funds must provide a method to demonstrate that its investments have had a positive sustainability impact that is in line with its theory of change. They must also have an escalation plan in the instance that real-world outcomes are no longer achievable.

Key Performance Indicators (KPIs)

A firm must produce KPIs to measure a product's ongoing performance in achieving its sustainability objectives and policies/strategies using credible, objective, rigorous, and evidence based KPIs. These must be relevant to sustainability objectives and must be ongoing.

For a Sustainable Improvers fund, these KPIs must detail metrics that demonstrate clear and measurable targets that demonstrate the sustainability profile of its assets, projected over the long term (more than one year). They must indicate how engagements/investor stewardship has improved an asset's sustainability performance, as well as what stewardship actions have taken place. This must be distinguished from changes in sustainability profiles that are due to asset rotation.

For a Sustainable Impact fund, there must be enhanced KPIs to measure impact and performance.

Resources and Governance

A firm must provide and maintain the necessary resources, governance, and organizational resources needed to deliver the product's sustainability objectives. This includes having the appropriate: professionals with skills/experience; technology and data/analytical tools; research facilities; oversight by governing bodies (where applicable); and any other resources that are necessary to achieve the stated sustainability objectives. These must be maintained to ensure that the product is adequately equipped to continuously achieve sustainability objectives.

All data must have had due diligence undertaken on any data, research, and/or analytical resources it relies upon. Any gaps and/or shortcomings must be identified, with corresponding mitigations provided.

Governance and organizational arrangements must appropriately support sustainability and investment objectives and policies/strategies, with incentives for delivery high-quality products.

Stewardship

Firms must maintain their stewardship/engagement policies, either at a firm level or a product level. This must be consistent with their sustainability objectives and policies. This is especially important when stewardship is a large part of policy and labels, whereby firms must provide relevant KPIs.

Alignment with European Regulations/SFDR

Previously, many ESG-targeted solutions in the UK followed the disclosures and classifications as directed by the European Union Sustainable Finance Disclosure Regulation (SFDR). This saw products categorised according to their disclosure requirements, named 'Articles'.

The FCA have stated that the new SDR labels do not currently map across the EU SFDR Article classifications, nor do they currently include the SFDR classifications of "do no significant harm" (DNSH) or the "principle adverse impacts" (PAI). This means that the new system is an approach that only labels products that are sustainable.

Furthermore, the FCA have implied that their Fund Authorisation team may challenge new funds that are submitted for authorization, but that this review "will not constitute approval of the label".

While the new SDR labels are only awarded to sustainability products, the FCA's proposals will see firms required to produce consumer-friendly disclosure documents to make the key sustainability features of an investment product clear. These are more detailed at the product and entity level than previously.

Pre-contractual disclosures

This will cover any sustainability-related features of the product – including products that may not have an SDR label, but that have sustainability-related features that are central to their investment strategy.

Sustainability Product-level Report

This is an ongoing report on sustainability-related performance of any SDR-labelled products.

Sustainability Entity-level Report

This is a report that covers the firm's sustainability-related activities, risks, and opportunities. This is required regardless of whether an in-scope firm uses an SDR label.