FCA Publishes Policy Statement and Final Rules on Sustainability Disclosure Requirements

13 December 2023

Following extensive consultation with industry, the Financial Conduct Authority (the "FCA") has published its Policy Statement, with final rules, on Sustainability Disclosure Requirements (the "SDR"). This is a significant step in the UK's development of a regime on sustainability-related disclosure and labels for funds and may influence the European Union in its review of the Sustainable Finance Disclosure Regulation (the "SFDR") and other jurisdictions.

The rules form new chapters of the FCA's ESG sourcebook. Other than a new "anti-greenwashing" rule that will apply to all UK FCA-authorised firms, the FCA's regime applies to UK fund managers (UK full scope and small authorised UK alternative investment fund managers ("AIFMs") and UCITS management companies) of UK funds, including UK alternative investment funds ("AIFs") and authorised funds, in particular those which are marketed to retail investors. Social entrepreneurship funds and venture capital funds, which are subject to their own regimes, are out of scope.

The FCA includes, in Annexes to its Policy Statement, helpful commentary on the principles supporting the SDR regime and an overview of the labelling regime.

There are different levels of rules, summarised as follows:

Section of the regime	Products in scope	FCA rule	Application date
All regulated firms			
Anti-greenwashing rule that sustainability-related claims must be clear, fair and not misleading.	All products and services.	ESG 4.3.1	31 May 2024
Firms using product labels			
Firms can begin to use four new sustainability labels (with required graphics) for funds, with the criteria for their use, with related **consumer-facing** (summarising how the product	Funds which use a sustainability label.	ESG 4.1 and 5.1 to 5.3	31 July 2024

Section of the regime	Products in scope	FCA rule	Application date
will pursue and measure the sustainability objectives) and **pre-contractual disclosures**, giving more detailed information on the sustainability product's investment policy.			
Ongoing product-level sustainability reporting for authorised funds (and certain types of listed AIFs).	Authorised funds and AIFs listed on a recognised stock exchange.	ESG 5.4 to 5.5	31 July 2025
"On-demand" ongoing sustainability reporting to clients on request.	AIFs not listed on a recognised stock exchange.	ESG 5.5.13-5.5.16	2 December 2025
Firms using sustainability-related terms without product labels			
Naming and marketing rules, consumer-facing and pre-contractual disclosures.	Funds which use a sustainability label or any retail fund that uses an ESG term in its naming or marketing which does not adopt a sustainability label.	ESG 4.3	2 December 2024
Annual product-level sustainability reporting.		ESG 5.4 to 5.5	From 12 months after the terms are first used
Distributors			
Requirements for distributors to ensure that product-level information (including the labels) is made available to consumers.	All funds distributed to retail investors.		31 July 2024
A sustainability entity report which contains the firm's approach to matters such as sustainability-related governance and risk management.	Assets managed in relation to in-scope business, which is currently managing a UK UCITS or managing a UK AIF.	ESG 5.6	2 December 2025 (firms with more than £50 billion in AUM) 2 December 2026 (firms with more than £5 billion in AUM)

Anti-Greenwashing Rule

The FCA's anti-greenwashing rule is that all references to the environmental or social characteristics of a product must be clear, fair and not misleading. The introduction of a general "anti-greenwashing" rule does provide the FCA with an explicit rule on which to challenge firms for unsubstantiated ESG claims. The FCA has separately published a Consultation on Guidance on the Anti-Greenwashing Rule.

Overseas Funds

Non-UK funds are not in scope of the regime. In this respect the FCA comments that it wants all firms marketing their products in the United Kingdom to be subject to the same broad requirements and is considering extending the regime to "overseas recognised funds", which are primarily overseas retail funds which are permitted to be marketed to retail investors in the United Kingdom. However, the FCA does not make any statement on the application of the regime to non-UK alternative investment funds which are marketed to UK retail or professional investors.

Naming and Marketing Rules

Sustainability Labels

The FCA's sustainability "labels" for products is the centrepiece of the regime. A firm may make use of the new sustainability "labels", with the accompanying graphic, where a fund meets specific criteria. Feeder funds may use the same sustainability label as the underlying master fund. Firms will need to notify the FCA when using (or revising or ceasing to use) a label and will need to review their use of a label at least every 12 months.

The FCA is clear that the labels are only for products that seek positive sustainability outcomes and are not available for purely "ESG integrated" or "exclusionary" funds. This is consistent with the FCA's earlier statement that it expects products with labels to have a "highly screened" portfolio, selecting assets to achieve a particular outcome, differentiating funds that generally integrate environmental or social considerations under Article 8 of SFDR. Article 8 products with ESG negative screening or basic ESG "tilts" may not plausibly contribute to definite sustainability outcomes.

A key point in the FCA's original proposals was the "naming and marketing rule", which required firms when using an ESG term in the naming or marketing of any retail

product to adopt a sustainability label for the product. When using these terms, outside a purely factual context, for funds marketed to retail investors, firms now have a choice: they may either adopt one of the FCA's sustainability labels or state that the product is not using a label and produce the same disclosures and reports as those required when a firm uses a sustainability label. Firms that use ESG terms in the naming and marketing of a product but do not use a label will need to pay careful regard to the FCA's separate anti-greenwashing rule and guidance.

Although the FCA no longer requires firms to use a label, it clearly intends firms that market funds to retail investors with promotion of strong sustainability themes to use a label. Funds with institutional investors may adopt the labels but are not required to do so. Over time, UK institutional investors may favour funds with the FCA's labels, and adoption of the FCA's sustainability labels may help a product stand out in the context of an EU offering under SFDR, as well as in the UK.

The foundation of the FCA's approach is that, to qualify for a label, a product must have a clear, specific and measurable "sustainability objective". A sustainability objective is the intention to undertake activities with the aim of directly or indirectly improving or pursuing environmental or social outcomes. The FCA also refers to this as "intentionality". The FCA's focus on the investor's intentions requires firms to identify a "plausible link" between the investment strategy used and a positive outcome for the environment or society. The FCA requires firms to define the environmental or social outcome via the contribution made both by the assets in which the product invests and through an investor's activities, such as stewardship, noting that "both contributions are critical". In its original consultation, the FCA set out three channels by which an investor may contribute to positive environmental or social outcomes promoted: through active investor stewardship and engagement; by directing capital to assets in order to influence their asset prices and reduce their cost of capital; or by allocating capital to assets that offer solutions to environmental or social problems. In its commentary, the FCA says that "many, if not most, products will generate outcomes via more than one of the channels" and also recognises that "robust methodologies to measure and attribute such outcomes are still being developed."

The FCA requires firms, to qualify for any label, to identify the stewardship strategy that supports the product's sustainability objective. The FCA does not provide a definition of stewardship but is clear in its commentary that it covers different ways the investor can contribute to an environmental or social objective. In a private equity context, it may comprise matters such as environmental and social action plans, placing of non-executive directors and ESG-related covenants in investment documentation. In a public markets context, it includes compliance with the separate Stewardship Code. The FCA states that firms may describe their stewardship at the firm level and should demonstrate some correlation between these activities and the outcomes by a particular

product, although without needing to demonstrate a causal link between those activities and the outcomes.

In a further comment, the FCA distinguishes between funds that pursue sustainability objectives directly (which will bear the Sustainability Impact label) and funds that pursue sustainability objectives indirectly (which will bear the Sustainability Focus or Sustainability Improvers label). In this regard, the FCA expects that all products with a sustainability label will aim to improve or pursue environmental and/or social outcomes.

As general criteria, firms that use the labels must ensure the following.

- **Sustainability objective**. All products using a label must have a clear, specific and measurable sustainability objective to improve or pursue positive environmental and/or social outcomes as part of their investment objectives. Firms must also identify and disclose whether pursuing the positive sustainability outcomes may result in material negative outcomes, broadly corresponding to the "do no significant harm" principle under SFDR.

- **Investment policy and strategy**. At least 70% of the gross value of the product's assets must be invested in accordance with its sustainability objective, with reference to a robust, evidence-based standard that is an "absolute measure" of environmental and/or social sustainability. As a limited exception, products that are designed to build their initial portfolio over time, such as a long-term asset fund ("LTAF"), may not meet the 70% threshold at the outset. Firms must also identify and disclose any other assets held in the product for other reasons, such as liquidity or risk management. A product can hold a pocket of assets other than for cash or hedging purposes so long as the pocket is justified, and the other assets do not have attributes that conflict with the sustainability objective.

- **Asset selection**. Firms must select the product's assets with reference to a robust, evidence-based standard that is an absolute measure of environmental and/or social sustainability and that is applied in a systematic way and may be based on an authoritative external standard, industry practice or a proprietary methodology. In its commentary, examples that the FCA gives are a minimum threshold for the proportion of an investee company's revenue that pursue positive environmental or social outcomes, reference to the EU Taxonomy or forthcoming UK Green Taxonomy, or a minimum threshold of greenhouse gas emissions for assets. Firms must assess that the evidence-based standard is sufficiently robust, using personnel independent from the manager's investment process, which may be by an internal process or a third party.

- **KPIs**. Firms must have robust and evidence-based key performance indicators ("KPIs") that demonstrate the product's progress towards meeting its sustainability objective, either at the product or asset level.

- **Stewardship**. As above, firms must identify their stewardship strategy to support the sustainability objective, including expected activities and outcomes. Firms must also have an escalation plan if any asset does not demonstrate sufficient performance against the product's sustainability objective.

- **Resources and governance**. Firms must ensure that they have appropriate resources and knowledge and apply a high standard of diligence in selecting ESG data.

The Four Available Labels

These are the FCA's final criteria for the four available labels:

Sustainability focus, where the product's sustainability objective is consistent with the aim of investing in assets that are environmentally and/or socially sustainable, determined using robust and evidence-based standards. An example the FCA gives in this category is a fund that invests in assets that contribute to climate change mitigation or adaptation, such as renewable energy infrastructure, forestry or resilient real estate.

Sustainability improvers, where the product's sustainability objective is consistent with the aim of investing in assets that have the potential to improve environmental and/or social sustainability over time, determined by the potential of those assets to meet a robust and evidence-based standard. In using this label, firms must:

- identify when the product and/or its assets are expected to meet the robust and evidence-based standards;

- identify short- and medium-term targets for improvements in the sustainability of the product and/or its assets, commensurate with the investment horizon of the product. Firms may find the requirement for multiyear sustainability projections challenging. The FCA also indicates in this regard that "it is for firms to decide how to treat products or assets that have met their target for improvement"; and

- obtain robust evidence to satisfy itself that the assets in which the product invests have the potential to meet the robust and evidence-based standard.

The FCA states that it expects firms' stewardship strategy to play a key role in this category and that firms must use evidence as the basis for selecting assets that include forward-looking metrics, transition plans, strategies or other credible information. An

example the FCA gives in this category is a fund that invests in companies in emerging markets that commit to improve their business practices in line with key global social standards, such as human rights and working conditions, with published strategies and specific timelines for meeting their targets.

Sustainability impact, where the product's sustainability objective is consistent with the aim of achieving a pre-defined, positive and measurable impact in relation to an environmental and/or social outcome. In using this label, firms must:

- specify a "theory of change" in line with the product's sustainability objective, describing how the manager expects its investment activities and the product's assets to contribute to achieving a positive and measurable impact in accordance with a robust and evidence-based standard. A theory of change is a description and illustration of how and why a desired change is expected to occur, at product or asset level. Funds with broad impact strategies may find it challenging to commit upfront to a detailed "theory of change" that will apply to each of their investments; and

- specify a robust method to measure and demonstrate that the manager's investment activities and the product's assets are achieving a positive environmental and/or social impact. The method of measurement can be quantitative or qualitative.

In distinguishing its impact label from the other labels, the FCA states that "the impact category aims to directly achieve a positive impact. A key feature of this category is that firms will need to measure and report on how their investment activities contribute to achieving the impact (their investor contribution) as well as how the assets are achieving the impact." There is a clear correlation between the Sustainability Impact label and SFDR Article 9 funds, although the FCA's focus on investor contribution (sometimes referred to as additionality) will limit the ability of UCITS funds, which are predominantly invested in public securities, to adopt the label. The FCA gives examples of ways firms may contribute to positive impact: "through investment activities such as engagement with the product's assets, investing in initial public offerings, participating in new rounds of capital raising, or directing new capital to projects and activities that offer solutions to environmental and/or social problems." An example the FCA gives in this category is a fund that invests in socially positive real estate assets.

Firms that meet the criteria for their investment products and seek to use the label must publish on their website details of the sustainability labels that have been applied to relevant products and details as to where the consumer-facing disclosure pertaining to such products can be accessed.

Firms must review their use of sustainable investment labels at least annually, as well as prior to any proposed changes to a labelled product and revise the use of a label as appropriate.

Sustainability mixed goals, where the sustainability product's sustainability objective is to invest in accordance with two or more of the sustainability objectives. The manager will need to identify the proportion of assets invested in accordance with the different sustainability objectives, which appears to be an upfront obligation.

Disclosures and Reporting Required

Asset managers must prepare set forms of disclosures and reports, either where they use a sustainability label or where they use one or more ESG terms in the product's name or in marketing materials, where the product or marketing materials are provided to retail clients.

The upfront disclosures comprise:

- a consumer-facing disclosure for retail clients. This is a standalone document (similar to the PRIIPs KID) that provides a summary of the key elements of the product's sustainable investment strategy.

- a pre-contractual disclosure which provides information on the product's investment policy, investible universe (its scope of investments) and target-asset composition, with specific information required to support the sustainability label. The FCA includes a list of information to include but not a specified template, which the industry might develop separately.

Ongoing product reports will contain ongoing sustainability-related performance information.

The reports build on the existing requirement for a public product-level sustainability report under the Taskforce for Climate related Financial Disclosures (TCFD) as currently required by the FCA's ESG sourcebook, with similar guidance by the FCA on how firms should approach data gaps in those reports. "Part A" of the product report contains the pre-contractual information summarised above and applies where the product does not have a fund prospectus or other pre-contractual disclosure requirements.

"Part B" of the sustainability product report will only be required for FCA-authorised funds or UK AIFs that are listed on a recognised investment exchange. This provides information on the firm's progress in meeting the product's sustainability objective and

details of metrics that a client or consumer might find useful. The FCA does not include a baseline of required sustainability-related metrics in the sustainability product report.

In parallel to the "on-demand reporting" provisions of the FCA's TCFD rules, UK AIFMs of unauthorised AIFs which opt to use a sustainability label for these products will provide the report on demand to investors on an annual basis where the investor needs the information to satisfy its own sustainability disclosure obligations.

Entity-level disclosures

Building on the FCA's requirement for firms to produce a TCFD entity report, all fund managers with assets under management ("AUM") of £5 billion or more will be required to produce a sustainability entity report in relation to their fund management business. The entity-level report covers the firm's approach to governance of sustainability risks and opportunities, how the firm manages sustainability-related risks and the sustainability related metrics and targets adopted by the firm overall. This requirement will be phased in, with asset managers with AUM of more than £50 billion making their first entity-level disclosures provisionally by 2 December 2025 and firms with more than £5 billion AUM making their first disclosures by 2 December 2026. Note that firms with AUM of less than £5 billion, which are currently exempt from the FCA's climate-related disclosures, will not be exempt from the new consumer-facing and product-level disclosure requirements.

Relation to EU SFDR

The FCA previously provided in its consultation a chart of how its proposed sustainability labels map to EU SFDR requirements, indicating that funds under Article 8 or 9 of SFDR were capable of qualifying for an FCA label so long as they met the specific criteria. In that regard, the FCA has provided a table of the relevant points of disclosure under SFDR that firms may use to meet the FCA's requirements, although it is clear that many Article 8 funds under SFDR would not meet the FCA's criteria. The FCA has also provided a table of how its labels closely correlate to the European Commission's "product categories" in its consultation on the review of SFDR. The FCA also comments, in regard to the EU's review of SFDR, that "we stand ready to work with the EU authorities on this important issue". An open question for the future is whether the FCA will recognise any overseas regime, including the SFDR in amended form, as equivalent to the UK regime.

Closing Observations

Arguably, the labels are not mutually exclusive, although this is likely be the case with any ESG labelling regime. For instance, funds that promote decarbonisation by portfolio

companies could either qualify as investing in assets that are environmentally sustainable (Sustainability Focus) or in assets that have the potential to improve environmental sustainability over time (Sustainability Improver), although the FCA gives guidance on how a "Climate Solutions" objective may fit under the different labels. Similarly, a strategy which invests in transition-type investments ("brown to green") could fall within the Sustainability Improver or Sustainability Impact categories.

The FCA acknowledges that stakeholders requested closed-ended AIFs that are now closed for admission to be out of scope. The FCA has not excluded such funds from scope other than funds which made no additional investments after 22 July 2013, which are out of scope of AIFMD. As the FCA does not otherwise specify separate treatment for closed-ended AIFs that are no longer marketing, it is unclear whether such funds will be brought into the FCA's sustainability reporting regime.

The FCA does not include investment advisers in scope of its rules. Hence, there is no direct impact on private fund sponsors established in the UK as "adviser-arrangers".

The FCA confirms that listed investment trusts are in scope of the naming and marketing rules to the extent that the product is listed and marketing sustainability characteristics to prospective retail clients.

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Please do not hesitate to contact us with any questions.

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