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OUR TOP 10 FAQs FROM THE FCA'S DRAFT ESG DISCLOSURE ROLES FOR UK RETAIL FUNDS

AUTHORISED CORPORATE DIRECTORS AND FUND MANAGERS WILL BE FAMILIAR WITH INDUSTRY AND REGULATORY GUIDANCE ON SUSTAINABLE FINANCE AND ESG ISSUED OVER THE LAST FEW YEARS – WHAT DOES THE FCA'S LATEST CONSULTATION MEAN FOR THE SECTOR?

Retail fund managers in the UK may be able to utilise a forthcoming sustainability label opt-in regime for in-scope UK investment funds in light of a recent [consultation paper](#) (the **CP**) published by the FCA.

Fund managers will no doubt be familiar with the EU's [Sustainable Finance Disclosure Regulation \(SDFR\)](#) and [Taxonomy Regulation](#), as well as the latest U.S. Securities and Exchange Commission (**SEC**) [proposals](#) for requirements relating to sustainable investment funds. The FCA's Sustainability Disclosure Requirements (the **SDR**) represents the UK's version of these regimes, albeit with a different approach and set of requirements which aim to build trust and integrity in ESG-labelled instruments, products and the supporting ecosystem.¹

The FCA plans cover two areas:

1. the introduction of defined sustainable investment labels: and
2. associated disclosure requirements.

This will be an opt-in regime with specific disclosure requirements applying at fund and firm level where a fund manager opts in regarding a fund it manages. For firms and funds not opted in, naming and marketing restrictions will still apply to in-scope funds. The FCA is also set to bring in a general anti-greenwashing rule for all FCA-regulated firms.

Here we cover our top 10 frequently asked questions on the latest proposals:

Q1 - What proposed labels are available for in-scope funds?

Labels can be used for authorised funds and unauthorised AIFs marketed to both retail investors and institutional investors, where the relevant product satisfies the relevant qualifying criteria (which is specific to each category of label). If not, firms marketing investment funds to retail investors must meet the naming and marketing rules. Firms providing portfolio management services can only use a label if 90% or more of the value of all constituent investment funds in which they invest qualify for the same label.

The CP proposes an opt-in (i.e. non-mandatory) labelling regime offering three categories for in-scope investment funds which meet certain qualifying criteria:

1. **"Sustainable focus"** (for funds investing in assets that are environmentally or socially sustainable);
2. **"Sustainable improvers"** (for funds investing in assets to improve the environmental or social sustainability over time); and
3. **"Sustainable impact"** (for funds investing in solutions to environmental or social problems to achieve positive, measurable real-world impact).

¹ The UK Government's ambition for Sustainability Disclosure Requirements and labels is set out in the [Roadmap to Sustainable Investing](#) published in October 2021 and the commitment made in the FCA's November 2021 [ESG Strategy](#) and [2022/23 Business Plan](#).



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Fund managers should be aware that where one of the above labels is used, the firm will remain responsible for the classification and ensuring that the chosen label is appropriate; the FCA makes it clear that any use of a label should in no way indicate FCA approval of the relevant fund.

Q2 - I am a UK authorised corporate director (ACD) or authorised fund manager – how might the proposed rules apply to me?

The proposals will be of immediate relevance to alternative investment fund managers (**AIFMs**), UCITS management companies (**UCITs ManCos**), portfolio managers and investment platforms.

A UK retail fund manager will typically be categorised as a UK UCITS ManCo or UK AIFM (either a full-scope UK AIFM or a small-authorised UK AIFM). The rules on labelling and related disclosures will apply to these firms, if they choose to opt-in. Where a firm does not opt-in there are still some mandatory requirements in certain situations.

Furthermore, the anti-greenwashing rule will apply to all UK authorised firms.

Q3 - I am a non-UK retail fund manager and market my non-UK retail funds in the UK – do the proposed rules apply to me?

The SDR proposals do not consider overseas funds, such as those domiciled in Ireland or Luxembourg, as in-scope, including where such funds are marketed into the UK. The FCA intends to follow up on the CP with a separate consultation as to how the proposals may apply in respect of overseas funds in due course – in the meantime, we would recommend non-UK fund managers continue to keep both the proposed SDR regime and FCA's wider ESG Strategy under close review.

Q4 - What does an in-scope firm need to do if it wishes to use one of the new labels?

The allocation of sufficient legal and compliance resource to implement and monitor the use of any label will be vital. The CP sets out a series of qualifying criteria which require firms to ensure that they are able to substantiate the claims they are making in relation to in-scope funds. Firms seeking to utilise the new labelling regime will need to review items including their fund documentation to ensure compliance with both the detailed cross-cutting and category-specific rules, as well as the new pre-contractual disclosure documentation required for retail and institutional clients, should the new rules and accompanying non-Handbook guidance be introduced in the UK during the course of 2024.

The SDR requires in-scope funds using a label to express environmental and/or social sustainability objectives to have investment objectives and policies aligned with a sustainability objective, use KPIs to measure ongoing performance, and implement an active investor stewardship strategy and appropriate resource allocation. It is worth noting that the labels are designed to be mutually exclusive and retail fund managers will need to decide which label to apply to in-scope funds.

Fund managers should note that in terms of the proposed pre-contractual disclosure requirements, even if a proposed SDR label is not used, where sustainability-related features are integral to the investment policy and strategy (excluding firms providing portfolio management services), such funds may still be in-scope of the proposed rules.

Q5 - What are the requirements relating to the new consumer disclosure document for in-scope funds?

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In-scope funds will be required to produce a consumer-facing disclosure document that is drafted in plain English and includes the following information on the fund's:

1. SDR label and relevant description, where relevant;
2. Sustainability goal;
3. Sustainability approach;
4. Any unexpected investments included in the fund; and
5. Performance against its objective.

At this time, there is no template provided as part of the SDR for the consumer disclosure document, which will sit separately as a standalone document to existing regulatory requirements such as the KID.

The FCA has indicated that such disclosures will also need to comply with requirements under the new Consumer Duty (particularly with respect to the "consumer understanding outcome"). Much like its ongoing work on the Consumer Duty, the FCA has grounded its CP approach in behavioural insights and market research on consumer feedback and understanding.

Q6 - How do the requirements apply to multi-asset or fund of fund structures?

There are interesting points to note around how the labels will apply to both multi-asset retail funds and fund of funds structures, where underlying investments in such products include funds using different SDR labels. Naming and marketing restrictions will not apply to retail funds within this category; however, to use a label, they would need to invest 90% of the value of products qualifying for the same label. Again, the labels are currently designed to be mutually exclusive.

The CP also states that in relation to sustainability-related terms in the naming and marketing of portfolio management agreements or arrangements to retail investors, such as segregated mandates. In particular, firms will be able to use certain terms, provided that 90% or more of the total value of the products in which the relevant portfolio invests qualify for a sustainability label and that the terms are not used in a misleading way.

Q7 - Even if I choose not to opt-in to the regime, are there any mandatory requirements that might apply to me?

Yes, fund managers should be aware that even where a fund chooses not to use (or does not qualify for) one of the new labels, it may still have to produce certain SDR compliant disclosures where sustainability characteristics are a central part of the fund's investment policy or strategy.

In addition, fund managers marketing to retail investors will also have to consider the CP's naming and marketing restrictions regarding in-scope products that do not qualify for and use one of the proposed labels (e.g. prohibiting such products from using terms such as 'net zero', 'ESG' or 'sustainable'). The FCA has also highlighted the relevance of the forthcoming Consumer Duty across its proposals – indeed, any fund manager looking to market an in-scope fund to retail investors will have to comply with an extensive range of regulatory requirements under both the SDR and Consumer Duty regimes.

Q8 - Does the consultation consider "greenwashing" beyond the proposed labelling regime?

The FCA is proposing general "anti-greenwashing rules", which would apply to all FCA authorised firms, within the ESG sourcebook of the FCA Handbook of Rules and Guidance. The FCA considers that its anti-greenwashing proposals "[clarify] existing rules" and as such, would come into force immediately upon the publication of the final Policy Statement around 30 June 2023 – the CP particularly highlights the following:

"A firm (whether it is undertaking sustainability in-scope business or not, including firms that approve financial promotions for unauthorised persons) must ensure that any reference to the sustainability characteristics of a product or service is:

(1) consistent with the sustainability profile of the product or service; and

(2) clear, fair and not misleading."

Q9 - How is the FCA proposing to monitor the implementation of the proposed rules?

Broadly speaking, the FCA has stated it will:

1. monitor the use of labels at a product level;
2. carry out periodic assessments;
3. take enforcement action where a firm has ignored disclosure requirements, made misleading disclosures, mis-used a label or breached the CP's naming and marketing rules; and
4. carry out a post-implementation review three years after the regime comes into force.

Q10 - How do the FCA's proposals sit alongside other sustainability regimes?

The CP builds on existing frameworks such as the Taskforce on Climate-related Financial Disclosures (TCFD) and is designed to be flexible in light of the UK's forthcoming "green taxonomy" and incorporate developments in other global standards' regimes (e.g. further work by the International Sustainability Standards Board (ISSB)). The development of relevant standards will of course be crucial to develop high quality reference points around the concept of a "credible standard" of "environmental and/or social sustainability" that "Sustainable Focus" labelled funds will be able to benchmark their investment objectives and policies against. At this stage, the CP contains details around the attributes of such a standard, rather than designating a limited range of reference points.

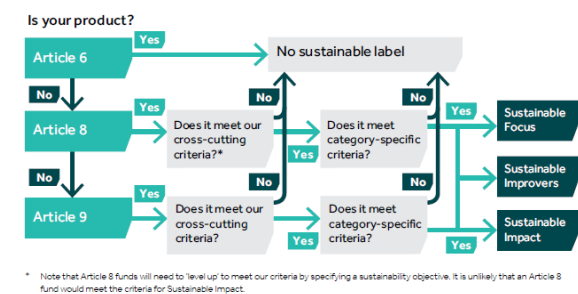
The FCA has considered the CP regime's international coherence with both SEC proposals and SFDR, and has indicated how funds classified under those regimes may map onto the FCA proposals. Retail fund managers in the UK will no doubt be familiar with the SFDR, which also creates three categories of funds:

- **Article 6:** funds that do not integrate sustainability into the investment process;
- **Article 8:** funds that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices ("light green" funds); and
- **Article 9:** funds that have sustainable investment as their objective ("dark green" funds).

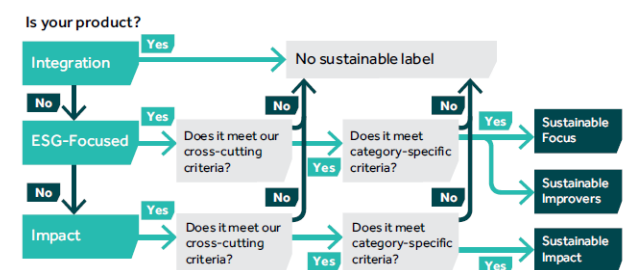
Fund managers should take note that the FCA (i) does not consider that ESG integration to be "a sustainable investment strategy" in its own right; and (ii) has not incorporated the "Do No Significant Harm" (DNSH) or "Principal Adverse Impact" (PAI) concepts located within the SFDR. The most analogous part of the regime to DNSH is the concept of "unexpected investments" in terms of the disclosure requirements within the CP.

Whilst the FCA has sought to avoid inconsistencies with the SEC and SFDR regimes, the three regimes do not map directly across. The FCA has, however, provided the following helpful flowcharts, which firms can refer to in order to assist them in mapping existing funds which are in-scope of SFDR (i.e., Article 6, 8 and 9 funds) and the SEC's three ESG fund categories (i.e., integration funds, ESG-focused funds and impact funds):

SFDR



SEC proposals



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What's next?

The deadline for comments on the CP is 25 January 2023. The FCA will then aim to review feedback and set out the final rules in a Policy Statement by end of H2 2023, with a phased approach to the introduction of the proposals starting from the middle of 2023 – 2026.

We will be working with clients and industry bodies throughout the proposals in more detail and provide further commentary in the coming weeks.

If you have any queries, please contact any of our retail funds and sustainable finance experts or your usual AG contact.

KEY CONTACTS



LORNA FINLAYSON

Partner, Financial Regulation
Edinburgh

+44 (0) 131 222 9579

+44 (0) 7980 303 483

lorna.finlayson@addleshawgoddard.com



RICHARD SMALL

Partner, Financial Regulation
London

+44 (0) 207 160 3004

+44 (0) 7889 231 898

richard.small@addleshawgoddard.com



LAURA LIGHTBODY

Legal Director, Financial Regulation
Edinburgh

+44 (0)131 222 9513

+44 (0)7789 484 544

laura.lightbody@addleshawgoddard.com



CHRISTOPHER WALKER

Associate, Financial Regulation
Manchester

+44 (0)161 934 6364

+44 (0)7388 955 604

christopher.walker@addleshawgoddard.com

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