The FCA's Sustainability Disclosure Regime: A Practical Implementation Guide

D. Complying with the Operational Aspects of the SDR: KPIs, Verification, Stewardship and Escalation Planning

This is the fourth briefing in a series of alerts focused on the Sustainability Disclosure Requirements (SDR) regime. In this alert, we focus on compliance with the operational aspects of the SDR, covering key performance indicators, verification, stewardship and escalation planning.

1. Setting KPIs

Under the SDR, the general qualifying criteria require SDR-labelled funds to have key performance indicators (**KPIs**) which measure progress made by the product or individual underlying investments towards achieving its sustainability objective. The FCA notes in its Policy Statement that KPIs should "deliver a fair representation of the product's progress towards the [sustainability] objective and enable consumers to understand that progress, including through the use of contextual and historical information".

Firms should determine KPIs by reference to the specific sustainability objective for each product:

- Sustainability Focus: KPIs should measure the sustainability of underlying investments.
- Sustainability Improvers: KPIs should measure sustainability improvements in the underlying portfolio.
- Sustainability Impact: KPIs should measure positive impact (both the impact of the fund's investments and investor's contribution).
- Sustainability Mixed Goals: KPIs should measure the sustainability and improvement of the underlying portfolio, and/or impact of both the fund's investments and investor contribution.

Our third briefing in this series covers the new labelling regime in more detail.

How does this stack up against the SFDR?

- Under the SFDR, in-scope firms are required to publish annual reports with a view to demonstrating progress over each annual reporting period. The SDR's KPI standards go a step further by requiring managers to set specific goals and targets in support of achieving the product's sustainability goals. These additional reporting requirements may well prove valuable for investors, since they will impose a further layer of discipline on asset managers to ensure that underlying assets perform well over time against ESG metrics.
- Firms will, however, need to consider carefully what KPIs may be suitable for assets or portfolios that are already considered sustainable in nature, with more limited room to improve ESG performance.
- In addition, for Sustainability Impact and Sustainability Mixed Goals products that include impact investments, managers will need to measure the positive impact that a product's assets have made **as well** as the "**investor's contribution**" to that positive impact. Helpfully, the SDR permits managers to measure this in a qualitative rather than a quantitative manner where doing so is suited to the investment.

Dealing with data gaps

Whilst there is some flexibility in demonstrating how products and underlying assets are achieving their KPIs, firms must take reasonable steps to ensure that any data used to meet the labelling requirements is accurate and complete, including through the use of proxies and assumptions where appropriate. There is, however, scope to provide a clear report to investors on the circumstances in which data is unavailable or has not been verified. This allows somewhat more flexibility than the SFDR regime, which has a particularly strong emphasis on the use of assumptions and modelling to resolve data gaps.

The FCA also notes that firms may wish to go further and "choose to disclose data quality metrics to provide transparency on the proportion of the product for which data are verified, reported, estimated or unavailable".

2. Independent Verification

As noted in our third briefing firms must demonstrate that a "robust, evidence-based standard for sustainability" is in place for SDR-labelled products. A key aspect of demonstrating this standard's compliance with the SDR regime is to ensure that it has been independently verified either by a third party or by the firm itself (through an internal independent assessment). In each case, the person(s) making the assessment must be independent from the investment process, and the firm in question will need to demonstrate that they are "appropriately skilled". Firms will also need to disclose the reasoning behind why the sustainability standard is appropriate and "the function or third party (not naming individuals) that carried out the assessment".

Responses to the FCA's consultation on the SDR noted that independent third party verification could be costly and that there may need to be a lead-in time while third parties "developed capabilities" to make the assessment. In response, the FCA has noted that "firms may consider their existing internal processes or functions [such as those individuals involved in product governance] to be appropriate for the assessment", provided the internal assessors fulfil the criteria set out above.

Firms seeking to launch an SDR-labelled product therefore need to determine upfront whether they:

(i) Go out to an external ESG consultancy to perform the required review; or

(ii) Are in a position to internalise the verification process. In practice this may mean:

- keeping one or more ESG analysts independent of the investment process;
- upskilling members of, say, the firm's risk function to perform this analysis; or
- relying on any independent NEDs or the firm's internal audit function,

assuming in each case that the individuals involved are qualified to apply the necessary level of scrutiny.

Firms will therefore need to think through the independent verification process, and factor in any internal or external costs and timing considerations, early on in the labelling process. The process may prove particularly resource intensive for smaller managers, and this should be factored into the cost of assigning an SDR label to a product.

Determining whether to rely on a third party verifier vs. internal verification

Third party verification

Incorporating a third party verification process will carry certain advantages. Firms may, for example, take the view that having a qualified third party approve their methodology will provide additional investor comfort and a lower risk of the FCA later asserting a conflict of interest or lack of independence in the verification process.

However, firms should also consider the issues involved in using third-party verification services, for example:

- the cost of outsourcing the verification process as against the cost of running the process internally;
- the fact that the third party will need to review the manager's investment strategy, which in many firms will regard as sensitive proprietary data; and
- the limited availability of such service providers in the market and the time required for those firms to develop the capabilities necessary to carry out the required assessment.

Internal verification

Firms wishing to internalise the verification will need to consider how to resource the verification process. It has been suggested that firms may rely on their internal audit function, independent NEDs or even adapt existing product governance procedures. As the SDR is fairly flexible with respect to how firms should structure their internal verification procedures, each of these solutions could in theory be utilised; however:

- not all managers will have access to an internal audit function or independent NEDs (for example, only larger asset managers would generally maintain an internal audit function). Smaller and mid-sized managers may therefore need to think creatively about who within the business is best placed to carry out the assessment – examples include individuals in risk and compliance teams;
- the FCA has made clear that those carrying out the assessment must be "**appropriately skilled**". Individuals involved in any of the functions referenced above will likely need to be "upskilled" with a view to applying effective scrutiny of the firm's ESG investment strategy and sustainability standards.

Another option would be for firms to allocate the responsibility for verification to one or more ESG specialists already operating within their organisation, although the requirement to keep these individuals independent from the investment process will need to be thought through. Even where a firm's ESG specialists do not sit on its investment committees, they may feed into day-to-day decisions regarding the profile of prospective investments where ESG is a key parameter in those investment decisions. In addition, such individuals may have been closely involved in setting an ESG scorecard or rating system against which investments are assessed; this, in itself, could be said to form part of the investment process.

3. Approach to Stewardship

Another aspect of the general qualifying criteria that apply to SDR-labelled products is the investor stewardship strategy associated with delivering the product's sustainability objective. Specifically, firms will be required to explain the expected activities and outcomes associated with their stewardship strategies. Although the FCA has noted that it does not expect firms to demonstrate a causal link between those activities and outcomes, firms must ensure that they dedicate appropriate resources to the execution of the strategy. Where firms who manage SDR-labelled products pursue longer-term stewardship strategies, they should explain that the intended outcomes for these strategies may take longer to achieve.

When considering SDR implementation, firms should take into account the interaction between the stewardship and KPI aspects of the regime. For example, the FCA notes that where stewardship plays a significant role in a product's investment policy and strategy, it may be appropriate to disclose KPIs related to the outcomes or progress achieved through stewardship.

Establishing a stewardship strategy

Establishing a stewardship strategy can be challenging and firms should dedicate sufficient resources to this aspect of the regime – key points to note are as follows:

- Traditional stewardship measures can be more challenging to apply in the context of non-equity investment strategies, given the inability to exercise control over such assets through voting arrangements. However, thought is increasingly being given through the Stewardship Code and other initiatives to how stewardship can be demonstrated in the context of fixed income and other strategies;
- The FCA's recent review on embedding its "Guiding Principles" for ESG and sustainable investment funds found that in a number of cases "**the design of** [managers'] **stewardship approaches generally did not meet** [the FCA's] **expectations**". In particular the FCA notes that it "**was often difficult to identify the nature of stewardship activities from fund literature alone and identify clear examples of progress from engagement**". It is therefore clear that firms should resource and document their stewardship approach appropriately. There are, in particular, a few constructive points that managers can take from the FCA's review:
  - firstly, managers should ensure that – to the best of their ability – they track, monitor and record the impact of their stewardship activities on the operations of investee companies. This should then feed into an analysis of how stewardship has furthered the ESG and sustainability objectives of the relevant fund or funds over time;
  - secondly, where stewardship activities are driven centrally, the manager should be able to articulate how such firm-wide stewardship activities relate to and advance the objectives of individual funds; and
  - lastly, engagement policies should comply with COBS 2.2B.6R and clarify how stewardship contributes to meeting the fund's ESG and sustainability goals.

4. Escalation Planning

A final significant component of constructing an SDR-labelled product is the concept of escalation planning. Specifically, firms are required to implement an escalation plan detailing actions to be taken in the event that investments fail to demonstrate sufficient performance against the fund's sustainability objective or KPIs. Firms will also need to include details on how long they anticipate such actions will take to resolve the issue.

The thorny issue of divestment

- The FCA's SDR Policy Statement is clear that managers must determine in advance:
  - what potential escalation measures may be taken; and
  - the timescale during which such actions should be taken.
- When considering the issue of escalation, an investment team's thoughts may naturally turn to whether and when divestment may ultimately be required with respect to non-performing assets.
- Indeed, in complying with the EU's SFDR regime, certain managers of Article 8 and 9 funds have found it tricky to navigate the question of whether to commit upfront to divesting assets that do not meet the fund's commitment to investing a percentage of its assets in "sustainable investments".
- The FCA's SDR guidance is somewhat more helpful in the sense that:
  - it allows for softer measures - such as interaction with the boards of investee companies or other stewardship measures - to be taken prior to actually exiting the investment.
  - it specifically indicates that the SDR does not necessarily require divestment from assets as part of the escalation plan. While this point was made in the context of the sustainable impact category, the same principle would arguably apply across all categories of SDR label (although this has not been expressly confirmed by the FCA).
- More generally, however, if an asset is no longer "performing" for sustainability purposes, the FCA notes that the manager will need to assess whether the relevant SDR label "remains appropriate" (assuming the fund remains invested in that particular asset).

5. Review of Firm Governance and Delegation Arrangements

The SDR requires firms managing an SDR-labelled product to have in place "appropriate resources, governance, and organisational arrangements" to support the delivery of the product's sustainability objective. The FCA highlights in particular the need to ensure that there is "adequate knowledge and understanding of the product's assets" and that firms should apply a high standard of diligence in the selection of data used to inform investment decisions (including third-party ESG data or ratings providers).

Given that the FCA's comments on governance reflect its previous Dear Chair letter on the Guiding Principles for the Design, Delivery and Disclosure of ESG and Sustainable Investment Funds, firms working towards launching an SDR-labelled product should ensure that they have effective internal governance mechanisms in place that meet the standards set by the Guiding Principles. For example:

- managers should operate a strong product governance structure with respect to their ESG and sustainable investment fund range;
- managers' governance procedures should ensure the identification, monitoring and reporting of ESG-related risks; and
- managers should monitor ongoing adherence to each fund's ESG investment objectives and policy, with exceptions reported to the relevant committee and overseen by the board.

You can read more about the FCA's Guiding Principles in our related client alert.

Ensuring compliance in a delegation context

Managers launching an SDR product or "rebranding" an existing product will also need to consider how ESG governance is addressed in a delegation context. The FCA notes, for example, that when entering into delegation arrangements with respect to SDR-labelled products, managers should ensure that:

- the delegate has resources, governance and organisational arrangements in place commensurate with the product achieving the product's sustainability objective;
- the delegate has adequate knowledge and understanding of the assets; and
- the delegate applies a high standard of due diligence in the selection of any data or other information used to inform investment decisions.

These points may, for example, need to be considered and documented in the context of investment management agreements with sub-managers.

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