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

C: SDR Labelling Regime

This is the third briefing in a series of alerts focused on the Sustainability Disclosure Requirements (SDR) regime. In this alert, we focus on practical aspects of compliance with the SDR labelling regime, namely: (a) deciding on an SDR label; (b) setting an SDR-labelled fund's investment objective; and (c) setting an SDR-labelled fund's investment strategy and approach to asset selection.

1. Deciding on a Label

Four new investment labels were introduced by the SDR with the aim of helping investors to navigate differing ESG-focused investment strategies and mitigating greenwashing risk.

The labels will be available for use by firms from 31 July 2024 in relation to "products seeking positive sustainability outcomes". More specifically, SDR-labelled products must pursue a "sustainability objective". The four labels are as follows:

- Sustainability Focus – investment in assets that are currently environmentally and/or socially sustainable.
- Sustainability Improvers – investment in assets that aim to improve their environmental and/or social sustainability over time (i.e., the assets may not currently be sustainable).
- Sustainability Impact – investment in assets with the aim of achieving a pre-defined positive and measurable environmental and/or social impact.
- Sustainability Mixed Goals[1] – investment in a combination of the above sustainability objectives.

The FCA has made clear that it has "not designed the labels as a hierarchy", but instead that each label "represent[s] different types of investment objectives and investment approaches". Notwithstanding this, it is clear that whilst certain labels are for funds investing in assets that are "improving" their sustainability credentials (sustainability improvers), other labels require assets to already be sustainable (sustainability focus) or to have a pre-defined positive and measurable environmental and/or social impact (sustainability impact).

[1] The SDR's "Sustainability Mixed Goals" label was introduced to accommodate products with blended investment strategies following the FCA's consultation on its proposals (which initially envisaged only three investment labels).

Practical issues to bear in mind:

When determining which SDR label is the right fit for a new product launch, or for an existing ESG-focused fund, firms will need to consider:

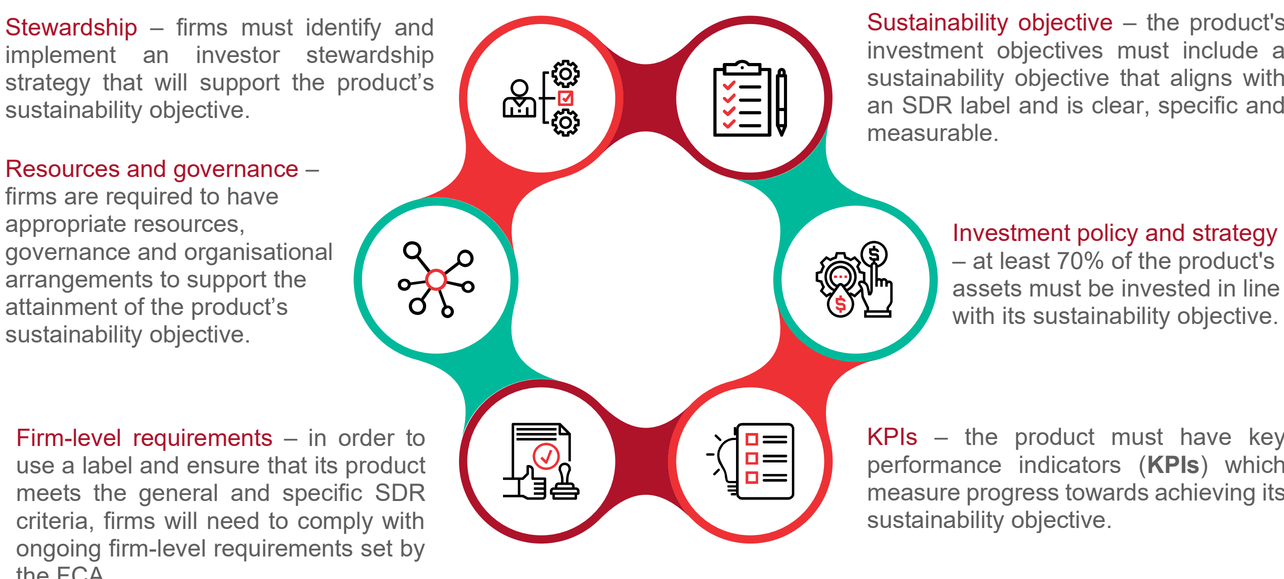
- the sustainability profile of assets to be held within the fund, and in particular whether the fund's assets:
  - (i) already qualify as sustainable;
  - (ii) are in the process of transitioning towards more sustainable business practices; or
  - (iii) focus on solutions to sustainability problems;
- whether the fund will have a single focus, or whether there is likely to be a mix of assets within the portfolio (for example, both transitional and non-transitional assets); and
- whether the fund is capable of meeting the required 70% threshold applying to the inclusion of such assets in the portfolio (see "**Setting the fund's investment strategy and approach to asset selection**" below).

Investment managers will be able to choose which of the four labels to use, provided the fund in question meets both the **general qualifying criteria** (applicable to all labels) and **specific qualifying criteria** (dependent upon the label) on an ongoing basis.

Firms will need to review their use of SDR labels at least annually. In addition, once a product has met its sustainability targets, firms will need to assess whether the current label remains accurate or whether the product would be better categorised under a different label. If a label is found to no longer be appropriate, the firm will need to cease using it, and notify both clients and the FCA.

a. General qualifying criteria

The general qualifying criteria – which we explore in detail further down – are as follows:

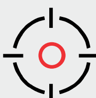


Within these general criteria are a number of more granular requirements – for example, firms are required to obtain an independent assessment of the standard for sustainability that is used to select the fund's underlying assets. This assessment may be conducted by a third party or by the firm itself provided that it is in all cases:

(i) independent from the investment process; and (ii) is carried out be appropriately skilled individuals. Our fourth briefing in this series discusses these related operational requirements in more detail.

b. Specific qualifying criteria

The key specific qualifying criteria for each label are as follows:



- Sustainability Focus – at least 70% of the product must be invested in assets that are environmentally and/or socially sustainable. This must be determined by reference to a "robust, evidence-based standard that is an absolute measure of sustainability".

- Sustainability Improvers – the product should have an aim of investing at least 70% in assets that have the potential to improve environmental and/or social sustainability over time, and that are determined by their potential to meet a robust, evidence-based standard of sustainability. Note that:
    - Firms will be required to identify the time period in which a sustainable improver product and/or its assets are expected to meet this standard, and incorporate short and medium-term targets for improvement, supported by the firm's investor stewardship strategy.
    - Firms using this label will also need to set "short and medium-term targets for improvements", which should align with the product's investment horizon. We would expect the length of the time horizon attached to "short and medium-term targets" to vary depending on the envisaged holding period.

  This category may be less suitable for investments with a shorter holding period, given the emphasis on assets demonstrating an improvement in their ESG credentials over a period of time.

- Sustainability Impact – the sustainability impact label is for products with a sustainability objective consistent with an aim to achieve a "pre-defined positive and measurable impact relating to an environmental and/or social outcome". As with other labels, the manager of a Sustainability Impact fund must invest at least 70% of the fund's assets in accordance with that aim. In addition:
    - Firms are required to specify a theory of change setting out how they expect their investment activities and the product's assets to contribute to positive impact.
    - Firms must also "specify a robust method for measuring and demonstrating" this impact (whether qualitative or quantitative), and will be required to measure and report on their investor contribution.

- Sustainability Mixed Goals – at least 70% of the product's investments must be made in line with a combination of the sustainability objectives set out above. The specific criteria for all relevant labels would need to be met by products using the Sustainability Mixed Goals label.
    - For example, where a fund invests in a mix of assets that are: (i) currently environmentally sustainable; and (ii) improving their environmental sustainability over time, then that fund may be labelled as "Sustainability Mixed Goals" provided that it complies with the specific qualifying criteria for sustainability focus and sustainability improvers (as well as the wider qualifying criteria as set out above).

  Firms are required to identify and disclose the proportions of each sustainability objective making up this combination.

How does this stack up against the SFDR?

The SFDR does not currently envisage a specific "transitional" category, or indeed a "mixed" category; for that reason, Article 8 of the SFDR has historically functioned as a "catch-all" category for transitional and non-transitional strategies.

The fact that the SDR offers both a transitional and mixed category is a strength of the new UK framework, both because it introduces a greater level of clarity for investors and also because it reinforces the importance of transition finance in achieving net zero.

2. Setting the Fund's Investment Objective

An SDR-labelled fund's investment objectives must include an explicit sustainability objective. This objective will be to "improve or pursue positive environmental and/or social outcomes", must align with a label and must be clear, specific and measurable. A product may have multiple objectives, provided they are all clear and specific – the FCA explains that the objectives should "build a clear picture of what the product is aiming to achieve".

When considering labels for existing funds, managers will therefore need to revisit the fund’s current investment objectives to ensure that they align with the requirements of the new regime. In this context, the FCA has noted that setting a fund’s sustainability objective by sole reference to the Sustainable Development Goals (**SDGs**) would not be sufficient, given the broadness of the SDGs. The FCA has, however, confirmed that the Sustainability Accounting Standards Board standards may be used "to help determine the topics a retail client would associate with environmental and/or social outcomes".

To the extent that the manager considers that the pursuit of the sustainability objective is likely to have a material impact on financial returns, this will need to be disclosed.

3. Setting the Fund's Investment Strategy and Approach to Asset Selection

Managers structuring SDR-labelled products will need to assess their investment strategies carefully against the standards set by the FCA.

As a threshold matter, the FCA has noted that labels are only applicable to products with strategies which aim to "achieve positive sustainability outcomes", and are not suitable for "products using strategies such as ESG integration or basic ESG tilts alone". This approach is somewhat similar to the SFDR, where EU regulators have made clear that the incorporation of passive screens into an investment strategy would not, in isolation, be sufficient to draw a fund within scope of Article 8.

a. Minimum 70% investment threshold

An SDR-labelled product must invest at least 70% of its assets in accordance with the sustainability objective. The FCA has noted the following key points in this regard:

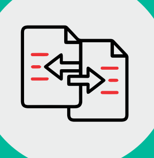
(i) "[the] assets must be selected with reference to a robust, evidence-based standard that is an absolute measure of environmental and/or social sustainability as applicable for each of the labels"; and

(ii) "any other assets must not conflict with the sustainability objective". We explore what qualifies as a "robust, evidence-based standard" below.

In general, the FCA's expectation is that managers can only make minimal deviations from the 70% investment threshold, other than where the fund is in its "ramp up" phase, or where the manager is taking action to bring the fund's assets back in line with its sustainability objectives, for example by putting an escalation plan into effect.

How does the 70% threshold apply in the case of Sustainability Improvers?

Concerns were raised in response to the FCA's original consultation around how the 70% threshold should be applied in the case of the Sustainable Improver category, given that transitional assets may not, at the outset of an investment, conform to typical sustainability criteria. The FCA's view is that "[f]or Sustainability Improvers, products invest in assets that demonstrate their potential, over time, to meet the standard". This indicates that firms managing a Sustainability Improver fund will need to set a sustainability standard up-front, and, rather than assessing whether potential investments meet that standard on "day one", firms will need to assess whether they have the potential to meet it over time (assuming that they transition appropriately).



How does this stack up against the SFDR?

The SDR's 70% investment threshold falls somewhere between the approach taken under SFDR Articles 8 and 9.

For instance, Article 8 does not require managers to invest in any particular threshold of sustainable investments, although Article 8 products must disclose the percentage of assets within their portfolio that are classified as "sustainable investments".

Article 9 of the SFDR, on the other hand, arguably sets a higher bar than the UK SDR. For example, all assets within an Article 9 fund are required to be classified as "sustainable investments" within the meaning of the SFDR, other than those held for liquidity and hedging purposes. This higher bar is reflected in market practice, with a smaller percentage of EU fund launches being classified as Article 9 than Article 8.

Unlike the approach taken under the SDR, this does in some respects create a "hierarchy" between Articles 8 and 9 in terms of the rigour required to be applied to ESG investment strategy. The FCA has expressly set out to avoid this outcome.

b. Permitted deviations from the threshold

The FCA expects that managers will make only "*minimal deviations*" from the SDR's 70% threshold. Firms managing SDR-labelled products will therefore need to consider the possibility that assets previously assessed as "sustainable" could subsequently devalue, thus causing the fund to fall below the 70% threshold (i.e. the "passive breach" issue). This may require managers to build in an investment buffer to reduce the likelihood of this outcome.

c. Investments held for hedging, liquidity and risk diversification

Funds may retain investments that do not specifically advance the sustainability objective, including assets being held for hedging, liquidity, or risk diversification purposes. This is subject to the condition, however, that these investments do not conflict with the product's sustainability objective and the fund continues to meet the 70% threshold.

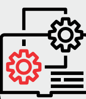
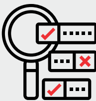
d. "Robust, evidence-based" standard

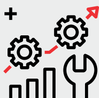
Assets invested in line with the fund's sustainability objective are required to be selected by reference to a robust, evidence-based standard. This standard is intended to be an "absolute measure of environmental and/or social sustainability" and is key to compliance with the SDR, since it prescribes which assets will qualify for inclusion within the 70% threshold.

The FCA's Policy Statement sets out several examples of standards that may qualify as "robust and evidence-based":

- general environmental and/or social criteria – the standard could set minimum thresholds focusing on investee companies' percentage of revenue or expenditure on operations, capital or research and development relevant to the sustainability objective;
- taxonomy-based standard – an authoritative taxonomy could be referenced in the standard;
- emissions profiles – the standard could, for example, set a minimum absolute threshold of greenhouse gas or carbon emissions intensity.

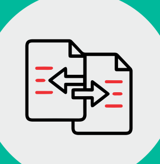
More generally, in order to qualify as robust and evidence-based, an investment methodology should exhibit the following criteria:

"Systematic"	
	▪ The methodology or approach should be applied in a systematic manner (i.e. in the same way across all investments). This can be based on or determined by an authoritative body (e.g. a government or regulator), industry practice (e.g. a third party data or analytics service provider), or a proprietary methodology (developed in-house by the firm).
"Evidence-based"	
	▪ There must be an objective and relevant data set underpinning the ESG analysis or methodology. This implies that firms should take steps to ensure that credible data sources are incorporated into their methodology, and attempt to limit data bias.

"Robust"	
	▪ The methodology must "stand up to scrutiny". Although the FCA has not explicitly referenced the source of this "scrutiny" , presumably the methodology should stand up to regulatory scrutiny and potentially also scrutiny by other ESG investment professionals. ▪ The requirement for independent verification outlined below should assist firms with demonstrating that they have met this standard.
"Absolute measure" of environmental and/or social sustainability	
	▪ There is limited guidance on the use of the term "absolute" for these purposes, although the FCA does confirm that it means absolute as opposed to "relative" in this context. ▪ In the absence of further regulatory guidance, this could be read as requiring the manager to impose a pass/fail threshold, in the sense that an asset either qualifies as sustainable or does not, by reference to a pre-set threshold test. Nonetheless, the FCA has not specifically excluded reliance on comparative "best in class" investment approaches (e.g. where investments are selected on the basis that investee companies perform better than others in their class on ESG metrics). ▪ With this in mind, the wording of the SDR could be taken to suggest that managers should not *solely* rely on comparative or relative measures of sustainability, but should also incorporate fixed minimum performance thresholds (e.g. on emissions) into their methodologies.

e. "Negative outcomes"

Firms managing SDR-labelled products will need to consider the implications of investing in assets that may have harmful or negative environmental and/or social outcomes, alongside more positive outcomes. In particular, firms will need to consider both the anti-greenwashing rule and the general rule that managers may not invest in assets that actively "conflict" with a product's sustainability objective. In addition, firms are required to consider and disclose whether pursuing the product's sustainability objective may result in material negative environmental and/or social outcomes.



SFDR "Do No Significant Harm" test *vs.* SDR "Material Negative Outcomes" test

One policy issue that regulators have had to grapple with in constructing ESG investment labels is the fact that an investment may have a positive impact on one area of sustainability (e.g. reduction in carbon emissions), whilst simultaneously having a damaging effect on some other area (e.g. biodiversity).

For example, the EU's SFDR excludes any asset that does "significant harm" to an environmental or social objective from the definition of a "sustainable investment". A well-publicised example of the difficulties inherent in applying this standard was the issue of whether nuclear energy – which could in theory play a key role in decarbonisation – could present a risk of significant harm to the environment more generally (e.g. given issues around the long-term management of high-level radioactive waste and spent nuclear fuel).

The UK's SDR regime similarly requires firms to take into account any "**material negative environmental and/or social outcomes [that] may arise in pursuing the sustainability objective**". This is somewhat similar to the SFDR's "**Do No Significant Harm**" standard, although with certain key differences:

(i) a "material" harm (or negative outcome) could potentially be read as setting a lower bar than "significant" harm;

(ii) whilst in-scope firms have a degree of discretion over the point at which harm is deemed to be "significant" under the EU SFDR regime, the concept of "significant harm" is interpreted more generally by reference to a detailed set of principal adverse indicators or "PAIs". There is more limited detail on the concept of a "material negative outcome" under the UK rules, and greater discretion therefore appears to be left to the manager in interpreting the UK standard; and

(iii) the fact that an investment has a material negative outcome on an environmental or social factor will not necessarily alter the status and classification of that investment for the purposes of the SDR (rather, the SDR sets a disclosure standard, in the sense that managers are required to assess and disclose any material harms). By contrast, under the SFDR an asset will be excluded from classification as a "sustainable investment" where it causes some significant harm; for example, this could preclude a fund from achieving an Article 9 SFDR classification or cause an Article 8 fund to fall below its projected threshold of sustainable investments.

Despite these differences in approach, the FCA does note that:

- managers may not invest in assets that actively "conflict" with a product's sustainability objective; and
- where firms are subject to the Consumer Duty, they should consider their Consumer Duty obligation to act in good faith. Specifically, firms should consider what a reasonable consumer would expect in a labelled product in determining whether to invest in assets that they have identified as potentially leading to negative outcomes.

Overall, therefore, the SDR regime appears to set an expectation that assets posing some material harm should be excluded where this may otherwise mislead an investor into investing in a product.

f. Derivatives and short selling

The SDR permits the use of derivatives and short selling strategies, although the FCA notes that firms should be transparent as to how these strategies are used, explaining how they support the attainment of the product's sustainability objectives for example. The FCA also notes that it is "not being prescriptive around how exposures should be calculated for the purposes of meeting any thresholds" and firms should therefore "apply the rules based on the profile of their investment strategy and in the way that best reflects the economic and strategic reality of their exposures".

Securities lending strategies are also permitted; however, the FCA comments that any impacts on voting or broader stewardship activities as a result of securities lending should be explained.

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