FRESHFIELDS

How to meet the UK sustainable investment labelling disclosure requirements: The FCA provides much needed guidance to applicants

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In a move likely to be welcomed by the market, the FCA has updated its ***webpage*** *on the Sustainability Disclosure and Labelling Regime to provide examples of how applicants can meet pre-contractual disclosure requirements.*

A key aspect of the labelling regime applicable to UK funds (considered in further detail **here**) relates to specific criteria to be met by applicants wishing to apply the sustainable investment labels, which must be supported by pre-contractual disclosures. The FCA recognises that the Sustainability Disclosure Requirements (***SDR***) and investment labels regime is new, and without precedent, and that market practice is therefore naturally evolving. The FCA therefore aims to showcase how applicants can meet the disclosure requirements.

Smoothing the process for applicants

Whilst the FCA does not sign off on the use of labels, it does need to approve certain changes to pre-contractual disclosures as a result of a decision to apply a label. Funds have been able to use labels and accompanying disclosures from 31 July 2024, but the initial take up has been relatively slow and there has been some criticism of the FCA's approach to amendments as being unnecessarily prescriptive.

Certain managers have decided not to pursue sustainability labels and instead rename funds and remove sustainability-related terms (noting that naming and marketing rules will apply from 2 December 2024, subject to limited **temporary flexibility**). However, a number of managers will likely be considering the launch of new funds in due course that meet the labelling requirements. This may be easier than trying to reverse engineer existing products to fit within the regime. We understand that the FCA has indicated that there is a healthy pipeline of funds preparing to use the labels.

In a bid to smooth the process for applicants as they prepare their documentation, the **document** published by the FCA contains illustrative examples and approaches across a selection of labels based on the FCA's experience of applications to date.

The examples given relate to disclosures for 'Sustainability Focus' and 'Sustainability Improvers' labels. Although the 'Sustainability Impact' or 'Sustainability Mixed Goals' labels are not specifically addressed, the FCA's view is that much of the practice identified will be relevant across all investment labels.

Whilst this will be helpful for managers seeking to apply a label, we note that the examples are non-exhaustive, both in terms of the areas of disclosures covered and the content of those disclosures, and that actual disclosures will need to be tailored to the specific fund.

In addition to their relevance for labelled funds, the examples may be useful for managers of certain non-labelled products using sustainability-related terms that are subject to restrictions under the SDR (such as 'ESG', 'environment', 'green' etc.). In particular, illustrations of how managers determine the assets the product invests in may be relevant when considering pre-contractual disclosures for such products.

Good practice disclosures

The FCA document includes examples of 'good practice' disclosures addressing the following requirements:

- The product must have an explicit sustainability objective as part of its investment objectives that is clear, specific and measurable.
- The manager must include the link between the sustainability product's sustainability objective and a positive environmental and/or social outcome.
- Information must be included relating to how the manager determines the assets the product invests in (including criteria applied in determining sustainability characteristics), the standard the manager relies upon (including the basis on which that standard is considered appropriate) and details of the manager's policies and procedures to monitor the performance of the product in achieving its objective.
- At least 70% of the gross value of the product's assets must be invested in accordance with its sustainability objective (except where assets do not have attributes that conflict with that objective).
- The manager must identify the KPIs it will use to demonstrate the product's progress towards meeting its sustainability objective, and include details of the KPIs and other metrics a retail client may reasonably find useful in understanding the product's investment policy and strategy.

Where the 'Sustainability Improvers' label is used, the FCA has provided examples of how the following requirements specific to this label may be addressed:

- The timescale by which the product or assets in which the product invests is expected to meet the required robust, evidence-based standard.
- The short and medium-term targets for improvements in the sustainability of the product or assets in which the product invests.
- A summary of the types of evidence the manager has relied on to satisfy itself that the assets have the potential to meet the required standard.

Examples of poor practice

The FCA has provided a few examples of poor disclosure practices that do not meet the SDR requirements. These include disclosure of an asset selection process that does not link to the specified sustainability objective and aim of the product or that does not include an explanation and evidence as to why the scoring or threshold is appropriate for defining sustainability. Another example of poor practice would be a failure to disclose a manager override for asset selection where this exists.

For the 'Sustainability Improvers' label, a further illustration of poor practice would be the failure to disclose the types of evidence the manager relies on to satisfy itself that assets have the potential to meet the required robust, evidence-based standard. In addition, where such products do not disclose short- and medium-term targets, or where such targets are inconsistent with the long-term horizon over which the assets are expected to meet the sustainability standard, that would fall below the required standard.

Interoperability with international standards

The UK labelling regime is currently only applicable to UK funds, but the FCA intends to consult on extending the regime to overseas funds marketed into the UK. At that point, the examples referenced in the FCA's document would also become relevant for such funds.

The FCA has noted its commitment to implementing rules that are coherent with international frameworks. In particular, the FCA designed the UK regime to be compatible with the EU's Sustainable Finance Disclosure Requirements (***SFDR***) "to the extent possible" with the intention that firms can leverage existing SFDR compliance processes. Nevertheless, there are a number of important differences which may involve additional complexity for managers seeking to apply the same strategies across the UK and the EU. Whilst it may be easier to align Article 9 SFDR funds, which have sustainable investment as their objective, with the SDR labels, Article 8 funds would need to 'level up' to meet the SDR criteria (in particular, by specifying a sustainability objective).

In the EU, fund managers may also need to consider the interaction with new **ESMA guidelines** on fund names using ESG or sustainability-related terms. These will apply to new funds from 21 November 2024 and existing funds from 21 May 2025, subject to EU national competent authorities having confirmed that they intend to comply with the guidelines in their jurisdictions (noting that some are seeking clarifications relating to certain aspects of the guidelines). The objective of these guidelines is to protect investors from unsubstantiated or exaggerated sustainability claims in fund names and therefore prevent the more egregious forms of greenwashing. While the guidelines are not intended to provide an EU sustainability labelling framework for investment funds, the fund naming will impact and trigger controls around how the funds are invested (e.g. the percentage of investments used for certain objectives and investments in industries like controversial weapons, tobacco or fossil fuels).

Broader context and recent global enforcement

The FCA's guidance has come at a particularly interesting time, in the midst of a series of global enforcement actions in the context of sustainable funds. To date, the enforcement actions have been directed at funds which do not operate in the way that investors would necessarily expect given their descriptions and/or marketing, and the firms involved have been penalised under general prohibitions against misleading and deceptive conduct, rather than any specific law or regulation relating to sustainable finance.

The Australian Securities and Investments Commission (***ASIC***) has won two cases in the Federal Court of Australia this year against Vanguard and Active Super (which we have written about in more detail **here**). In the Vanguard case, ASIC alleged that limitations in the research and screening of investments within Vanguard's Ethically Conscious Global Aggregate Bond Index Fund led to investments in certain fossil fuel companies, which is not what investors would expect given the description of the fund as an "ethically conscious" investment opportunity. Similarly, Active Super's marketing of its investments, in which it had apparently eliminated investments which posed too great a risk to the environment, was found to be inconsistent with its actual holdings (both directly via managed funds and indirectly via ETFs).

Most recently, in late October 2024, the Securities and Exchange Commission (***SEC***) charged the investment adviser WisdomTree Asset Management Inc. with making misstatements and compliance failures in relation to three ESG-marketed exchange-traded funds. WisdomTree had represented in prospectuses that the funds would not invest in companies involved in certain products or activities, including fossil fuels and tobacco. However, the SEC found that WisdomTree had used data from third-party vendors that did not screen out all companies involved in fossil fuel and tobacco-related activities, and that it did not have any policies and procedures over the screening process to exclude such companies, requiring it to pay a civil penalty of $4 million.

All of these cases demonstrate the growing desire by regulators to ensure that the labelling and marketing of sustainable funds is consistent with their underlying investments and fair to investors. It remains to be seen whether regulators in Europe and the UK will, after having given more guidance to firms on the labelling, naming and composition of funds than their Australian and US counterparts, use their more specific regimes as a basis for enforcement in the near future.