Ayres · Punchard

Ayres Punchard Investment Management Limited Response to FCA CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels

Q1: Do you agree with the proposed scope of firms, products and distributors under our regime? If not, what alternative scope would you prefer, and why?

Yes.

Q2: Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?

Yes, and we agree wholeheartedly with the proposal to implement the anti-greenwashing rule immediately after the publication of the PS.

Firms already involved in sustainable investment are already well aware of the make-up of their funds and have a good idea as to where they will be placed in terms of the proposed labelling. The arguments and discussions that have been ongoing for the last 10 years mean that most reputable sustainable investment firms are already very close to being able to implement these measures. Providing a long timescale would indicate a lack of urgency that runs counter to the reality of the damage being done by the greenwashing and opacity that the regulation seeks to address.

Q3: Do you agree with the proposed cost-benefit analysis set out in Annex 2. If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage.

Yes.

Q4: Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why.

While we broadly agree with the characterisation of what constitutes a sustainable investment, we believe that there should be some explicit recognition of the fact that a sustainable investment should avoid negative social and environmental outcomes.

At the very least, there needs to be a stronger recognition of the value of identifying and understanding negative impacts in terms of the risk that corporate transgressions in these areas have for shareholder value and investor returns.

There has been a tendency for the industry to over-emphasise the positive impacts whilst ignoring the negative impacts. Positive impacts are easily marketable and can therefore be utilised to provide a sometimes misleading view. On the other hand, there is a disincentive to highlight negative impacts and a willingness to trade off serious negative impacts against positive impact.

This is an important point and has been discussed by the UN Global Compact in their White Paper 'The UN Global Compact Ten Principles and the Sustainable Development Goals: Connecting, Crucially.' In that paper, they write that 'there is emerging concern that unless business action in relation to the SDGs is underpinned with principles, companies will be "…quick to jump to promotional initiatives, skipping the essential starting point of reducing negative impacts on people associated with their own business activities and value chains".' We believe that these concerns have become a reality in the sustainable investment industry.

The UN Global Compact also state 'that neglecting the responsibilities attached to such social and environmental principles cannot be offset by any effort to promote these same principles – as an advocacy or public relations effort – or through philanthropic or related "do-good" programmes that while perhaps advancing some aspect of sustainable development do not respect basic due diligence and do-no-harm principles.' The notion of 'do-no-harm' is the essential starting point of social and environmental sustainability and we believe that they must be incorporated into the characterisation of what constitutes a sustainable investment.

The reduction of negative impacts is 'the essential starting point,' and the consideration of negative impacts is at least as important as the consideration of positive impacts.

We agree with the description of the channels by which positive sustainability outcomes may be pursued.

Q5: Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?

We broadly agree with the proposed approach, however we believe that there needs to be some form of accommodation for portfolio management services. Portfolio management services do not fit well into the proposed labelling regime. This could be remedied by the introduction of a fourth composite label for portfolio management services that exclusively invest in funds that meet the different labelling criteria.

A portfolio management service might include funds from across the three labels, for example it may include a mix of sustainable focus and sustainable impact products. Under the current proposals, such a portfolio management service would not qualify to use either label. A fourth label for portfolios could allow for more broad sustainability strategies whilst still communicating the proportion of products with each label held within the portfolio to consumers.

Additionally, further guidance for portfolio managers on how the labelling requirements apply to them, with examples, would be highly beneficial.

Q6: Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on:

a. **Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?**
b. **Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?**
c. **Sustainable Impact: whether ‘impact’ is the right term for this category or whether should we consider others such as ‘solutions’; and the extent to which financial additionality should be a key feature?**

We generally agree with the proposed distinguishing features, and likely product profiles and strategies, for each category.

However, we have a number of observations in respect of the detail:

- We are strongly of the opinion that the 70% threshold for the ‘sustainable focus’ label is too low. It would be far more appropriate to set this much higher, preferably at 100%. We specialise in researching and engaging with sustainable investment funds and we would reject funds that included such a significant proportion of unsustainable investee companies. We believe that every company selected for investment within a sustainable investment mandate should meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme.

- For the ‘sustainable improvers’ label, it seems that investor stewardship should indeed be a key feature. The distinction between the ‘sustainable improvers’ and ‘sustainable impact’ labels is sufficiently clear.

- For the ‘sustainable impact’ category, the term impact does seem to be the right term. The term ‘impact’ is understood by clients and we have spent years educating clients and advisers on the difference between sustainable, impact, and ethical investments. Changes to the nomenclature at this stage would be counterproductive.

- At 4.25, it is stated that approaches such as negative screening or exclusions ‘may ... qualify for a sustainable investment label if combined with other strategies.' While we agree with this as it applies to the specific approaches used, it is important to stress that proper consideration of negative sustainability outcomes more broadly are an essential element of ensuring sustainable outcomes (as noted above in our comments on Question 4) and should be considered alongside the positive sustainability outcomes.

- Products under both the ‘sustainable focus’ and ‘sustainable impact’ labels should have an objective to avoid negative sustainability outcomes. This is already articulated for the ‘sustainable impact’ label at 4.39, and 4.28 goes a little way in expressing a similar sentiment for the ‘sustainable focus’ label, however the requirement to avoid negative outcomes should be made more explicit in the labels’ objectives.

- The references to what ‘a reasonable investor would regard as being environmentally and/or socially sustainable’ seem to be an important safeguard against abuse with regard to greenwash and negative impacts; their inclusion is undoubtedly positive.

- There does seem to be some potential for over-reliance on KPIs and quantitative sustainability data, in spite of the fact that this data is often very qualitative. Sustainability data can be highly complex and therefore resistant to meaningful simplification through quantification. There is a risk that pushing firms too much in the direction of KPIs and quantitative data will cause them to focus only on those sustainability issues that are quantifiable and not those which are most relevant or substantive. The fact that most quantitative data comes from investee companies themselves is problematic too, as the metrics that companies self-report on are more likely those that they are excelling in (and not those in which they are laggards).

- Too much of a focus on KPIs and quantitative data may lead to firms increasingly using select datasets reported by investee companies that are easily quantifiable but only offer a limited picture of an investee company’s true sustainability impact (whether positive or negative). More qualitative sources from third parties that capture a wider range of sustainability factors and impacts are likely to be sidelined by such an approach.

- There is a danger that funds will favour sustainability impacts that are more easily quantifiable or measurable, rather than those that have a greater actual impact or salience to normative global sustainability goals or principles (and, vice versa, will ignore negative impacts that are difficult to quantify or measure in simple terms).

- As a solution to this potential issue, we believe that more qualitative information should be gathered and utilised, and firms should seek evidence from sources other than the company themselves. The emphasis on KPIs and quantitative data should be toned down and proper recognition should be accorded to the importance of qualitative data.

Q7: Do you agree with our proposal to only introduce labels for sustainable investment products (ie to not require a label for ‘non-sustainable’ investment products)? If not, what alternative do you suggest and why?

We believe that labelling should be introduced for all funds available to UK retail investors. Making the labelling regime mandatory across the whole investment industry would bring greater clarity for retail investors. Differences between funds would be immediately apparent and investors would be able to easily distinguish between the different categories including those funds that fail to meet any sustainability criteria.

Our proposed labels would be:
- Sustainable Focus (funds)
- Sustainable Improvers (funds)
- Sustainable Impact (funds)
- Sustainable Portfolio (managed portfolios)
- Unsustainable or Non-Sustainable (funds and portfolios)

Q8: Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider:
- **whether the criteria strike the right balance between principles and prescription**
- **the different components to the criteria (including the implementing guidance in Appendix 2)**
- **whether they sufficiently delineate the different label categories, and;**
- **whether terms such as 'assets' are understood in this context?**

We generally agree with the proposed qualifying criteria. It seems that, as a whole, they do strike the right balance between principles and prescription and sufficiently delineate the different label categories.

While the focus is understandably on positive sustainability outcomes, this should not be at the expense of considering negative sustainability outcomes (as outlined above in our comments on Question 4).

The reference to the Sustainability Accounting Standards Board standards should be accompanied by reference to other widely used frameworks such as the Ten Principles of the United Nations Global Compact (which act as a normative standard of sustainability) and the Sustainable Development Goals (which were adopted by all UN Member States as a shared blueprint and aspiration for sustainability).

We strongly agree with the inclusion of point 2 of principle 6 (ESG 3.2.3R(2)(f) in the draft handbook text), which helps to safeguard against abuse with regard to greenwash and negative impacts.

Our concerns on the potential over-reliance on KPIs and quantitative data outlined in our comments on Question 6 are also relevant here.

The proposed requirements to report clearly on stewardship and engagement activities are highly welcome and we see these as very important.

Q9: Do you agree with the category-specific criteria for:
- **The ‘Sustainable focus’ category, including the 70% threshold?**
- **The ‘Sustainable improvers’ category? Is the role of the firm in promoting positive change appropriately reflected in the criteria?**
- **The ‘Sustainable impact’ category, including expectations around the measurement of the product's environmental or social impact?**
- **Please consider whether there are any other important aspects that we should consider adding.**

We broadly agree with the category-specific criteria. However, as noted in our comments on Question 6, it would make more sense for the 70% threshold for the ‘sustainable focus’ label to be at 100%.

The proposed requirements for ‘sustainable improvers’ products to report clearly on stewardship and engagement activities are highly welcome and we see these as very important.

For the ‘sustainable focus’ and ‘sustainable impact’ labels, the criteria should include a requirement for the objective to avoid negative sustainability outcomes (that is to say, negative impacts).

We do not agree with the wording of the implementing guidance for the specific criteria for the ‘sustainable focus’ label, in which it is stated that the credible standard ‘should be articulated in terms of positive sustainability attributes, rather than negative attributes, and be absolute as opposed to relative.’ This wording implies a primacy for the consideration of positive outcomes over the consideration of negative outcomes, when the avoidance of negative impacts must be taken as the starting point for assessing sustainability. We have laid out our views and reasoning for this in our comments on Question 4. Advising firms against articulating the credible standard in terms of negative attributes is inconsistent with this and will lead to unintended negative consequences.

Additionally, the reference to ‘absolute as opposed to relative’ requires further expounding.

We strongly agree with the inclusion of the requirement for firms to ‘as far as reasonably practicable, avoid investment in assets that a reasonable client would consider to be in conflict with the credible standard of environmental and/or social sustainability’ in the implementing guidance for the specific criteria for the ‘sustainable focus’ label. This requirement should also be included in the implementing guidance for the specific criteria for the ‘sustainable impact’ label.

Q10: Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?

The approach to firm requirements around categorisation and displaying labels seems appropriate.

Q11: Do you agree with our proposed approach to disclosures, including the tiered structure and the division of information to be disclosed in the consumer-facing and detailed disclosures as set out in Figure 7?

Yes.

Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?

Yes.

Q13: Do you agree with our proposals for consumer-facing disclosures, including location, scope, content and frequency of disclosure and updates? If not, what alternatives do you suggest and why?

Yes.

We strongly agree with the inclusion of the 'unexpected investments' disclosures, which we see as being very important.

Q14: Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?

Yes.

Q15: Do you agree with our proposals for pre-contractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on the scope, format, location, content and frequency of disclosure and updates.

Whilst we broadly agree with the proposals for pre-contractual disclosures, we strongly disagree with the proposal contained in 5.53. Not mandating a 'Do No Significant Harm' approach, i.e. disclosures on how a sustainable investment does not significantly harm the sustainability objective, risks opening a floodgate for greenwashing. Please refer to our response to Question 4.

We particularly agree with the implementing guidance's requirements to disclose how firms 'will monitor, assess, manage or address and [sic] any negative social and environmental impacts that may arise in pursuit of the sustainability objective' and to disclose assets 'that a reasonable client might not expect … , including the circumstances in which such assets may be held and the purposes for which they would be held.'

Q16: Do you agree with our proposals for ongoing sustainability-related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.

Yes—in particular, we welcome the proposals for stewardship disclosures.

Q17: Do you agree with our proposals for an 'on demand' regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?

Yes.

Q18: Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.

Yes.

Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?

Yes.

Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?

Yes.

Q21: Do you agree with our proposed product naming rule and prohibited terms we have identified? If not, what alternative do you suggest and why?

Yes.

Q22: Do you agree with the proposed marketing rule? If not, what alternative do you suggest and why?

Yes.

Q23: Are there additional approaches to marketing not covered by our proposals that could lead to greenwashing if unaddressed?

We feel that there is a risk that by allowing firms to market and promote the positive aspects and impacts of their funds without properly highlighting the negative impacts, this could lead to greenwashing.

Whilst we acknowledge that there is scope in the proposals to require firms to disclose negative aspects of their investment funds, i.e. 'unexpected investments,' there is nonetheless a risk that firms could abuse the lack of direction in terms of the decision not to implement 'do-no-significant-harm' style disclosures, and potentially mislead investors (as they do now) over the negative impacts of their investments.

Q24: Do you agree with our proposals for distributors? If not, what alternatives do you suggest and why?

We broadly agree. However we have the following points to make:

- The use of offshore domiciled funds (mostly Republic of Ireland and Luxembourg) is widespread in sustainable and impactful portfolios. These funds have FCA recognition for distribution to UK retail clients and provide great thematic exposure in sustainable investment. We would like those manufacturers to be able to apply for labels for their funds being marketed in the UK retail market.

- We would also welcome clarification on how the use of offshore (overseas) funds will affect sustainable portfolio managers, particularly on the use of labels and whether overseas funds that meet the criteria for a label would be permitted to do so for the purposes of portfolio management services.

Q25: What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?

The proposed rules and guidance should apply the same to pension products (funds and, where required, sustainable pension wrappers themselves) as they do to the investment fund industry. That is to say, the rules being proposed for portfolios could be used for pension portfolios too. This would deal with the question of how best to deal with changes in the composition of products over time.

Q26: Do you consider the proposed naming and marketing rules set out in Chapter 6 to be appropriate for pension products (subject to a potentially lower threshold of constituent funds qualifying for a label). If not, why? What would be an appropriate threshold for the naming and marketing exemption to apply?

Yes, and we see no reason why the threshold would be lowered for pension products. We view the 90% threshold set for portfolio management arrangements as also being appropriate for pension products.

Q27: Are there challenges or practical considerations that we should take into account in developing a coherent regime for pension products, irrespective of whether they are offered by providers subject to our or DWP's requirements?

This is a potentially vast subject, encompassing the demand for sustainable investment products and strategies by occupational pension schemes. The proposed rules should cover

funds that are being marketed to these schemes. However, the discretionary mandates being used to manage the schemes themselves would need to be regulated in the same way.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie do you foresee any challenges or concerns in making consumer‑facing disclosures, pre‑contractual disclosures and building from the TCFD product and entity‑level reports?

We don't see any reason (subject to earlier points raised) why the disclosures outlined in Chapter 5 would not be appropriate for pension providers.

Q29: Do you agree that the approach under our TCFD‑aligned product‑level disclosure rules should not apply to products qualifying for a sustainable investment label and accompanying disclosures? Would it be appropriate to introduce this approach for disclosure of a baseline of sustainability‑related metrics for all products in time?

Yes and yes.

Q30: What other considerations or practical challenges should we take into account when expanding the labelling and disclosures regime to pension products?

There seems to be an assumption that it may be difficult to control risk using a sustainable investment approach:

> *8.10 'However, we recognise that this may not be appropriate for pension products. For example, default arrangements change over time to reflect the change in consumers' retirement journey and risk appetite.'*

We don't think this is still the case. It is possible to build lower risk sustainable investment strategies and over the last 5 years a number of investment managers have developed sustainable short duration fixed interest strategies, absolute return strategies, and sustainable value (equity) strategies that can be used to facilitate the type of lifestyle / risk reduction pre-annuity style pension arrangements that were not possible using sustainable investment funds in the past.

This means that the 90% rule and the proposed labelling rules could be utilised for pensions.

Q31: Would the proposals set out in Chapters 4‑7 of this CP be appropriate for other investment products marketed to retail investors such as IBIPs and ETPs. In your response, please include the type of product, challenges with the proposals, and suggest an alternative approach.

Yes.