

ESG in the UK: Sustainability Disclosure Requirements and Investment Labels

The FCA published its final policy statement, rules and guidance on the application of the UK's sustainability disclosure requirements and investment labelling regime ("**SDR**") to asset managers on 28 November 2023. With the FCA currently consulting on a proposed extension of the regime to portfolio managers, with the 'anti-greenwashing rule' now in full effect and with the labelling regime coming on-stream on 31 July 2024, we thought it a good time to take a look at what the SDR entails and consider if, and to what extent, private equity and venture capital fund managers ("**PE/VC Managers**") are and can expect to be impacted by the rules.

Introduction

The FCA published its final policy statement, rules and guidance on the SDR in consultation paper PS23/16 on 28 November 2023. The FCA's stated rationale for introducing the SDR is simple; namely, to ensure that financial products which are marketed to investors as sustainable do as they claim to do and that those responsible for managing and marketing those products are able to produce evidence to back up those claims. With these goals in mind, the FCA is in the process of introducing a range of measures which are designed to inform and protect investors and improve their trust in the UK market for sustainable investments.

Whilst the focus of the new regime is the protection of 'consumers' (i.e. retail investors), there are elements of the regime which apply to all FCA authorised firms (i.e. the 'anti-greenwashing rule') and certain disclosure obligations which have been designed with institutional (as well as retail) investors in mind.

In this article we take a look at the regime and ask what (if any) impact it has and will have on PE/VC Managers in the UK and overseas.

The UK regime at a glance

In summary, the SDR is comprised of four elements:

1. The introduction of an 'anti-greenwashing rule' applicable to all FCA authorised firms and intended to ensure that firms are fair,

clear and not misleading when making sustainability related claims.

2. Four optional sustainable investment labels which managers can apply to their investment products. The investment labels are designed to help investors distinguish between sustainable and non-sustainable investment products and between different sustainable investment products.
3. Product naming and marketing rules, which are intended to ensure that the use of sustainability-related terms in product names and marketing materials is accurate.
4. A range of disclosure obligations, designed to provide investors with pre-contractual and ongoing information about the sustainable investment objectives and activities of firms and their products.

For a discussion of which managers and products currently fall within the rules, please see 'Scope of the SDR' below.

The 'anti-greenwashing rule'

The 'anti-greenwashing rule' came into effect on 31 May 2024 and, as noted above, is applicable to all FCA authorised firms.

The rule is intended to ensure that all communications regarding a financial product or service which refer to the environmental or social (i.e. sustainable) characteristics of that product or service are fair, clear and not misleading. The FCA is taking a broad approach to which communications fall within the rule and has alluded to it applying to any and all statements,

assertions, strategies, targets, policies, information and images relating to an investment product or service.

The FCA published detailed guidance on the 'anti-greenwashing rule' on 23 April 2024 in publication FG24/3, clarifying its expectations in relation to any sustainability related claims – namely, that such claims must be (broadly speaking):

1. factually correct and capable of being substantiated;
2. clear and presented in a way that can be understood, with a focus on transparency;
3. complete (i.e. claims should not omit or conceal information which might influence decision-making); and
4. fair and meaningful in relation to any comparisons drawn to other products and services.

The investment labelling regime

Under the SDR managers can elect to apply one of four mutually exclusive sustainable investment labels to their products, subject to meeting the relevant qualifying criteria to do so.

The four labels are:

1. Sustainability Impact;
2. Sustainability Focus;
3. Sustainability Improver; and
4. Sustainability Mixed Goals.

Contrary to the European Commission's stated intention for the Sustainable Finance Disclosure Regulations ("SFDR"), the UK regime is very much intended to operate as a marketing label, designed to provide investors with a clear indication of a product's sustainability objectives and credentials during the marketing phase.

The FCA has stressed that no hierarchy exists between the labels, in contrast to the market's perception of product categorisation under

Articles 6, 8 and 9 of the SFDR, which investors generally consider to reflect an increasing order of "greenness".

Also, in contrast to the SFDR, the SDR contains no equivalent of the "do no significant harm" principle, a rule which if applied to the investment labelling regime would preclude the use of a label if, in pursuing its sustainable objective, a product caused a significant negative impact on another environmental or social factor. That being said, the FCA are introducing rules that require the identification and disclosure of any negative environmental and/or social effects which could arise as a result of a labelled product pursuing its sustainable objectives.

In order to utilise an investment label, a manager and its product must meet specified criteria and comply with ongoing disclosure obligations. The criteria fall into two broad categories: general criteria which are applicable to all products seeking to use an investment label, and label-specific criteria.

The general criteria are, in summary:

1. **Sustainability objective:** A product must have the improvement or pursuit of positive environmental and/or social outcomes as an investment objective.
2. **Investment policy and strategy:** As a general rule, at least 70% of a product's assets must be invested in line with its stated sustainability objective. This is to be measured by reference to a 'robust, evidence-based standard' which serves as a measure of the product's environmental and/or social sustainability. Any other assets held for other reasons (e.g. derivatives and cash) must be disclosed, together with the rationale for holding them.
3. **Independent assessment:** An independent assessment of any standards by which the sustainability of a product is measured must be undertaken. This may be undertaken by third parties or internally, provided that there is a clear segregation between the manager's investment and assessment processes.

4. **KPIs:** Firms will be required to define KPIs to measure a product's progress towards its stated sustainability goals on an asset-by-asset or 'whole fund' basis.
5. **Resources and governance:** Firms are required to ensure they have available appropriate resources, governance and organisational arrangements to support the delivery of a product's sustainability objective.
6. **Stewardship:** Firms are required to identify and disclose the stewardship strategy they will adopt in order to deliver a product's sustainability objectives, including activities they expect to undertake and anticipated outcomes. Escalation plans to address scenarios in which assets are not demonstrating sufficient progress towards the sustainability objective must be specified.

In addition to meeting the general criteria, products and firms must also satisfy the criteria specific to their chosen investment label. These are, in summary:

1. Sustainability Focus label
 - A product's sustainability objective must be consistent with an aim to invest in assets that are environmentally and/or socially sustainable, as determined by a robust, evidence-based standard.
 - At least 70% of a product's assets must meet the above standard, and other assets acquired/held must not be in conflict with its stated sustainability objective.
 - Investment according to investment themes is permitted, subject to satisfying the other qualifying criteria.
2. Sustainability Improvers label
 - A product's sustainability objective must be consistent with an aim to invest in assets that have the potential to improve environmental and/or social sustainability over time.

- The period of time by which a product and/or its assets are expected to meet the sustainability objective must be provided (including short and medium-term targets) and reported against.
- The firm's stewardship strategy is required to support the delivery of a product's sustainability objective and to accelerate improvements in sustainability over time.

3. Sustainability Impact label

- A product's sustainability objective must be consistent with an aim to achieve a pre-defined positive measurable impact in relation to an environmental and/or social outcome.
- Firms are required to specify how they expect their investment activities and a product's assets to achieve a positive impact.
- Firms are also required to specify a robust method for measuring and demonstrating the positive impact of both the assets a product invests in and the firms' investment activities.

4. Sustainability Mixed Goals label

- Products adopting the 'Sustainability Mixed Goals' label will be required to meet the criteria applicable to each of the other labels that a product is invested across.

The investment naming and marketing rules

To ensure that sustainability-related terms are used appropriately and accurately, the FCA is introducing a range of rules that regulate the use of such terms in product names and their marketing materials.

The general position is that a product will only be permitted to use certain sustainability-related terms in its name and marketing materials if:

1. the product uses a sustainable investment label (although 'impact' can only be used in a product name if the product adopts the 'Sustainability Impact' label); or
2. the product doesn't use a label but has sustainability characteristics, (a "**Non-labelled Product**"), provided that it uses sustainability terms in compliance with the new product naming and marketing rules (see below).

The product naming rules are intended to ensure that the names of Non-labelled Products accurately reflect the product's sustainability characteristics. It is worth noting however that the terms 'sustainable', 'sustainability' and 'impact' are prohibited. In addition, Non-labelled Products are required to produce the same types of disclosure as those products using a label (see below for more information on disclosures). In addition, Non-labelled Products must publish a statement confirming that the product does not have a label and why, whilst feeder funds must use terms which are consistent with those used by their underlying master funds.

The product marketing rules regulate the use of sustainability terms in the marketing materials of Non-labelled Products and require production of the same level of disclosures as are required by the naming rules (see above).

Disclosures

The new rules impose four layers of disclosure obligations in relation to products using a label or wishing to use sustainability-related terms without a label, namely:

1. **Consumer-facing disclosures**, designed to provide investors with clear and accessible information about a product's sustainability features.
2. **Product level disclosures**, which in turn are comprised of:
 - pre-contractual disclosures; and
 - ongoing/periodic disclosures.

3. **Entity-level disclosures**, relating to the manager's approach to managing sustainability-related risks and opportunities.
4. **Distributor disclosure obligations**, intended to ensure that those in the business of distributing products to investors ensure that the relevant disclosures are made available to investors.

A detailed look at the content of the disclosure requirements is beyond the scope of this note. However, as discussed below, the extent to which the various disclosure obligations will apply to any given PE/VC fund and/or manager will largely depend on AUM and the categories of investor marketed to.

Implementation Timeline

The SDR will be phased in over the next three years as follows:

1. The 'anti-greenwashing rule' came into effect for all FCA-authorized firms on 31 May 2024.
2. Asset managers can begin to use product labels from 31 July 2024. The FCA is currently considering extending the regime to portfolio managers on 2 December 2024.
3. For asset managers using product labels:
 - Consumer-facing disclosures, pre-contractual disclosures and the naming and marketing rules will apply from 31 July 2024, with disclosures to be published and the naming and marketing rules to be met at the same time the relevant label is first used.
 - Ongoing product-level disclosure requirements will apply from:
 - For public disclosures (required for listed AIFs), 31 July 2025, with disclosures to be published 12 months after the date the label is first used and annually thereafter; and

- For on-demand disclosures (required for unlisted AIFs), 2 December 2025.
4. For asset managers using sustainability-related terms without a label:
 - Consumer-facing disclosures, pre-contractual disclosures and the naming and marketing rules will apply from 2 December 2024; and
 - Ongoing product-level disclosures must be produced annually from the date falling 12 months after the terms are first used.
 5. Entity-level (i.e. manager level) disclosures will apply to firms with AUM greater than £50bn from 2 December 2025.
 6. The entity-level (i.e. manager) disclosure obligations will be extended to firms with AUM above £5bn from 2 December 2026.

Scope of the SDR

As mentioned earlier in this article, the 'anti-greenwashing rule' now applies to all FCA authorised firms. However, the applicability of the balance of the rules to PE/VC Managers will be driven in large part by managers themselves via their chosen investment and fund-marketing strategies and by the make-up of their target investor bases (rather than by the rules *per se*).

From a territorial perspective, overseas managers and funds established outside the UK are currently out of scope. The FCA is keen to ensure a level playing field, however, and together HM Treasury is looking at how the regime might be extended to overseas funds which are marketed into the UK. At present there is no timetable for extending the regime to cover overseas managers or overseas funds.

The SDR also do not currently extend to UK portfolio managers or to their products or services, although this is currently the subject of a FCA consultation (CP24/8) which is due to close on 14 June 2024. It is worth noting that the FCA's approach to SDR in the context of portfolio

managers mirrors the approach it has taken in relation to asset managers and their funds – i.e. the focus is primarily on protecting retail investors, with the SDR's naming and marketing rules not applying and its labelling regime (and by extension the associated disclosure regime) being an opt-in option rather than a mandatory requirement for managers with a professional investor client base (discussed in more detail in relation to funds below).

As of the time of publication, only UK asset managers and their UK investment products will be fully in-scope from 31 July 2024. This currently means managers of the following funds:

1. authorised funds (including funds of funds, feeder funds and master funds);
2. unauthorised UK AIFs listed on a recognised exchange (including investment trusts), but excluding Social Entrepreneurship Funds, Qualifying Venture Capital Funds and closed-ended funds that have not invested since 22 July 2013; and
3. unlisted unauthorised UK AIFs, but again excluding Social Entrepreneurship Funds, Qualifying Venture Capital Funds and closed-ended funds that have not invested since 22 July 2013.

With respect to UK based PE/VC Managers and their UK funds in particular, as noted above closed-ended AIFs are generally within scope, as are full-scope UK AIFMs and small authorised UK AIFMs. As such and as a general rule, the labelling regime, product-level disclosures, naming and marketing rules and entity level disclosures will apply to these managers and to their UK funds. However, on closer inspection it seems that the extent to which UK PE/VC Managers and their funds will be required to comply with the new rules may well be relatively limited and circumstantial.

Taking each of the rules in turn:

1. Labelling regime

The labelling regime is entirely optional, so it is for managers to determine whether to use a label

and, in doing so, to opt into the associated disclosure and naming/marketing rules. Whilst use of a label may appear compelling from a marketing perspective, particularly in light of ever-increasing investor appetite for sustainable investment products, we would query whether a label will carry much additional weight if a fund is already being marketed in the EU as an Article 8 or 9 fund under SFDR. For funds that are not within SFDR, it currently remains to be seen what (if any) weight investors will give to the UK's investment labels.

2. The naming and marketing rules

The naming and marketing rules (and associated disclosure statements and requirements) apply to funds using a label and to those funds not using a label but wishing to utilise certain sustainability-related terms in their names and/or marketing materials. Whilst these rules apply to UK AIFMs and closed-ended UK AIFs, a review of the FCA's guidance and of the relevant sections of the updated FCA Handbook reveals that these rules will not apply unless a fund is marketed to retail investors. Given that PE/VC funds are generally not available to retail investors, the application of the naming and marketing rules will only become relevant if a label is used (which, as noted above, is entirely optional).

3. Consumer-facing disclosures

Unless marketed to retail investors, consumer-facing disclosures will not be relevant to PE/VC funds.

4. Pre-contractual and ongoing product level disclosures

As per the naming and marketing rules, the pre-contractual and ongoing product level disclosure requirements apply to funds using a label and to those funds not using a label but wishing to utilise certain sustainability-related terms in their names and/or marketing materials. However, for funds in the latter category, the rules will only apply if marketing to retail investors, so the majority of PE/VC funds will fall outside the scope of these disclosure requirements unless they opt to use an investment label.

5. Entity level disclosures

As noted above, in-scope managers will only be required to comply with the entity (i.e. manager) level disclosure requirements if the manager's AUM exceeds specified thresholds, namely:

- £50 billion (applicable from 2 December 2025); and
- £5 billion (applicable from 2 December 2026).

As such, PE/VC Managers with lower AUM will remain out of scope of the entity level disclosure requirements.

Conclusions

The introduction of the SDR and investment labelling regime is a welcome step in the battle to combat greenwashing and promote investor confidence in sustainable investment in the UK. However, from the perspective of PE/VC Managers questions remain over whether (and if so, to what extent) the rules will have much impact.

Although the 'anti-greenwashing rule' applies to all FCA regulated firms, overseas managers, overseas funds and UK portfolio managers are all currently out of scope of the majority of the new regime, whilst UK based PE/VC managers and their funds will only be caught by the rules in limited circumstances.

All managers with sub-£50 billion AUM (falling to sub £5 billion AUM from 2 December 2026) will be outside the scope of the entity (i.e. manager) level disclosure requirements, with even the biggest managers under no obligation to disclose entity level information until 2 December 2025.

With regard to product level disclosures and the naming and marketing rules, UK PE/VC Managers opting not to use an investment label for their funds will only fall in-scope of the new regime if marketing to retail investors, which traditionally are not the target market for PE/VC funds.

In conclusion then, it remains to be seen whether investor sentiment will drive managers to opt into the UK labelling regime, although with increasing investor appetite for sustainable investment

opportunities we may well see an uptick in the use of investment labels. However, with any UK managers marketing funds into the EU under increasing pressure to present investors with products which comply with Article 8 or 9 of the SFDR, and given the inherent asymmetries in the requirements of the SDR and the SFDR, it is unclear at this time whether the incremental benefit of obtaining and maintaining an SDR investment label purely for the UK market is sufficient to warrant the added cost and complexity of SDR-specific compliance.

For any managers who fall in-scope of the new rules, ESG data collection and reporting poses a potentially significant logistical challenge. To alleviate the burden of SDR compliance on managers, Corvus Group has partnered with Worldfavor to provide a world class ESG reporting solution. If you would like to discuss our ESG solution, the application of the SDR regime to your business more generally or any of the other topics covered in this article, please don't hesitate to get in touch.

The Corvus Group is an independent provider of administrative and advisory support services to the closed ended funds and asset management industries.

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