STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

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Standards Board for Alternative Investments

FCA Discussion Paper Response

Sustainability Disclosure Requirements (SDR) and Investment Labels

1. Introduction

We at the Standards Board for Alternative Investments ("SBAI") welcome the opportunity to respond to the Financial Conduct Authority's ("FCA") Discussion Paper CP21/4 [1] on Sustainability Disclosure Requirements (SDR) and Investment Labels ("DP").

At the SBAI we actively contribute to the global debate on Responsible Investment ("RI") [2]. Our Responsible Investment Working Group, made up of over 160 individuals representing global asset managers and institutional investors, has published several pieces on this topic:

- Responsible Investment Policy Framework (including recommended disclosures) [3]
- Review of Global Responsible Investment Regulations (updated November 2021) [4]
- Practical Implementation of Responsible Investment in different alternative investment strategies:
  - Equity Long/Short [5]
  - Credit [6]
  - Macro [7]
  - Systematic [8]

We support effective regulation and welcome efforts to enhance risk awareness and disclosure in relation to sustainability. Sustainability risks (and opportunities) where applicable or desirable need to be addressed as part of a fund manager's investment and risk management process. In addition, adequate risk disclosure, of all types of risks, enables better investment decision making and facilitates the efficient pricing of risk and opportunities in global markets. Effective risk management and disclosure is at the heart of our Alternative Investment Standards [9].

We would welcome the opportunity to discuss any of the points raised below and our work on Responsible Investment in general with the FCA.

This consultation response contains:

1. Important high-level observations on the proposed approach (Section 2)
2. The responses to the consultation questions (Section 3)

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[1] https://www.fca.org.uk/publication/discussion/dp21-4.pdf
[2] Also referred to as ESG
[3] https://www.sbai.org/resource/responsible-investment-policy-framework.html
[4] https://www.sbai.org/resource/responsible-investment---review-of-regulatory-expectations---2021-update.html
[5] https://www.sbai.org/resource/implementation-of-ri-in-els-strategies.html
[6] https://www.sbai.org/resource/implementation-of-ri-in-credit-strategies.html
[7] https://www.sbai.org/resource/implementation-of-ri-in-macro-strategies.html
[8] https://www.sbai.org/resource/implementation-of-ri-in-systematic-strategies.html
[9] https://www.sbai.org/standards/

2. High Level Observations on the Proposed Approach

Prior to responding to the specific questions in the DP, we would like to provide some context to our responses.

As a general point we support any efforts to make proposed regulations align with existing global regulations and initiatives.

We also raise the following points discussed in more detail below:

- **Investment Label Criteria:** We believe that criteria based on the sustainability objectives of the product (including details of how these will be measured) would be more appropriate than relying solely on the proportion of sustainable assets.
- **Sustainable – Transitioning Label:** We believe this should not include an assumption that the proportion of sustainable assets will increase over time and should be flexible enough to encompass portfolios that have an objective to invest in “brown” assets and move them to “green”.
- **Responsible Label:** We believe the FCA should consider not continuing this label. We believe it would be more appropriate to label funds with sustainability objectives and allow all others to be categorised as “Not promoted as sustainable”.
- **Entity Level Criteria:** We do not believe that the firm should have to meet criteria relating to its overall investment process for a product to be labelled as sustainable. The investment process for the specific product should meet the criteria but the firm may have other products that are not promoted as sustainable and therefore would not have the same investment process.
- **Challenges:** we provide some details of the jurisdictional and asset class-based challenges that some asset managers may encounter. We would be happy to discuss these further if it would be useful.

Investment Label Criteria

Throughout the DP there is a discussion of criteria that should be met for a product to qualify for a specific investment label. The focus of the criteria appears to be based substantially on the proportion of sustainable investments (to be defined by a taxonomy) within a product.

We would propose that the sustainability objectives of a portfolio should be the important criteria for investment labels. At any point in time there will be portfolios that hold a proportion of sustainable assets that have not been purchased because they are sustainable. As an example, technology stocks often rank highly with ESG scoring vendors, but these may be present in a product due to value or growth factors and not sustainability. Labelling a product of this kind as “Sustainable” may be misleading to investors as the asset manager would not be required to maintain this proportion of sustainable assets as this is not part of the investment strategy.

If the FCA does retain a threshold of sustainable assets for the labels we recommend that explicit consideration is given on how to account for assets such as short positions and derivatives within this calculation (see further detail in our response to Question 12). In addition, there will need to be careful thought on how this will be measured. A snapshot or point-in-time report could be misleading and may be open to “playing the game” by increasing the proportion of sustainable investments in advance of

reporting points. It may be more appropriate to consider a measurement over a period of time such as an average over all valuation points during the reporting period.

Question:

Has the FCA considered requiring the following objectives for each Sustainable label with a requirement to disclose the objectives and how they will be measured:

- Sustainable – Transitioning: A product with an objective to invest into "brown" asset to drive change to "green" assets.
- Sustainable – Aligned: A product with an objective to invest most of its capital in assets that are considered sustainable by the relevant taxonomy.
- Sustainable – Impact: A product with an objective to effect environmental or societal change through its investments.

Sustainable – Transitioning Label

In the DP this label appears to be aimed at products that are in the process of moving towards being a Sustainable – Aligned product. The assumption being that the proportion of sustainable assets will increase over time.

Many products with a transition objective aim to invest in "brown" securities and make changes through engagement or direct ownership to make these specific issuers "green". Many asset managers see this as an effective sustainable strategy as the focus is on change rather than divestment.

In this scenario the strategy may involve selling out of positions that have reached the required sustainability level to reallocate capital to different "brown" stocks and repeat the process. In this case the amount of sustainable assets in the fund would not necessarily always increase over time.

We believe this is one of many valid sustainability strategies and that the transitioning label should be flexible enough to include these products.

Question:

Has the FCA considered removing the assumption that the level of sustainable assets will increase over time from this label?

Responsible Label

The DP proposes a label in between "Not promoted as sustainable" and the three "Sustainable" labels – Responsible – where the criteria is that it may contain some sustainable assets and the firm engages in stewardship.

We would encourage the FCA to reconsider the use of this label and its suggested mapping to SFDR (Article 8) for the following reasons:

1. It is not clear that this is a useful label. Many portfolios may hold a certain level of "sustainable" investments, but this does not mean they are investing in a responsible way with regards to sustainability. These securities could be purchased for many reasons such as value or growth opportunities with no consideration given to their sustainability.

2. If reporting is at a certain point of time this may not be indicative of the portfolio or the strategy overall and could therefore be misleading.
3. Article 8 in SFDR is for funds that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics. The fact that a portfolio happens to hold some sustainable investments does not mean it would fall into this definition.
4. With the requirement for stewardship this could be limited only to equity portfolios which may provide an incorrect comparison with other products that would have to use the "not promoted as sustainable" label.

Question:

Has the FCA considered retaining just the three Sustainable labels (which map to Article 8 and Article 9 of SFDR) which provide useful information to investors on the objectives and strategies of the fund. All other products would then fall under "Not promoted as sustainable" (mapping to Article 6 of SFDR).

Entity Level Criteria

The DP suggests an approach where each entity would have to meet certain criteria prior to being able to use one of the Sustainable labels for its product.

The labels proposed will be useful at a product level and provide more clarity to investors. To apply a label to a product, the product will be required to meet certain criteria and, as per our suggestion above, this should include the sustainability objective of the fund as well as how the investment process meets that objective.

Asset managers may run a large selection of products which could fall under different investment labels – some may be sustainable, and some may not – and the investment process may differ for each product. Applying minimum criteria to the firm wide investment process for a product to be labelled sustainable may not be appropriate. This could mean that firms that run a non-sustainable product and therefore do not actively consider sustainability in all their investment processes may not be able to label their sustainable products as Sustainable.

Question:
Has the FCA considered that entity level disclosures should consist of the organisation's sustainability goals and the organisational initiatives in place to achieve this?

Product level disclosures could then contain details of the investment process that are specific to the product being invested in.

Challenges to Data Disclosure

Disclosure reporting can be challenging for some asset managers depending on a few factors. We support the FCA's acknowledgement that there will be some limitations.

We have listed below some of the more common challenges that have been discussed in our Responsible Investment Working Group:

- **Jurisdiction:** Many asset managers will invest in securities that are not domiciled in the UK. Not all jurisdictions have mandated issuer disclosure and where this is not the case a large

amount of resource may be required to source this information – particularly for portfolios that have many positions or have high portfolio turnover. It is typically more developed markets that have mandated these disclosures but even in some large, developed nations such as the US there is limited reporting from issuers currently.

- **Public vs Private Markets**: Issuer disclosures are typically only mandated for public issuers and therefore cover mainly listed equity and debt (although data will be available for derivatives of these positions as well). Asset managers that invest in private market holdings will have to source this data directly.
- **Asset Classes:** Beyond equities, bonds, and their derivatives there is a limit to data that is available. Assets such as indices, baskets, structured credit, syndicated loans, and reinsurance usually rely on an intermediary that may or may not collect this data.

Question:

Has the FCA considered allowing flexibility within its disclosure requirements allowing asset managers to disclose where they have not been able to collect the required data for certain positions and explain the reasons why?

3. Responses to CP Questions:

Please find below our responses to the specific questions raised in the DP. We would be happy to discuss any of these further with the FCA.

Question 1: What are your views on the tiered approach set out in Figure 12? We welcome views on any concerns and/or practical challenges.

In principle simpler and comparable information for retail investors and more detailed information for institutional investors makes sense. There are some practicalities to consider:

- Institutional investors may also have a preference to receive information in a comparable format to aid with a view across their whole portfolio.
- The FCA should discuss with global institutional investors which information they are already requesting to consider the level of disclosure required. Many pension funds do not have the resources to analyse detailed information on a frequent basis and, depending on the pension fund's objective, may prefer a simplified format.

Where possible simplified reporting should be a sub-set of the information that is required in the detailed reporting. This will reduce the resource required for firms that may have to report both ways.

Question 2: Which firms and products should be in scope of requirements for labels and disclosures? We particularly welcome views on whether labels would be more appropriate for certain types of products than for others, please provide examples.

While disclosure is important for retail investors, we believe it is equally important for institutional investors. The beneficiaries of many institutional investors, for example pension funds, are members of the public and other institutional investors, for example university endowments, have beneficiaries that

are keen to see capital allocated in a sustainable way. We don't believe the scope of labels and disclosures should be limited to retail investors for these reasons.

Labels, in principle, likely make sense for all products. Disclosures; however, may not necessarily be appropriate for all products given the objective of providing greater transparency and trust. As an example:

- Products that have a high turnover of assets mean that any disclosures could be point-in-time disclosures rather than being an accurate reflection of the direction of the portfolio.
- Certain asset classes may prove difficult to report disclosure data on due to lack of data from underlying issuers, jurisdictions where the data is not mandated, or as investments are purchased through intermediaries (e.g., syndicated loans, reinsurance, or secondary market positions.)

The FCA could consider offering a comply or explain approach to disclosures for funds not labelled as having dedicated sustainability objectives. The explanation detailing the analysis completed and the reason for non-compliance could then be provided to investors. Where funds have dedicated sustainability objectives data will be sourced for the investment process and therefore disclosure should be possible.

It is unclear whether the intention is that funds that do not fall into a sustainable label will be required to report. We would suggest that at a maximum a limited sub-set of disclosures would be applicable to this category.

We also note our response from CP 21-17 on climate related disclosures with regards to scope:

"We support the adoption of a concept of proportionality in this CP. We also agree that for any benefit to investors to be meaningful, there should be broad coverage for the regulations.

AUM does not necessarily correlate with the number of people or resources in an organisation. Given the complex nature of the requirements, we would be more supportive of an additional exemption for firms with less than a specified number of people. This is the approach taken by the EU under SFDR which allows firms with less than 500 employees to opt out of reporting the individual metrics.

The FCA could consider applying this threshold with a requirement to provide the reporting on request to investors who require it to meet their own climate related regulatory requirements.

We note that the proposed threshold would exclude many smaller or more niche funds, but asset owners may be required to report where they are invested in these funds. The FCA may wish to consider a lighter or more flexible reporting framework for smaller firms."

Question 3: Which aspects of these initiatives, or any others, would be particularly useful to consider (for example in defining terms such as responsible, sustainable, and impact) and how best should we engage with them?

We believe that regulatory frameworks are more effective when they are globally consistent as asset managers rarely operate in, or market to, a single jurisdiction. In this light, we encourage the FCA to remain as consistent to the SFDR framework as possible when considering future policy. Many UK market participants will have spent resource (both financial and time) aligning with these regulations and divergence from them will involve a repetition of this process. Asset managers have a fiduciary duty to

manage capital appropriately and it may be counter-productive to divert too much resource from this main function due to diverging regulatory requirements.

In our Responsible Investment Policy Framework document[10] we show a spectrum of approaches to Responsible Investment:

Different Approaches to Responsible Investment

Category	Approach	Description
Responsible Integration		The Inclusion of RI-related factors into investment and risk management processes, where they have financial materiality. This involves the use of all relevant financial and non-financial information to aid asset valuation and risk assessment, but RI factors are not used to pre-define an asset universe.
Responsible Asset Selection	Exclusions	An "Exclusion List" or "Negative Screening" is used to pre-define an investment universe. Exclusions may be based on "damaging industries" such as gambling, fossil fuels, or tobacco, relatively low ESG ratings or other considerations such as faith-based investing.
	Inclusions	"Positive Screening" is used to pre-define an investment universe. Inclusions may be on a "best in class" basis, i.e., those with relatively high ESG ratings or on a "thematic" basis with investments in particular sectors or industries targeted.
	Impact	Investing with the specific goal of delivering meaningful societal and environmental outcomes, for example, reduction of carbon emissions, or more generally contributing to societal goals such as the UN's Social Development Goals (SDGs).
Responsible Ownership	Voting	A form of engagement based on participating in Annual Company Meetings and using voting rights to support RI-related initiatives or express a negative view on current practices.
	Engagement	Having a dialogue with underlying issuers or companies with a view to achieving improvements on RI-related practices. This can also be used for improvements in wider industries through collective engagement for example with regulators or investor groups.
	Activism	A more involved form of engagement where investors look to promote change through building up a significant holding within a company and potentially gaining a seat on the board. This may also be a more public form of engagement.
Responsible Corporate & Market Citizenship	Organisational Initiatives	Initiatives and policies put in within the Investment Manager's own firm to address environmental, social and governance issues for example, energy efficiency, diversity, and employee wellbeing.
	Good Market Citizen	Being a responsible market citizen by governing the firm's behaviour in the market and ensuring the maintenance of free and effective markets, for example, by having strong controls in place to prevent market abuse.
	Carbon Hedging	Offsetting carbon emissions either directly produced by the firm (for example via travel) or funded within the portfolio (for example by investing in high carbon emitters) using carbon credits or other forms of carbon hedging.

Often RI or sustainability integration and products that have dedicated RI or sustainability objectives can be talked about as one thing; however, we believe there is an important distinction. We would encourage the FCA to base definitions on models such as the above which clearly delineate the consideration of

[10] https://www.sbai.org/resource/responsible-investment-policy-framework.html

financially material sustainability risks, from funds seeking to achieve a dedicated sustainability objective such as carbon neutrality.

In the spectrum above we view Responsible Ownership and Responsible Corporate and Market Citizenship as approaches than can be used regardless of whether there is a sustainability objective for the product or not.

Question 4: Do you agree with the labelling and classification system set out in Figure 3, including the design principles we have considered and mapping to SFDR? We welcome views on further considerations and/or challenges.

We agree that the FCA should map any classifications to SFDR. Many in scope firms will already have completed a substantial exercise to identify which SFDR classifications their products fall into.

Section 3.8:
"Objective, descriptive vs Subjective labels": We agree that an objective approach would make it simpler to determine which label applies and provide clarity to investors. We also agree that traffic lights, medals, or any other format that would appear to label products as "good" or "bad" should not be used. Caution will be needed to avoid overly prescriptive objective criteria which would either require many different labels or run the risk of some products falling in gaps between labels.

"Investment objectives and strategies versus allocation of investments to sustainable products and activities": In our view investment objectives and strategies may be a more effective criteria than the proportion of investments that are considered sustainable. Many portfolios that do not have dedicated sustainability objectives will at points hold investments in assets that can be considered sustainable. As an example, many portfolios may hold technology stocks which tend to have relatively higher ESG ratings, but these may be invested in due to the value or growth opportunities rather than sustainability opportunties.

If the proportion of investments that are considered sustainable is used as criteria for labels, then care needs to be taken on how this is measured.

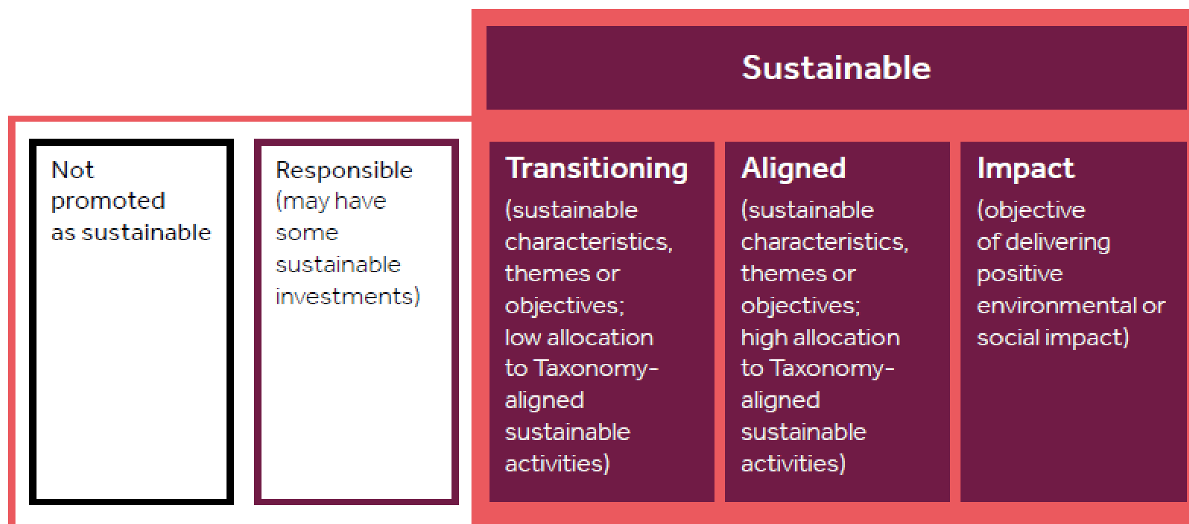
A measurement at the time of reporting will be a point-in-time measurement and could be misleading to investors and is potentially open to "playing the game" i.e., increasing the proportion of these investments in time for the reporting period.

It may be more appropriate to consider a measurement that can take account of the portfolio over time i.e., an average over the period or similar.

"Consistency and compatibility with the current market and existing initiatives and flexibility as the market develops": We support the FCA's stance that any regulation needs a degree of flexibility to accommodate market developments and avoid stifling innovation.

Figure 3 provides 5 labels that are being proposed:

Figure 3: Potential approach to a sustainable product classification and labelling system



Note: The five blocks in this Figure represent potential categories of product in the classification and labelling system. Each would be supported by clear definitions and criteria

Potential mappings against SFDR have also been proposed:

- Article 6: Not promoted as sustainable
- Article 8: Responsible and Sustainable – Transitioning
- Article 9: Sustainable – Aligned and Sustainable – Impact

We are supportive of the Transitioning label. We believe this is a gap in a lot of frameworks as the portfolios may not currently score well on certain ESG scoring systems but can hold an important objective of improving certain companies or sectors. Consideration should be given to how this will be measured, i.e., is there an expectation that the level of sustainable investments will increase over time or that clear improvement be demonstrated when exiting the position (or an explanation of why this was not possible).

Responsible Label:

We would encourage the FCA to reconsider the use of this label and its mapping to SFDR for three reasons:

1. It is not clear that this is a useful label. Many portfolios may hold a certain level of "sustainable" investments, but this does not mean they are investing in a responsible way with regards to sustainability. These securities could be purchased for many reasons such as value or growth opportunities with no consideration given to their sustainability.
2. If reporting is at a certain point in time this may not be indicative of the portfolio or the strategy overall and could therefore be misleading.
3. Article 8 in SFDR is for funds that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics. The fact that a portfolio happens to hold some sustainable investments does not mean it would fall into this definition.

We would argue the FCA should retain the three Sustainable labels as these provide useful information to investors on the objectives and strategies of the fund and that all other products should fall into an equivalent of Article 6 under SFDR.

Question 5: What are your views on "entry-level" criteria, set at the relevant entity level before products can be considered "Responsible" or "Sustainable"? We welcome views on what the potential criteria could be and whether a higher entity-level standard should be applied for "Sustainable" products. We also welcome feedback on potential challenges with this approach.

The objective of the investment labels is to provide transparency on the product and increase investor trust. It is not immediately clear how minimum criteria at an entity level would support this. Firms may offer a range of products to meet investor demand that fit into different investment labels and may include products that do not promote sustainability. Firms will also be marketing to different investors which may include US state pension funds that are currently prohibited from making investment decisions based on non-financial factors.

The factors that may be considered for these entry-level criteria detailed in 3.17 are: "matters relating to systems and controls, governance, ESG integration and stewardship." The implication of this is that a firm would not be able to label a product as "Sustainable" unless all its activities are aligned with this investment label. This means for firms running a range of products they may have to label all products at the lowest common denominator which would be inaccurate.

We would recommend that firm level criteria should not differ depending on product labels. The aim of any regulation should be to ensure that the product is labelled correctly and to ensure it is doing what it says it is.

As an alternative firms could be required to disclose their ESG policies as they apply at the entity level. This may include a breakdown of different processes for different categories of firms as well as what is being done at a corporate level (see below for an example of how we have suggested doing this).

The firm should be able to demonstrate the criteria in relation to a specific product that is labelled as Sustainable.

In our Responsible Investment Policy Framework document[11] we detail a list of disclosures that can be made at a corporate level to demonstrate any commitment to ESG or sustainability at an entity level including:

- What is the asset manager doing at a firm level?
- What environmental policies has the firm put in place?
- What social policies has the firm put in place?
- What governance processes has the firm put in place? (This section can refer to other procedure documents or policies and does not need to replicate all governance controls).
- Who oversees the organisational policies?

[11] https://www.sbai.org/resource/responsible-investment-policy-framework.html (see section 3.4.1 Organisational Initiatives)

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- Does the manager offset carbon?
- If yes, how is it measured and accounted for?
- What instruments are used to offset the carbon emissions?

Question 6: What do you consider to be the appropriate balance between principles and prescriptions in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

We would suggest that criteria should be mostly principles based. This allows greater flexibility than more prescriptive criteria.

We would suggest that firms are required to provide explanations of why they have applied a certain label which may include the following details:

- The stated objective of the product that means it meets the label definition
- How the product intends to meet that objective
- How the firm will measure the achievement of this objective
- The timescale that changes can be expected
- On average what proportion of assets have achieved this objective over the timescales detailed above.

Different products will have different objectives and the key to meeting the definition of the investment label should be that a stated objective is in line with the label and that this objective is being measured.

Question 7: Do you agree with these high-level features of impact investing? If not, why not? Please explain, with reference to the following characteristics:

- **Intentionality**
- **Return expectations**
- **Impact measurement**
- **Additionality**
- **Other characteristics that an impact product should have**

Prior to responding directly to this question, we have a couple of points to note on Box 3 which details the classification criteria.

Entity level: Please see response to question 5

> a. Sustainable – Impact – Products with the objective of delivering net positive social and/or environmental impact alongside a financial return.
>
> *Minimum criteria*: Intentionality, theoretical ability to deliver and measure additionality through investment decision-making and investor stewardship, impact measurement and verification.

We agree with the minimum criteria detailed above but would add an additional criterion that there should be a process in place where the impact of the investments is measured and reviewed on a regular basis.

> c. Sustainable – Transitioning – Products with sustainability characteristics, themes or objectives that do not yet have a high proportion of underlying assets meeting the sustainability criteria set out in the UK Taxonomy (or can otherwise be verifiably established to be sustainable, where a taxonomy is not yet available). These products pursue strategies that aim to influence underlying assets towards meeting sustainability criteria over time, for instance through active and targeted investor stewardship. The expectation, therefore, is that this proportion will rise over time.

We do not believe the last sentence of the above definition is necessarily correct. If a product has the objective to aid investments with transition, then the positions may be exited once this objective has been achieved and the capital reallocated to new investments that need to be changed. This means it does not necessarily follow that the proportion of sustainable investments will rise over time.

We agree with the definitions of impact investing and note agreement with the statement that “additionality” may be a high barrier. The difficulty with applying this as part of the criteria is the ability to measure the impact. If the investment was not made at all this may be able to be measured but it would be difficult to measure whether the investment would be sourced from somewhere else had the specific product not made that investment. The important information for an investor about the product is whether the investment made the impact it was intended to rather than whether it made an impact because there was no other source of funding.

Question 8: What are your views on our treatment of transitioning assets for:

- **a) The inclusion of a sub-category of “Transitioning” funds under the “Sustainable” label.**
- **b) Possible minimum criteria, including minimum allocation thresholds for “Sustainable” funds in either sub-category?**

We agree that products with a transition objective should be included under the sustainable label as they have a dedicated sustainability objective. The FCA needs to be clear whether this label would include products that invest in “brown” securities to drive them towards “green” (dedicated sustainability objective so reasonable to include in sustainable label) or whether it means portfolios where the objective is that the portfolio becomes sustainable at the end of a period (less clear whether this makes sense to include as sustainable – would it not just wait until it reaches the threshold for the aligned label).

Under the minimum criteria having a specific portion of sustainable assets may not be appropriate for a fund that has transition of companies as its objective. A newly launched fund could be made entirely of “brown” assets and as discussed in prior questions positions may be exited when a specific level of sustainability is reached, and capital reallocated to “brown” investments.

3.3 talks about the use of benchmarks. This may make sense in certain situations particularly for products that aim to have low carbon emissions but may not make sense for other sustainability objectives such as those more focused on social factors. We do not believe the use of benchmarks should be criteria, but firms could be required to explain where they do not use a benchmark.

Question 9: What are your views on potential criteria for “Responsible” investment products?

As noted in question 4 we do not believe the “Responsible” label is useful for the objectives of the regulation.

Given proper risk management requires that firms consider all financially material risks, including sustainability risks, regardless of any sustainability objectives – the main difference between Responsible and Not Promoted as Sustainable appears to be stewardship.

Stewardship is effective in products that trade equities and some debt, however, is not possible in a lot of other asset classes. We have completed a set of memos discussing the use of ESG in different asset classes including equity long/short, credit, macro, and systematic strategies[12] that discuss the difficulty of engagement or stewardship in asset classes such as derivatives, syndicated loans, and structured credit. In addition to the reasons we mention in our response to question 4, this may have the unintended consequence of restricting the use of this label to equity or listed debt products.

Question 10: Do you agree that there are types of products for which sustainability factors, objectives, and characteristics may not be relevant or considered? If not, why not? How would you describe or label such products?

We believe that all asset managers would consider any sustainability risks that are financially material to their product, but this does not mean the fund is promoted as sustainable. Certain risks can be more or less material in different strategies depending on factors such as asset class, portfolio concentration, portfolio average holding period, and jurisdiction.

We believe it is appropriate to have a label that states the product is not promoted as sustainable, but it should be clear this does not mean there is no consideration of material sustainability factors in the investment process.

Question 11: How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

We believe that these products should follow the same criteria for labelling as any other products.

Question 12: What do you consider the role of derivatives, short-selling, and securities lending to be in sustainable investing? Please explain your views

Our Responsible Investment Working Group, which is made up of over 160 individuals from asset management and allocator firms, has considered this question in depth.

Derivatives:

Our report on the Practical Implementation of Responsible Investment in Equity Long/Short strategies[13] and a separate report covering Systematic Strategies[14] raise the following points:

- Data may be available based on the underlying issuer for single name derivatives or on a lookthrough basis for baskets or indices. This means that financially material sustainability risks can be considered in the investment process.

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[12] Available in our Responsible Investment Toolbox: https://www.sbai.org/toolbox/responsible-investment.html
[13] https://www.sbai.org/resource/implementation-of-ri-in-els-strategies.html
14 https://www.sbai.org/resource/implementation-of-ri-in-systematic-strategies.html

- Dedicated sustainability approaches can technically be applied using derivative positions i.e., certain sectors can be excluded or included based on sustainability criteria – but it is less clear what the impact of these approaches would be. As an example, when excluding an equity position this has the impact of not funding the company and potentially increasing the cost of capital for that issuer. It is not clear that exclusion of a derivative position would have the same effect.

If a derivative based product was to apply a sustainable label, there should be some requirement to explain how the use of derivatives is achieving any dedicated objective.

When calculating the proportion of assets in sustainable investments, the FCA should explicitly state whether derivative positions should be included or not.

Short Selling:

Our memo on practical guidance for implementing responsible investment in equity long/short strategies[15] contains a detailed discussion on the use of short selling in ESG. In summary:

- The same data will be available for holding a short-listed equity or credit position as a long position.
- Exclusion lists can be applied to short positions. This is typically used to express an ethical view that the portfolio should not benefit financially from certain sectors or industries.
- Shorting can be used to express a negative view on a company for sustainability reasons. This may be a public statement if the position is large enough to be disclosed under regulations or the product has an activist strategy.
- Shorting can negatively impact companies with poor sustainability credentials by impacting the cost of capital for the firm or putting downwards pressure on share prices which may in turn impact executive compensation packages.

There is some debate in the industry on how short positions should be used in this context. The decision needs to be based upon the sustainability objectives of the fund.

When looking at carbon related objectives whether short positions should be netted or offset against long positions is a source of discussion. Within our working group the view has been formed that this is dependent on the objective of the portfolio:

- Where a portfolio is looking to manage carbon risk (e.g., the risk of carbon taxes being imposed in certain jurisdictions) then short positions act as an offset and can be netted.
- Where a portfolio is looking to make a real world impact such as a Net Zero commitment it does not follow that short positions would remove carbon emissions and therefore may not make sense to net these against long positions when determining carbon footprints.

When calculating the proportion of assets in sustainable investments the FCA should explicitly state how short positions should be accounted for.

[15] https://www.sbai.org/resource/implementation-of-ri-in-els-strategies.html

Where a product has a policy of going long “good” securities and short “bad” securities it may not be appropriate to include the short positions in the proportion of assets. Netting here would reduce the value of the sustainable assets and using gross positions would seem like there were investments into non-sustainable positions.

We feel this is another reason why the objective of the product should be a more important criteria for labels than the proportion of sustainable assets.

Securities lending will have a lot of the same considerations as short positions.

Question 13: What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

We believe it is important that the two disclosure rules should be streamlined. Ideally there would be one combined report that asset managers can submit. This will help reduce duplication and the resources required for regulatory reporting.

There will be challenges for some asset managers in producing disclosure reporting and we support the FCA’s acknowledgement that there will be some limitations. Challenges include:

- **Jurisdiction:** Many asset managers will invest in securities that are not domiciled in the UK. Not all jurisdictions have mandated issuer disclosure and where this is not the case a large amount of resource may be required to source this information – particularly for portfolios that have a large number of positions or have high portfolio turnover. It is typically more developed markets that have mandated these disclosures but even in some large, developed nations such as the US there is limited reporting from issuers at the moment.
- **Public vs Private Markets:** Issuer disclosures are typically only mandated for public issuers and therefore cover mainly listed equity and debt (although data will be available for derivatives of these positions as well). Asset managers that invest in private market holdings will have to source this data directly.
- **Asset Classes:** Beyond equities, bonds, and their derivatives there is a limit to data that is available. Assets such as indices, baskets, structured credit, syndicated loans and reinsurance usually rely on an intermediary that may or may not collect this data.

We recommend that any reporting allows flexibility for asset managers to disclose where they have not been able to collect the required data for certain positions and explain the reasons why.

Question 14: What are your views on consumer-facing disclosure including the content and any considerations on location, format (e.g., an ESG Factsheet) and scope?

At the SBAI we represent institutional investors only and as such we have not responded to this question.

Question 15: What are your views on product level disclosures including structure, content, alignment with SFDR and degree of prescription.

We support alignment with SFDR whenever possible as many asset managers will already have spent time and money implementing reporting for this regulation.

Section 4.15 discusses detail being provided on metrics and methodologies used to calculate them, and the level of proxy data used in calculations. We are supportive of this type of disclosure. Many methodologies are in their infancy and no standard has yet been agreed upon. For example, should the carbon footprint of an issuer be attributed entirely to its equity holders or should debt holders also bear some of this. Providing metrics without explanation will lead to misunderstanding of data and false comparisons.

Our Responsible Investment Policy Framework[16] provides details of the types of disclosures that asset managers should make to investors on processes and governance of processes:

Area	Observations
Overview	• What is the manager's high level RI objective – is RI treated as source of alpha, a risk management tool, or the primary goal of the portfolio? • Where does the firm sit on the spectrum of RI Approaches? • Does the manager intend to run any dedicated RI products? • Is the manager a signatory to any third-party responsible investing organizations (including the SBAI)? • What resources will be dedicated to the RI Approach? • Are there any sources of alpha that are excluded from the product and what is the rationale for doing so?
Responsibility	• Which individuals or teams are responsible for the governance of the policy?
Monitoring, Governance	• What oversight is completed? • For RI Products, what are the measurable goals of the investment mandate? • What reporting can investors expect to receive, and on what frequency?
Organisational Initiatives	• What is the asset manager doing at a firm level? • What environmental policies has the firm put in place? • What social policies has the firm put in place? • What governance processes has the firm put in place? (this section can refer to other procedure documents or policies and does not need to replicate all governance controls). • Who oversees the organisational policies?
Carbon Hedging	• Does the manager offset carbon? • If yes, how is it measured and accounted for? • What instruments are used to offset the carbon emissions?
RI Integration	• Details of how RI-related factors are integrated into the investment decision-making process (including asset allocation, security selection, portfolio construction and risk management). • An explanation of what factors or thresholds will determine if an RI-related factor is considered material or non-material. • Details of any quantitative (or qualitative) analysis that is used to determine the risk/reward attribution of a specific RI-related factor and how will this be evaluated.

[16] https://www.sbai.org/resource/responsible-investment-policy-framework.html

	• Details on any sources of data, and any estimates or assumptions that will be used in the decision-making process.
Exclusions	• Will the manager consider exclusion lists provided by investors? – If yes, what are the criteria for this i.e., requires an SMA of a certain size or must not restrict the current investment universe if applied to a commingled fund. • Detailed descriptions of the criteria for exclusion of securities from the portfolio. • Can these criteria be changed and if so, what is the process for doing this? • How is the investment universe determined both before and after the exclusions? • What are the governance processes for ensuring the correct exclusions have been applied? • What sources of data, estimates or assumptions will be used in the decision-making process?
Inclusions	• What are the criteria that will be used to determine the investment universe? • How will these metrics and other information be sourced or calculated? • How and when will these metrics be used within the investment decision-making process? • If over-weighting assets on an inclusion list, how will the relative weightings be calculated? • How will the portfolio be monitored against these metrics on an ongoing basis and how often will any rebalancing of the portfolio take place? • How will the risk of crowded trades be monitored as part of investment and risk management processes? • How are investment choices contributing to the stated RI objective of the investment mandate?
Impact	• What are the Impact Goals of the portfolio? • What are the impact metrics and targets that will provide investment decision information? • What are the exit criteria for an investment that is no longer contributing towards the impact goals? • How will the portfolio be reviewed and measured against the impact goals and how will this assessment be reported to investors? • What are the non-impact related factors that may cause an investment to be exited, for example a stop loss on the investment?
Voting, Engagement & Activism	• What is the proxy voting policy and is this achieved through direct voting or outsourced voting? • Will the manager's proxy voting records be made available to investors and if so, how regularly? • How is engagement on RI-related issues factored into the investment process and at what point? • Where engagement is completed to improve RI-related factors as a matter of policy, what are the criteria and metrics for how this will be assessed?
Data	• What is the source of the data for the selected vendor(s)?

	• Does the data cover enough of the investment universe to be effective in the investment process or for investor reporting? • Where the data is sourced from public information, how reliable is the data in the geography of the investment universe? • How much weight is given to "E", "S" or "G" factors and is appropriate for the stated RI objectives? • For more subjective social factors, is large scale vendor data appropriate or would a more focused data provider be required? • Have multiple vendors been reviewed and tested and why were specific vendors chosen? • What is the methodology behind any scoring from vendors and what assumptions are used? • If choosing to source the data independently, ensure the firm has sufficient resources both in terms of bandwidth and local knowledge of the relevant jurisdiction.

Question 16: What are your views on building on TCFD entity-level disclosures including any practical challenges you may face in broadening to sustainability-related disclosures?

As discussed in an earlier question we believe details on how sustainability is incorporated into the investment process are best placed within product level reporting. Many firms will offer both sustainable and non-sustainable products and, while there may be some firm wide considerations, the investment process for these products is likely to differ.

Entity level reporting should be linked to what the firm itself is doing to be sustainable.

Question 17: How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standards? Please explain any practical or other considerations.

We fully support alignment with other global regulations and international standards. Basing asset manager reporting on issuer reporting requirements helps to streamline the process, ensure an international standard, and reduces the resources required to produce the reporting allowing firms to dedicate more time to the investment and risk management processes.

Question 18: What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?

Through discussions with our Responsible Investment Working Group, we have learned that there are many instances where asset managers are reliant on other market participants for information. We believe that reporting should be encouraged throughout the investment chain to make the process more streamlined and to ensure data availability.

Examples:

- Structured Credit: These assets (e.g., CLOs) are often packages of multiple securities that are purchased from the originator. If information is not provided by the originator, then it may be difficult to obtain.

- Syndicated Loans: These are often accessed through an intermediary such as an investment bank with no direct contact with the issuer. If the intermediary does not provide this data, then it may be difficult to obtain.
- Indices and Baskets: These are both as a collection of assets and if data is not available from the index provider this will be hard to source.
- Reinsurance: Data would be required from the primary insurer.

As we do not represent retail investors who would make the most use of distributors we are not best placed qualified to respond on this point; however, it would make sense that the distributors are required to pass the consumer facing reporting onto retail investors.

Question 19: Do you consider that there is a role for third-party verification of the proposed approach to disclosures, product classification, and labelling and organisational arrangements of product providers? Do you consider that the role may be clearer for certain types of products than others?

This is a difficult question. On the one hand third-party verification may increase trust in the reporting; however, this also comes at a cost.

The cost of regulation in the asset management industry is constantly increasing – either through having to hire dedicated individuals or through having to use outsourced providers. This disproportionately disadvantages smaller asset managers and newer entrants to the market.

We believe that these small and emerging managers are vital to the industry to increase competition and choice for investors. Increasing barriers to entry through raising the cost of business would be detrimental to this.

We would recommend that third-party verification is **not** required. The FCA could revisit this at a later point if it has reason to believe that there has been misreporting; however, the regulator retains the right to reprimand for misreporting in line with other regulatory reporting. This would be in line with other global ESG regulations which do not require third party verification.

Question 20: What approaches would you consider to be most effective in measuring the impact of our measures, including both regulatory and market-led approaches, and should disclosures be provided in a machine-readable format to better enable data collection and analysis?

To answer this question, it needs to be clear what impact the FCA is trying to achieve with this regulation. SFDR has a stated objective of directing capital to more sustainable investments; however, this discussion paper does not appear to state this as an objective. The objectives appear to be to increase transparency and trust in sustainability reporting.

- Transparency can be measured by comparing how many asset managers produced this type of reporting prior to the implementation of the regulation (although note that this might be distorted by the earlier implementation of SFDR).
- Trust is hard to measure.