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ESG in UK Financial Services: The Current State of Play

Article By:

Matt Hancock

Katharine Bond

Jo Rickards

The Financial Conduct Authority's (FCA) work at the intersection of Environmental, Social and Governance (ESG) concerns and UK financial services forms part of a wider push by the UK government towards "*Greening Finance*". The last year or so has been a particularly active period for the FCA in this space.

This GT Alert summarises recent regulatory activity and the FCA's ambitious proposals for product labelling and disclosures in its recent discussion paper on sustainability disclosure requirements (SDR) and investment labels.

It is worth emphasising that this Alert focusses on the current and likely forthcoming UK legal requirements relating to transparency and disclosure. The substantive standards or aspirations that businesses adopt (voluntarily or because of public or stakeholder pressure) are manifold. They may relate to how a business deals with its own people (including its outsourced suppliers in different jurisdictions) or society and the environment at large. Whatever the expectations on them, businesses would do well to approach ESG compliance in a holistic fashion, meaning not just compliance with strict legal requirements (as and when these are implemented) but also in articulating a dynamic, benchmarked programme of standards and aspirations that will reliably meet the constantly evolving expectations of stakeholders and society.

A Chronology of Recent Developments

In all the steps the FCA has taken over the last year or so, the consistent themes are transparency, market integrity and consumer protection. The FCA's work also looks to what is already happening in other jurisdictions and internationally, in particular the work of the Taskforce on Climate-related Financial Disclosures (TCFD)[1].

In order to understand the FCA's direction in respect of ESG-related regulation, it is useful to summarise some of the recent FCA and relevant political activity around ESG and sustainability.

- In December 2020 the FCA required UK-listed companies with a premium listing (including all FTSE-listed equities) to make certain climate-related disclosures in their annual financial reports or to explain why they have not done so. This includes details of the steps the company is taking (or not, as the case may be) to manage climate-related risks and the governance arrangements it has in place around climate-related risks and opportunities. The same rule applies to standard listings from January 2022. The disclosures are those recommended by the TCFD.

- In March 2021 the FCA was asked to "have regard to" the Government's commitment to net zero carbon emissions in all of its regulatory activities.

- In his Mansion House speech on 1 July 2021, Chancellor Rishi Sunak talked about making the UK the "*best place in the world*" for Green finance. Part of this effort, he said, was new requirements around the disclosure of sustainability information.

- These warm words quickly translated into something far more concrete with a "Dear Authorised Fund Manager Chair" letter on 19 July 2021 from FCA Supervision. It is well known that the FCA will be less sympathetic towards regulated businesses where it has clarified its approach or thinking through letters such as this. The focus of this letter was on a spate of applications for FCA authorisation of investment funds making ESG or sustainability claims, but where the claims made by those funds did not bear scrutiny. The FCA made clear that such applications would be rejected, but also that going forward it expected to see funds (including those already authorised) making clear, accurate and ongoing disclosures to customers around ESG claims and deliverables. This was part of the FCA's drive to create a well-functioning and efficient market for ESG related products in the UK and to bolster consumer confidence. The letter included some guiding principles that set out the FCA's expectations for investment funds making ESG/sustainability claims including those already authorised (the Guiding Principles). Whilst they are not especially radical, focussing as they do on comprehensible disclosure and monitoring of existing investments, the Guiding Principles should be closely looked at by all funds making ESG or sustainability claims[2].

- In November 2021 the FCA published an overarching strategy document setting out its refreshed ESG priorities. On the question of intervention in markets, the FCA said in this document that whilst it will take action where necessary, its focus will be on setting regulatory foundations (or "guard rails") to let the market deliver solutions. The FCA also said it will seek to ensure any such interventions make sense given standards applied in other jurisdictions and internationally, in order to prevent market distortions. We return to the question of possible regulatory action further below. The FCA strategy also contains a number of long-term commitments to achieving certain outcomes in the years ahead, including:

– Increased quality in climate and sustainability disclosures, to assist pricing and investment decisions.

– Fostering greater trust in ESG-based investments and protecting consumers from misleading marketing.

– Focussing on firms' governance arrangements to ensure a comprehensive and careful consideration of material ESG risks and opportunities.

– Encouraging active investor stewardship to influence decision-making in favour of sustainability.

- In December 2021 the FCA introduced a new ESG chapter of the FCA Handbook containing new rules and guidance for asset managers, life insurers and FCA-regulated pension providers to make climate-related financial disclosures on their websites, on an annual basis at both an entity and a product level. These rules gel with the recommendations of the TCFD. Some respondents to the related consultation were concerned that relevant data might not be available or that gathering it might create methodological issues. This is a classic case of aspirations being ahead of the current reality of gathering and marshalling climate-related data. The FCA has since clarified that, unless assumptions or proxies can be used, then the data need not be disclosed. Nonetheless, in-scope firms will need to be sure they keep track of the state of the art on data environmental management.

A Proposed Regime for Product Labelling and Sustainability Disclosures

Against that backdrop, in November 2021 the FCA published a Discussion Paper on Sustainability Disclosure Requirements and investment labels. It is in many respects a far-reaching and ambitious Discussion Paper and builds on the rules already in place for listed companies and asset managers, life insurers and pension providers (see above). The resulting rules and guidance will apply to asset managers and FCA-regulated asset owners (although the scope of the new proposed new rules and guidance is itself up for consultation, meaning the final remit could well be far broader). It is clear that this is a Discussion Paper in the truest sense – whilst mindful of the need not to be out-of-step with equivalent regimes (such as the SFDR) the FCA are consulting on some quite fundamental questions in respect of its approach – much is still up for grabs. For example, whilst the paper focusses on product "manufacturers", the FCA is not ruling out regulation for those further along the distribution chain including financial advisers.

The Discussion Paper addresses what the FCA views as the extensive and potentially bewildering choice of funds and products available that have some characteristic linked to ESG concerns and the different language used to describe what is on offer. Whilst the FCA says it welcomes the diversity and innovation in this new market, it is also (as so often in the last year) concerned to protect consumers and the integrity of and trust in this new market. The FCA hopes this will be achieved by introducing standardised disclosures and a new UK Taxonomy.

Labels

The FCA proposals envisage two distinct layers of disclosure: (1) disclosures to consumers containing key product information and (2) more detailed disclosures at the entity and product level aimed at institutional investors and other stakeholders. We return to these disclosures below.

For labelling purposes, the FCA proposes five distinct categories of product (that in turn map to the SFDR), each with its own entry-level criteria. It is worth setting out these five proposed categories in full:

- Not promoted as sustainable;
- Responsible (may have some sustainable investments);
- Sustainable has three sub-categories:

– Transitioning (sustainable characteristics, themes or objectives; low allocation to new Taxonomy-aligned sustainable activities – but where investments made are transitioning towards sustainability);

– Aligned (sustainable characteristics, themes or objectives; high allocation to new Taxonomy-aligned sustainable activities); and

– Impact (objective of delivering positive environmental or social impact). As the FCA notes, such products will be comparatively rare.

Much will of course turn on how the entry-level criteria for these categories are set. Whilst the FCA has tentatively proposed some potential criteria, it has also consulted broadly on this topic and recognises the differing interpretations of even well-used terms such as “impact investing”. It is worth noting for present purposes that the FCA’s proposals exist at entity and product level. At the entity level, before using Responsible or any of the Sustainable product labels, the relevant entity will have to show how ESG considerations are embedded in its investment decision-making and in the exercise of its ownership rights.

Disclosures

The disclosure requirements under consultation go further than the December 2021 rules for asset managers, life insurers and FCA-regulated pension providers (see above). They would go beyond climate-related information to cover sustainability and environmental and societal impact more broadly. As already noted, the requirements would exist at two levels: consumer-facing and more detailed disclosures.

- Whilst much is still up for discussion, the FCA anticipates the consumer-facing disclosures would include (for example) the objective of the product including sustainability objectives, the approach towards stewardship of investments and the proportion of assets allocated to sustainable investments. The FCA recognises that inevitably consumers will struggle to comprehend some of the vocabulary and concepts. It is still considering how best to overcome this (key) hurdle. Note that these proposed disclosures gel with the Guiding Principles set out in the FCA’s Dear Authorised Fund Manager Chair letter earlier in 2021 (summarised above).

- The more detailed disclosures would be aimed at sophisticated and institutional investors. The FCA anticipates the requirements will exist at both the product and the entity level. At the product level, there is not much detail in the proposals, but the FCA anticipates the more detailed disclosures would (for example) include not simply data but also statements about methodologies used. At the entity level the FCA proposes to build on the rules already in place for asset managers, life insurers and FCA regulated pension providers (see above).

It is worth emphasising that this is a high-level consultation, and the FCA’s direction and views on key issues remain open to be influenced. Whilst the consultation period closed in early 2022, at least one further consultation may be required before the FCA finalises any rules.

Verification and Supervision

The FCA comments that it expects to challenge firms’ claims for themselves and their products, for example during Supervisory interactions or at the point of authorisation (see again the FCA's Dear Authorised Fund Manager Chair covered above). Although not mentioned in the paper, there is the looming risk of enforcement or litigation, a helpful tool to hammer home the FCA's message, albeit one often time- and resource-intensive for the FCA to bring about. More unusually, the FCA is consulting on whether third-party providers ought always to play a role in organisational arrangements and labelling. As the FCA notes this would create cost issues for some, but it might serve to bring about a higher level of disclosure across the board.

What Next?

The FCA has a clear mandate in respect of ESG. Whether or not directly captured by the new or proposed rules, regulated firms should consider any environmental credentials the FCA advances as part of their marketing or profile raising. They should at the bare minimum look at the FCA's Guiding Principles. Those firms captured by new rules (for example those with premium or standard listings or asset managers) should be sure to partner with the right team of external service providers to ensure they understand what they are required to do, but also what the state of the art is in respect of data and labelling. The FCA will be asking questions about compliance with these rules and businesses active in multiple jurisdictions will need to harmonise compliance.

More generally, whilst not a legal requirement, businesses should use this moment of flux to adopt a framework that will set them up not just to comply with UK law (and the laws of all the jurisdictions in which they operate) but also to meet the constantly evolving landscape of public and stakeholder expectations on ESG.

ENDNOTES:

[1] An international and non-governmental body founded and chaired by Michael Bloomberg.

[2] The Guiding Principles do not apply to funds that take ESG considerations into account in making mainstream investment decisions.

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