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SDR and labels policy
Financial Conduct Authority
12 Endeavour Square
London E20 1JN
United Kingdom

Submitted via email to: cp22-20@fca.org.uk

Re: Consultation Paper ("CP22-20") on Sustainability Disclosure Requirements and investment labels

Dear Sir/Madam:

State Street Global Advisors[1] appreciates the opportunity to provide feedback on the second consultative paper issued by the Financial Conduct Authority ("FCA") regarding *Sustainability Disclosure Requirements (SDR) and investment labels*.[2]

There have been several helpful revisions compared to the earlier discussion paper ("DP21-04"), issued by the FCA in November 2021,[3] to which State Street Global Advisors responded.[4] State Street Global Advisors continues to support the FCA's work to enhance transparency of climate and wider environmental and/or social-related risks and opportunities across the investment chain in addition to tackling potential greenwashing practices.

In particular, we welcome the FCA's stated commitment to global standardisation. Leveraging the recommendations issued by the TaskForce on Climate-related Financial Disclosures ("TCFD") is a helpful starting point. TCFD has been endorsed by global firms, with many FCA-regulated firms, including State Street Global Advisors, evolving their reporting capabilities in recent years. However, even with TCFD-aligned rules being mandated in the UK,[5] there is a long way to go before TCFD will be fully embedded into investee companies' public disclosures. There may be widescale improvements should governments and

[1] SSGA is the investment arm of State Street Corporation. With $3.5 trillion in assets under management* as of 31 December 2022, SSGA is one of the largest asset managers in the world. *AuM as of 31 December 2022 includes approximately $59 billion of assets with respect to SPDR® products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. For more information, please visit SSGA's website at www.ssga.com.
[2] FCA Consultation Paper on SDR and labels, cp22-20.pdf, October 2022
[3] FCA Discussion Paper on SDR and labels (DP 21-4), November 2021, see here
[4] SSGA response to FCA on DP21-04, see here
[5] UK to enshrine mandatory climate disclosures for largest companies in law - GOV.UK (www.gov.uk)

regulators endorse global standards under development, for example, by the International Sustainability Standards Board ("ISSB").[6] Additionally, mapping[7] these proposals against similar regulatory regimes, namely, the EU's Sustainable Finance Disclosure Regulation ("SFDR")[8] and the U.S. Securities and Exchange Commission ("SEC") proposals,[9] is essential. Harmonisation across these regimes—or, at least, clarification with respect to their interoperability – is of particular importance to global firms and investors. Inconsistent terminology, disclosure, as well as naming and marketing rules, increase the cost of sustainable investing, which will in turn increase costs for end-investors/consumers.

Divergence across national sustainable disclosure and labelling regimes is also giving rise to different interpretations of what constitutes a 'sustainable investment'. For example, in the regulatory regimes proposed by the FCA, the European Securities and Markets Authority ("ESMA") and the U.S. SEC, there are fundamental differences in the qualifying criteria to obtain a 'sustainable label', as outlined in our detailed comments below. This is, in our view, entirely counterintuitive to common supervisory objectives of enhancing investor protection and tackling potential greenwashing. Given legal uncertainty and unclear supervisory expectations have impeded implementation work in other jurisdictions to date, we suspect that this aspect of the regime, if not calibrated correctly, could be detrimental to its overall success. The FCA should clarify its expectations for the interim period in which it has finalised its Policy Statement and is still considering the application of SDR and the labels to overseas funds.

Moreover, an important consequence of the labelling criteria proposed in the UK regime is the limited funds that would qualify for a sustainable label, which, in turn, could result in retail investors being exposed to increased concentration risk. For instance, 'sustainable focus' funds must be primarily invested in sustainable investments meeting a "credible standard of environmental and/or social sustainability".[10] In practice, we expect that it is going to be only developed large cap stocks in certain sectors that can satisfy this requirement. As retail investors and intermediaries in the UK are likely to be focused on investing in sustainable funds, retail investors' investments could be channelled into highly concentrated sectors. This would not result in suitable outcomes for retail investors, nor does it appear to be compatible with our enhanced obligations under the FCA's new 'Consumer Duty'. In addition, although we understand the decision to require consumer-facing product disclosure, there is a real risk of retail investors not delving into all relevant fund documentation where a regulatory label exists.

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[6] IFRS - Exposure Draft and comment letters: General Sustainability-related Disclosures and IFRS - Exposure Draft and comment letters: Climate-related Disclosures
[7] FCA CP22-20, Annex 1, p. 82
[8] EUR-Lex - 32019R2088 - EN - EUR-Lex (europa.eu)
[9] SEC.gov | SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices; and
[10] FCA CP22-20, p. 32, para 4.30

Additionally, the proposed regime does not lend itself to exclusionary index tracking funds. Whilst we appreciate that there needs to be further calibration of the labelling criteria in order to effectively apply the regime to index tracking funds, we do not believe index tracking funds should be precluded entirely. State Street Global Advisors would be happy to discuss this further with the FCA.

Consistent with our 2022 letter, State Street Global Advisors strongly welcomes the unequivocal clarification that there is no intended hierarchisation between the new sustainable investment labels. We also support the removal of obsolete categories such as ‘not considered to be sustainable’ or ‘responsible’. These changes are crucial to avoid incentivising portfolio allocation away from high-emitting companies and sectors---which would be to the detriment of those companies obtaining financing to adapt their business in line with the UK government’s net zero commitment.

Overall, we continue to support the FCA’s work. Immediately below is our feedback on specific issues related to scope and timing, classification and labelling, disclosures, as well as distributors/other intermediaries.

State Street Global Advisors’ Recommendations

Scope and Timing

We agree with the FCA’s stated objective to introduce a disclosure and labelling regime that helps investors distinguish between sustainable investment products, while also combatting potential greenwashing, and increasing transparency of sustainability-related risks posed to investment portfolios. However, we are concerned that the UK SDR and labelling regime is not calibrated suitably for:

- **Overseas Funds**

  Many global asset managers, including State Street Global Advisors, are undertaking significant implementation work to meet increased regulatory expectations in relation to sustainable investing. This includes entity-level and product-specific disclosure requirements, periodic reporting, considerations on the use of sustainable terms in fund naming conventions and marketing materials. We would support a holistic and consistent regulatory framework, in developing the UK SDR and labels, for both domestic and offshore funds, given they are part of the same distribution ecosystem.

  Timely clarification on the application of the UK SDR and labels to overseas funds is crucial, both for FCA-regulated firms that market and distribute products globally, as well as UK-incorporated firms investing globally and seeking to qualify for an FCA sustainable product label. We recommend that the FCA advance its additional consultative work on extending the regime to overseas funds and provide guidance to firms on the interaction of the UK SDR and labels with similar regimes existing in other jurisdictions.

The volume of work required by firms and supervisors to comply, review and approve precontractual disclosures and marketing rules should not be underestimated. We therefore encourage the FCA to advance its work on the application of this regime to overseas funds, taking into consideration the need for sufficient implementation periods.

- **Index-based Investment Strategies**

We continue to recommend a flexible approach in the application of these proposals to index-based investment strategies. Investment managers managing index-based strategies have limited input with respect to the methodology or standards applied by index providers.

Index providers have developed sustainability-related index products in the market, which are created using the index providers' proprietary index construction methodologies and using third-party data sources. Currently, most index providers do not provide investment managers transparency, nor are they subject to legal liability, regarding the construction of their index products.

The imposition of responsibility on the manager (firm) to ensure that the index meets the conditions and thresholds associated with the label is inappropriate. Index tracking managers do not have access to the intellectual property, the applicable data sets or resources required to do so. Similarly, the timeframes within which the benchmark provider can change the constitution of the index are likely to be different to those required to notify investors and the FCA of a change in label. Whilst we agree that proportionate due diligence and periodic oversight of the index provider and index methodology is appropriate, we believe that index providers should be legally responsible and accountable for ensuring the accuracy of the indices they provide.

- **Multi-asset Funds**

Multi-asset funds invest across the investment universe, and may hold equities, bonds and cash. There are benefits for retail investors investing in multi-asset funds, particularly given the diversification of assets across a broad range of strategies, sectors and geographies. Since the framework does not provide for a fund attaining more than one label, we do not see how such funds could ever have a sustainable investment label.

Furthermore, narrowly defined, ambiguous and/or outstanding labelling criteria underlining the new sustainable labels could lead to unintended consequences. Specifically, the proposals appear to exclude a significant proportion of the investment universe, which not only disadvantages those asset classes and funds, but would also considerably reduce retail investor choice and, possibly, expose retail investors to increased concentration risk.

With respect to the proposed implementation timelines, we appreciate that the FCA has taken a measured approach by phasing in TCFD-aligned rules starting predominantly with the largest public companies. However, we do not expect to see the UK TCFD-aligned rules to become fully embedded into reporting capabilities immediately, particularly in view of the nascent state of reporting today and the need to evolve certain technical aspects (*e.g.*, measurement methodologies for all categories of Scope 3 greenhouse gas emissions). From a practical perspective, updating investment strategies and fund objectives requires regulatory approval and, where applicable, a shareholder vote. The amount of work that is required to implement and enforce such a regime should not be underestimated.

Classification and Labelling

We agree that a standardised product classification and labelling system would benefit retail investors, particularly with respect to comparing the sustainability characteristics and features of sustainability products. However, the proposals do not adequately capture the entire existing investment universe.

The proposed labelling regime has been significantly revised compared to the initial proposals under discussion in DP21-04. The FCA now distinguishes between three types of sustainable products (sustainable focus, sustainable improvers and sustainable impact) according to “the nature of the objective and the primary channel by which each can plausibly achieve or encourage positive sustainability outcomes.”[11] As noted in our introductory comments, we support the changes to the overarching labels themselves; specifically, the removal of the ‘responsible’ and ‘not promoted as sustainable’ categories, in addition to the clarification that there is no hierarchy between funds with an FCA sustainable label, and those without one.

The success of SDR and labels, in our view, lies with their comprehensibility – retail and institutional investors, investment managers, distributors, supervisors and other financial market participants must possess a clear understanding of the way in which the labels are constructed. As such, we do not believe specifying a specific “primary channel” in which a sustainable outcome has to be achieved per label is intuitive or investor-useful. We recommend that the FCA delete references to ‘primary channel’ when distinguishing between each sustainable label. Retail investors can navigate sustainable products according to the investment objective.

[11] CP22-20, p. 6

Furthermore, there are areas in which the proposed labelling criteria are too restrictive, or do not accurately reflect sustainable investing practices today. Our main concern is unintended consequences resulting from niche labelling criteria that discourage retail investors from seeking diversified exposures.

Specifically, under the 'Sustainable Focus' category, the FCA should clarify its expectations with regards to the "credible standard" to which an investment fund assesses its portfolio in order to obtain the sustainable focus fund label. We assume that this is not to be interpreted as independent assessment or assurance by a third party, since the FCA recognises the challenges of requiring third-party verification at this stage.[12] However, it should be clarified that an independent assessment could be satisfied in-house. In addition, it would be helpful to provide some examples of the types of standards that the FCA would consider credible.

<u>Disclosures</u>

We are supportive of enhanced transparency in relation to the features, characteristics and objectives of a fund using a sustainability-related term.

- **Consumer-facing Product-specific Disclosures**

As mentioned, we understand the rationale "*to standardise information on the product's key sustainability attributes*" through the additional consumer-facing product-specific disclosures; however, we consider that to be the role of the overarching product labels and their corresponding definitions. The definition of each of the three labels describe, in sufficient detail, the objectives under which a sustainability outcome will be achieved. Bifurcating disclosures, in a way that results in retail investors receiving less, simplified or different information to that of an institutional investor invested in the same product, could act as a deterrent for retail investors thoroughly assessing all relevant fund documentation. In our view, all investors should be on a 'level-playing field' with uniform access to a product's sustainability-related information.

- **"Unexpected investments"**

The proposals envisage disclosure of "*holdings that* [a] *firm would reasonably expect consumers of the product to find 'surprising*." This could lead to broad and diverse interpretation and application across firms because there are different levels of understanding of sustainability in the retail market. To reduce the likelihood of investment managers being required to make highly speculative, even subjective, assessments, which in turn could (by inclusion or omission) confuse or mislead end investors, the FCA should provide additional guidance/ examples of the types of investments it would consider surprising in this regard. There may also

[12] CP22-20, p. 48, para 4.79

be negative connotations associated with the term “unexpected”, especially where those investments are aligned with the fund’s investment strategy.

- **Notices on Overseas Domiciled Funds**

For global investment managers, a consistent holistic framework for domestic and overseas funds would be preferable. We welcome the FCA further considering this aspect of the regime in due course, with another consultation planned later in the year. We appreciate that the consultation paper is seeking to find an interim solution, by requiring prominent notices on overseas domiciled funds to the effect that they are not subject to the UK regime, in the absence of clarity on its application to overseas funds. It should be highlighted that this still requires implementation and, therefore, could be considered somewhat disproportionate as an interim solution.

- **Investor Stewardship**

We agree with the proposed minimum requirement for attaining any sustainable label should be maintaining an active investor stewardship strategy in a proportionate manner. However, demonstrating “continuous improvement” in the sustainability of a product through investor stewardship is likely to be difficult to measure in practice, especially in terms of linking it to a specific sustainable outcome. In addition, we request clarification that the requirement to disclose an investment stewardship strategy can be satisfied through reference to existing group-level stewardship policies and program.

Naming and Marketing

We fully agree that investment funds’ naming conventions and marketing materials should be clear, fair and not misleading. There are instances, however, where the requirements may coincide with other restrictions. For example, index tracking funds are often obliged to use the name provided by the index provider within the fund name. It would therefore be problematic to enforce naming and marketing restrictions on such funds in the absence of applying the regime to index providers.

In conclusion, State Street Global Advisors, once again, appreciates the opportunity to comment on the development of the UK Sustainable Disclosure Requirements and investment labels. Please do not hesitate to contact either of us should you have any questions or if you would like to discuss our comments further.

Yours sincerely,

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