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UK Sustainable Finance Regulatory Developments

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Recent UK regulatory sustainable finance developments

The following regulators having recently been developing the UK's approach to sustainable finance:

- Bank of England (**BoE**).
- Financial Conduct Authority (**FCA)**.
- Prudential Regulation Authority (**PRA**).

In this guide, we will begin with the work the FCA has been carrying out to develop the UK's sustainable finance regime.

FCA development of the UK's SDR and Taxonomy regime

Throughout 2021, the FCA has been increasing its capacity to focus on ESG and, in April 2021, established a webpage about its work on climate change and sustainable finance. The FCA has also appointed a Director of ESG to develop the FCA's approach to sustainable finance in the UK and globally. As with the EU, key planks of the FCA's work is the development of SDR and a related taxonomy. The FCA is developing its SDR through the publication consultation and discussion papers which are examined below.

Development of SDR – climate change disclosure rules

In June 2021, the FCA published proposals on climate-related disclosure rules for asset managers and asset owners in CP21/17 and for listed companies in CP21/18. In December 2021, the FCA published its policy statements and new rules on climate-related disclosure rules for asset managers and asset owners in PS21/24 and for listed companies in PS21/23.

The new disclosure rules take effect from January 2022 and apply on a comply or explain basis and take effect for accounting periods beginning on or after 1 January 2022.

In this article, we focus on the FCA disclosure requirements in PS21/24 to introduce TCFD-aligned disclosure requirements for asset managers, life insurers, and FCA-regulated pension providers, with a focus on the information needs of clients and consumers.

Development of SDR – climate change disclosure rules cont'd

A summary of the key points of the proposed rules as finalised in PS21/24 is set out below.

Scope	Entity level disclosure	Product level disclosure
Entities **asset managers** such as portfolio managers, UK UCITS management companies, full-scope UK AIFMs and small authorised UK AIFMs. **asset owners** such as certain life insurers and pure reinsurers and non-insurer FCA regulated-pension providers Subject to: A diminimis threshold, it is not proposed to apply these requirements to firms that have less than £5 billion in AUM or administration on a 3-year rolling average – which will be assessed annually. Proposals do not apply to defined benefit pension schemes.	**Obligation** Firms will be required to make annual reports on how they take climate-related risks and opportunities into account in managing or administering assets on behalf of their clients and consumers. These disclosures must be made on the firm's main website.	**Obligation** Firms will be required to make annual disclosures in respect of the **individual products** or **portfolio management services** they offer. Annual disclosures must be published on the firm's website and put in appropriate client communications or upon client request in specific cases. The FCA does acknowledge that this would not always be appropriate, for example, in the case of discretionary services provided to individuals. Therefore, the FCA is proposing that such product level disclosures should be made to the client upon request, once a year.
Products: **asset managers** products include: authorised funds, unauthorised AIFs and discretionary portfolio management services. **asset owners** products include**:** insurance-based DC pension schemes, non-insurance based DC pension schemes and SIPPs.	**Contents of disclosure** The contents of the report must be consistent with the TCFD's recommendations – which require that firms consider and disclose climate-related risks in four areas – namely governance, strategy, risk management and metrics and targets. Must include a signed compliance statement.	**Contents of disclosure** These disclosures would comprise a baseline set of core, mandatory carbon emissions and carbon intensity metrics, additional metrics where possible and a scenario analysis. Firms must include disclosures on governance, strategy and risk management insofar as they are materially different to disclosures made at entity level and where firms consider that more detailed information would be useful to clients and consumers.
Territorial scope: all in scope FCA regulated firms with respect to their assets managed or administered from the UK, regardless of where the client, investors, product or portfolio is based.	**Impact of delegation** Where asset managers delegate (i.e. in a host ACD scenario), the delegation should include how climate-related matters have been considered when selecting the delegate – i.e. ESG-related due diligence on delegates will effectively become mandatory.	

Development of SDR – climate change disclosure rules cont'd

Implementation and Interaction with SFDR

Implementation

The FCA intend to implement its proposed new rules and guidance in a new Environmental, Social and Governance (**ESG**) Sourcebook. Initially, the ESG Sourcebook will relate to the climate-related disclosures, but the FCA anticipates that it will expand to cover related and wider ESG topics over time.

Timing - Phase 1 – Effective 1 January 2022

Asset managers with Assets under Management (**AuM**) in excess of £50 billion and asset owners with AuM (or under administration) in excess of £25 billion in relation to in-scope business. First disclosures to be published by 30 June 2023 and subsequent disclosures by 30 June each calendar year. In relation to "on demand" disclosures to institutional clients, firms must provide the information from 1 July 2023.

Timing - Phase 2 – Effective 1 January 2023

ESG Sourcebook to apply to remaining in scope asset managers and asset owners. First disclosures to be published by 30 June 2024 and subsequent disclosures by 30 June each calendar year. In relation to "on demand" disclosures to institutional clients, firms must provide the information from 1 July 2024.

Interaction with SFDR

Where disclosure requirements under EU rules cover matters similar to those under the TCFD recommendations (for example, certain carbon emissions metrics), the FCA aims to ensure consistency both with the EU and internationally.

Waivers

The FCA does note in PS21/17 that a firm can apply for a waiver if it believes that making the required disclosures for a particular product would be unduly burdensome.

Development of ESG disclosure rules - FCA Dear Chair letter and DP21/4

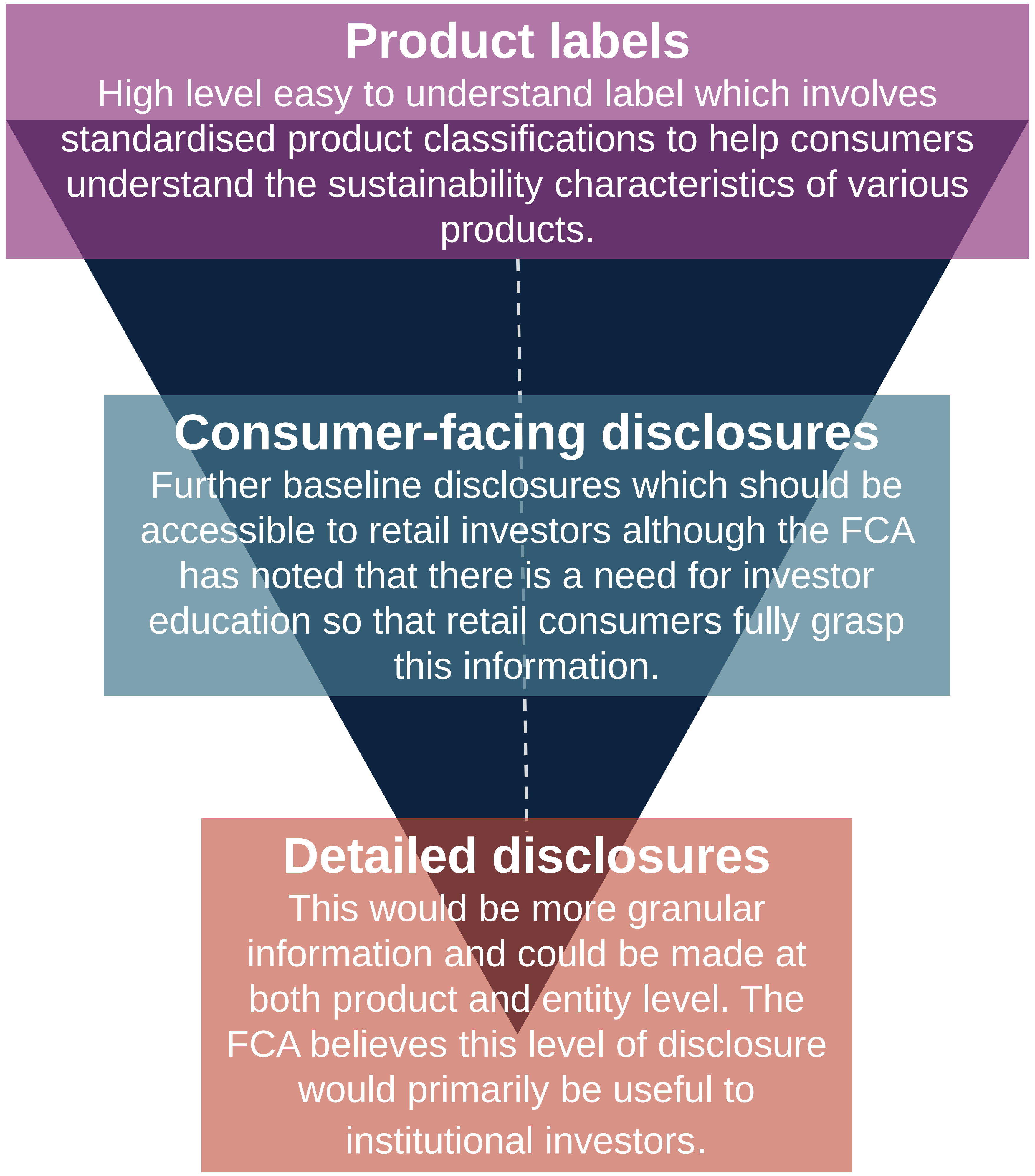
In **July 2021**, the FCA published a Dear Chair letter addressed to the chairs of authorised fund managers (**AFMs**) containing guiding principles on design, delivery and disclosure of ESG and sustainable investment funds. The FCA is clear that authorised funds should describe their investment strategies clearly and that assertions made regarding sustainable goals should be reasonable and substantiated. Examples of poor practice included:

- misleading ESG related names
- unsubstantiated claims of positive environmental impact
- proposed holdings at odds with stated ESG claims

The FCA has published a set of guiding principles, and for further information on these guiding principles, please see our article here.

In **November 2021**, the FCA further developed its thinking on the UK's SDR and published a discussion paper (DP21/4) on sustainability disclosure requirements and investment labels. The FCA is seeking initial views on SDR for asset managers and certain FCA-regulated asset owners, and a new labelling system for sustainable investment products. Acknowledging that some UK firms may also be covered by the EU SFDR, the FCA is seeking views on how the UK regime can remain consistent with the SFDR in DP21/4.

The FCA is proposing a three-tiered disclosure regime with both entity and product level disclosures. Under this approach, the entity-level and product-level disclosure requirements would build on the FCA's TCFD-aligned disclosure requirements as set out in PS21/24.



Proposed Product Label Regime

The FCA is proposing that the labelling regime should use objective criteria and descriptive labels such as setting out the proportion of sustainable investments or the nature of the product's objectives. The FCA does not believe that subjective labels such as traffic lights would be appropriate for a regulatory regime, and it would be difficult to supervise effectively. The FCA has also set out a proposed mapping for the UK label system to the EU SFDR.

		Sustainable		
Not promoted as sustainable	Responsible The product may have some sustainable investments.	Transitioning The product has sustainable characteristics, themes or objectives; low allocation to Taxonomy aligned sustainable activities.	Aligned The product has sustainable characteristics, themes or objectives; high allocation to Taxonomy aligned sustainable activities.	Impact The product has objective of delivering positive environmental or social impact.
FCA proposed indicative mapping of UK labels to the EU SFDR				
Article 6 SFDR	Article 8 SFDR	Article 8 SFDR	Article 9 SFDR	Subset of Article 9 SFDR

The FCA is also considering how overseas funds marketing into the UK would be treated, and it is exploring the best approach to introducing SDR requirements for financial advisers in due course.

The FCA is seeking industry input on its proposals and expects to publish a consultation paper in Q2 2022.

Key PRA developments

The PRA is continuing its work on its supervisory approach to climate-related financial risks and expects firms to have fully embedded its Supervisory Statement 3/19 by December 2021. The five key expectations under SS3/19 are:

- embed climate-related financial risks into their governance framework;
- under the Senior Managers Regime (SMR), allocate responsibility for identifying and managing climate-related financial risks to the relevant existing Senior Management Function (SMF), and ensure that these responsibilities are included in the SMF's Statement of Responsibilities;
- incorporate climate-related financial risks into existing risk management frameworks;
- undertake longer-term scenario analysis to inform strategy and risk assessment;
- develop an appropriate approach to climate disclosure in line with the TCFD framework

Practical considerations for firms

The development of the UK ESG regime will require considerable work for affected firms as the government and the regulators develop their legislative and regulatory stance. While some changes are already clearly set out, such as the PRA's SS3/19, firms should be aware of the direction of travel that HM Treasury and the regulators have given and should be considering the following issues:

Interaction between UK/EU Sustainability regimes

Certain firms will be affected by EU SFDR and Taxonomy regime as well as the requirements of the UK regime and will need to consider how to manage differing approaches. The FCA has acknowledged that this may be an issue and, in DP21/4, is looking for views as to how contradictions and undue complexity can be avoided.

For example, it is worth noting that the EU requires website disclosure for tailored portfolios, whereas the FCA acknowledges that this may not be appropriate and is proposing to allow firms to provide that disclosure to clients on request. It remains to be seen how far this approach will go and whether, for example, model portfolio solutions (MPS) fall under the tailored portfolio category or whether the FCA would regard MPS as suitable for website disclosures.

In addition, it looks like the FCA is considering a more flexible approach to whether disclosures are made at an entity level or group level, whereas current ESA guidance suggests that the EU regime will require entity level disclosure.

Labelling

The FCA has given an indication of how it intends to map its labelling regime against the SFDR regime and firms could begin considering how it would label appropriate products.

Supervisory approaches

In September 2021, the FCA explained in a speech that it expects climate change to form a central part of how firms do business. This will increasingly form part of the FCA's supervisory engagement strategy, and firms should expect to be subject to greater challenge on these issues.

As mentioned above, the PRA is continuing to work on its supervisory approach to climate-related financial risks and expects firms to have fully embedded its Supervisory Statement 3/19 by December 2021. From January 2022, the PRA will start to actively supervise firms against these expectations.

As climate change comes into the PRA's core supervisory process, the assessment of climate-related financial risks will be included in all relevant elements of the supervisory cycle, i.e. the management of climate-related financial risks will become subject to formal supervisory assessments. The PRA will expect boards, firm executives and senior managers to be able to demonstrate their understanding of the risks climate change poses to their areas of responsibility and their plans to address them.

Firms should ensure that they are adequately prepared for the growing focus on climate change and ESG as part of their regulatory supervision.

Investor Education

In DP21/4, the FCA acknowledges that typical investor language may not be easily accessible to retail investors and that there will need to be a certain amount of investor education, and it is carrying out further investigation into how best to explain relevant terminology and how to present disclosures in a digestible manner. The FCA is considering the use of an ESG factsheet template and welcomes industry views on this.

Involvement in Innovation initiatives

As firms consider how best to get to grips with disclosure regimes which may vary across the jurisdictions in which they operate, it may be worth considering whether to become involved in regulatory innovation projects. For example, interested parties can register to review the cohort of innovators working on ESG tools in the FCA sandbox to better understand the technological options that may be available to help firms manage their ESG data.

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