Update on UK government and FCA regulatory developments – ESG and climate change

20 December 2021

1. Speed read

In the context of COP26, the UK has taken the opportunity to issue an array of documents and proposals, hoping to establish its credentials (post Brexit) as a leading light on ESG and climate change, and a rival to the EU, which is already well down the track with its own ambitious proposals. Some EU initiatives are indeed already in force (eg the Sustainable Finance Disclosure Regulation or SFDR) and others are shortly to begin to apply (eg the EU Taxonomy Regulation).[1]

This bulletin gives a snapshot of key UK proposals as relevant to banks, investment firms, asset/fund managers and advisers in the UK.

This includes a proposed new regime on transition planning (including mandatory disclosures), the UK's new Sustainability Disclosure Requirements (**SDR**), proposals for a product labelling and classification regime, bringing ESG ratings into the scope of FCA regulation, and introducing a regime similar to that being made for ESG to MiFID II as regards sustainability preferences and financial advisers.

2. How did we get here

In a speech in 2019, the Economic Secretary to the Treasury lay down a marker, referring to the "UK's long history of international leadership on climate change":[2]

"*The financial sector has perhaps more potential than any other part of our economy to bring about a greener future. It is the City that can bring forward new financial products and services to meet rising demand for sustainable investment. It is the City that can unlock capital for renewable energy and other clean technology required to reduce emissions in this country, and overseas. And it is the City, with its restless commercial zeal, that will seize the opportunities of clean and resilient growth, and lead us toward a low carbon future.*

Our Strategy seeks to bring about a complete change in the way the City thinks and acts.

We must ensure the financial risk and opportunities from climate change are integrated into mainstream decision-making. Because let's be clear: the climate challenge poses an existential risk to the future of the planet and, by extension, our economy too.

If our financial system is to remain resilient – and relevant – then the City must adapt.

The threat is real, the opportunities are growing, and the world is watching. So the time for action has come. The City must lead the way."

3. UK initiatives

It is fair to say that it has taken some time for the zeal contained in this stirring call to arms to be reflected in real world proposals and initiatives. But, with a flurry of action, the UK has recently launched various initiatives and proposals, presumably seeking to capitalise on its hosting of COP26 in November 2021 for maximum publicity, both locally and internationally. Some of the key initiatives are set out below.

For those with pan European businesses, it is necessary to contextualise the UK proposals against those on the EU side and consider where there is overlap vs divergence. On this the answer is clear. Put simply, the UK has largely gone its own way in almost all respects bar one – the taxonomy. The UK pointedly says the UK taxonomy *"draws on the EU approach which the UK helped design as a former member state"*.[3] For more on this, see below.

New UK transition plan regime

HM Treasury (**HMT**) has said the UK will be the world's first "Net Zero-aligned Financial Centre" and UK financial institutions will have to have robust firm-level transition plans setting out how they will decarbonise.[4] There is not a lot of detail yet but initially, this seems likely to be imposed on a "comply or explain" basis – ie either you publish a transition plan that aligns with the government's net zero commitment or (if not) explain why.

Initial scope is unclear, but possibly, at the outset, this will comprise asset managers, regulated asset owners and listed companies.

HMT has said the UK will move towards making the publication of transition plans mandatory in 2023.

This will be incorporated into the UK's regime on Sustainability Disclosure Requirements (**SDR**) – in particular, the UK government will *"strengthen requirements to encourage consistency in published plans and increased adoption by 2023. The Government intends to legislate to deliver this"*.[5]

The government is also setting up a Transition Plan Taskforce to bring together industry, academia, regulators and others to develop a 'gold standard' for transition plans, metrics and reporting, by the end of 2022.[6]

The FCA has added to this, saying it will engage with stakeholders in the first half of 2022, with a view to promoting credible and effective transition plans that consider the Government's net zero commitments. It will consider the governance of transition plans, including Board oversight, senior management responsibilities and objectives, and remuneration/incentive structures. It will also consider the content and disclosure of transition plans, building from TCFD guidance

Timing:
Unclear, but as above, FCA stakeholder engagement will begin in H1 2022.[7]

NB: The UK government has also stated as follows, foreshadowing further policy initiatives next year for regulated firms: "*The government will... update the Green Finance Strategy in 2022. This will go beyond the timescales in this Roadmap and set out an* ***indicative sectoral transition pathway*** *out to 2050 to align the financial system with the UK's net zero commitment. The updated strategy will assess industry progress on Phases 1 [disclosures] and 2 [use of disclosures and stewardship]. It will also consider triggers for stronger policy to facilitate Phase 3 [reorienting capital flows] and help ensure that the UK meets its climate and environmental objectives.*"[8]

New UK Sustainable Disclosure Requirements (SDR)

In its roadmap, the UK government has proposed Sustainability Disclosure Requirements (**SDR**s) to be implemented on an economy wide basis.

For FCA regulated firms, further detail has since been provided via a high level FCA discussion paper, however this is likely to develop significantly following market engagement.[9]

Any new proposed disclosures will be an "add on" to the TCFD[10] based disclosure requirements already rolled out or proposed by the FCA (eg for listed companies and asset managers). But the core will be the global baseline sustainability reporting standards to be developed by the new International Sustainability Standards Board (**ISSB**) of the International Financial Reporting Standards Foundation.

Timing:

3 Nov 2021	FCA discussion paper published
7 Jan 2022	Deadline for responses
Q2 2022	Proposed rules to be published for consultation

For those that want more detail:

(a) Consumer facing disclosures – The retail facing layer of disclosure would be a subset of the overall disclosure. It should comprise key sustainability-related information to enable retail to make considered choices about their investments – eg:

- investment product label;
- objective of the product, including specific sustainability objectives;
- investment strategy pursued to meet the objectives;
- proportion of assets allocated to sustainable investments (as per the UK taxonomy);
- approach to investor stewardship;
- wider sustainability performance metrics.

On this, the FCA is likely to prescribe a baseline set of sustainability metrics to enable retail clients to understand the sustainability performance of a relevant product over time (eg carbon reduction metrics). This could include the core metrics required under TCFD disclosure rules, supplemented by other social (S) and governance (G) metrics.

Quite rightly, the FCA recognises that technical language and metrics may not be easy for retail to follow – investor education will need to play a role. But it will also do consumer testing – and possibly propose an ESG factsheet. In any case, the challenges here should not be underestimated.

The consumer-facing disclosure will be designed to be read alongside the Key Information Investor Document (**KIID**), providing additional colour on ESG matters while avoiding duplication of information.

(b) Disclosures for sophisticated or institutional investors – This is intended to support decision-making about both the products they are investing in and their providers. The regime would therefore require both product and entity level disclosures.

Points for possible inclusion:

- Information on the methodologies used to calculate metrics. *"While data gaps exist and methodologies have yet to converge, it is critical that firms are transparent about how they have calculated metrics."*[11] Where proxies, assumptions etc are used to fill data gaps, these would need to be clearly explained.
- Information on data sources, limitations, data quality etc.
- Further supporting narrative, contextual and historical information.
- Further information about UK taxonomy alignment.
- Information about benchmarking and performance.

The FCA also suggests that the Principal Adverse Impact (**PAI**) indicators under the SFDR regime could be a starting point for environmental metrics beyond climate, as well as for a set of minimum safeguards for social indicators.

(c) Entity level disclosures – This has not been fleshed out. But the FCA notes how important such disclosures may be to clients/investors (retail and otherwise), both in terms of how firms manage sustainability risks, opportunities and impacts, and more broadly, the impact firms are having on the environment (E) and society (S). *"It also enables existing clients and consumers to hold their providers to account."*[12]

Helpfully, the FCA also says it will propose *"flexibilities that would allow firms to make disclosures at the level of consolidation which they consider would be most decision useful for clients and consumers. This approach also recognises that many firms are already making TCFD-aligned disclosure rules voluntarily at a group level."*[13]

Also helpfully, the FCA has gone out of its way to ask for feedback on aspects of SFDR that may be useful to consider or build on, in constructing the stand alone UK regime. It also wishes to take into account what disclosures firms/groups may prepare under the ISSB sustainability standards (ie corporate reporting).

New product labelling and classification regime

In its roadmap, the UK government has proposed for the FCA to develop a new product labelling and classification regime to make it easier for retail investors to consider and assess the various products available to them. Further detail has since been provided via a high level FCA discussion paper, but as with the SDRs, this regime remains subject to potentially much development following market engagement.[14]

The FCA notes that retail investors appear to be strongly influenced by what they consider objective and reliable product labels. It also considers that classifying and labelling investment products according to objective criteria, and using common terminology, could help to combat potential greenwashing and enhance trust.

The FCA suggests two options: firstly, a regime that will only apply to products that make sustainability claims or are marketed as being sustainable; OR secondly, a regime that covers all investment products available to retail investors. For the second option, the FCA proposes five categories of product labelling:

		Sustainable		
Not promoted as sustainable	**Responsible** (may have some sustainable investments)	**Transitioning** (sustainable characteristcs, themes or objectives; low allocation to Taxonomy – aligned sustainable activities)	**Aligned** (sustainable characteristcs, themes or objectives; high allocation to Taxonomy – aligned sustainable activities)	**Impact** (objectives of delivering postive environmental or social impact)

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.

For further detail, see Appendix 1.

Importantly, the difference between 'Aligned' and 'Transitioning' is the portion of assets considered sustainable (based on the UK taxonomy or other criteria). That is, a product in the 'Transitioning' category would (at the time of the assessment) have a low allocation to sustainable activities, while 'Aligned' products would have a higher allocation, presumably above a specified threshold). On the other hand, this approach would recognise that investors can play an important role in facilitating the transition and avoid discouraging investment in economic activities and projects in the process of transitioning to a more sustainable profile.

Entity level criteria may be added on top of product level criteria – ie to use a 'Sustainable' or 'Responsible' product label, the product provider must demonstrate key attributes such as: meeting existing governance, systems and controls requirements; identifying how ESG considerations are integrated into investment processes to minimise risks and take advantage of opportunities; stewardship; voting/engagement etc.

Timings:

3 Nov 2021	FCA discussion paper published
7 Jan 2022	Deadline for responses
Q2 2022	Proposed rules to be published for consultation

For those who want more detail:

At minimum, this will apply to retail products but beyond that the scope is unclear – eg it is unclear whether the products covered will just be asset and fund management products or if PRIIPs, retail investment products, or pension products may be in-scope too.

There are two reference points for consideration. First, the ambitions of the product – eg its objectives, strategies, how it is pursuing them etc. Secondly, the proportion of its investments currently allocated to sustainable projects or activities (possibly with the UK taxonomy as a reference point).

The FCA wishes for its labelling and classification system to use objective criteria and descriptive labels; eg referencing the proportion of sustainable investments, or the nature of the product's strategy. Conversely, they wish to avoid a value judgement as to whether a product is 'good' or 'bad'. Eg they have not suggested 'medals' or 'traffic lights'. They also consider this may be more difficult to supervise.

They wish for the system to be built on and mappable against existing standards. It should be simple and intuitive to understand. It should also be verifiable – and the system as a whole capable of being supervised effectively.

Helpfully, the FCA notes the desire to be consistent/compatible with the current market and existing initiatives, flexible enough to cope with market developments, and broad enough to reflect the range of products in the market, ideally using terminology already familiar to investors/the industry.

These points are well made and welcome, although it is open to question as to whether what has been proposed meets all these tests.

It is likely that there would need to be a baseline level of prescription in the criteria that must be met for a 'Responsible' or 'Sustainable' label – presumably something quantifiable, with measurable thresholds. Possibly there would be higher threshold entity level standard for 'Sustainable' products, relative to 'Responsible' products.

Other points to note in relation to both the SDR and labelling

- **Third party verification, audit etc** – To build trust and support a robust approach, the FCA wishes to explore whether there could be a role for independent third party verification of product level disclosures.
- **Advisory group** – The FCA has created the delightfully named DLAG or Disclosures and Labels Advisory Group, including industry experts, trade bodies and consumer representatives, to provide the FCA with feedback, technical advice and constructive challenge. This is welcome.
- **New UK overseas funds regime** – The FCA is considering how overseas funds marketed into the UK should be treated, including in respect of the new post Brexit UK overseas funds regime that will essentially allow EU UCITS to be sold/continue to be sold in the UK to retail.
- **Derivatives and short selling** – With a nod to the debate within the EU on such matters, the FCA specifically requests feedback on derivatives and short selling issues – eg whether the use of derivatives in pursuing sustainability strategies should have a bearing on classification, as well as views on the use of short-selling strategies.
- **Securities lending** – Similarly, the FCA invites feedback on this in the context of sustainable investing; eg whether certain requirements should apply and whether sustainability should be taken into consideration in stock lending criteria.

Financial advisers to consider ESG when providing advice

HMT and the FCA are exploring *"how best to introduce sustainability-related requirements for financial advisors".*[15]

The FCA in particular considers it appropriate to confirm that *"advisers should consider sustainability matters in their investment advice and ensure their advice is suitable and reflects consumer sustainability-related needs and preferences. We acknowledge that the EU has taken this approach in introducing suitability requirements for different types of financial market participants. However, these were not onshored in the UK prior to the UK's withdrawal from the EU."*[16]

It appears this is the subject of ongoing consideration, with a detailed consultation and cost benefit analysis to be prepared.

Timings:
Unclear.

ESG ratings provides

In its roadmap, the UK government explains how important ESG ratings are to the investment process, and how much differentiation exists in methodologies and scores. On this, the FCA has previously noted: *"One recent study... calculated an average overall correlation of 0.54 across the six rating providers in their sample – much lower than the 0.98 correlation observed between the largest three credit rating agencies".*[17]

The UK government also have concerns as to data gaps and assumptions. They are therefore considering bringing such firms into the scope of FCA regulation.

Timings:
Unclear, but further announcements due in 2022.

Digitisation of reported information

In its roadmap, the UK government expresses concerns as to the demand for sustainability disclosures to be easily read and analysed electronically and acknowledges calls from the industry as to enhanced digitisation and storage of sustainability information to support machine readability.

"The government and regulators are considering how to deliver an approach to digitisation of sustainability data that builds on the UK's existing digital infrastructure for reporting. This includes assessing the value of a centralised register for ESG data."[18]

Timings:
Unclear.

Asset managers and owners

In its roadmap, the UK government outlines how important stewardship is as "supporting a market-led transition to a more sustainable future."[19] It wants asset managers and owners to actively monitor, encourage, and challenge investee companies, promoting long-term, sustainable value generation. It wants them to take account of the information generated by the UK's SDR regime when "allocating capital", and sign up to the revamped UK Stewardship Code. It wants them to show leadership; eg by joining net zero initiatives and publishing **a high-quality transition plan by the end of 2022**, including near-term science-based targets and a clear pathway for their organisations to become "net zero".

The government says it will assess progress on these matters at the end of 2023, with the suggestion that further regulatory initiatives will be considered if insufficient progress has been made.

In fact, it seems almost certain that the results of this assessment will be mixed, especially given the limited take up of the Stewardship Code – such that more initiatives will be forthcoming.

UK taxonomy

The UK government has clarified its position on this, promising to deliver a UK taxonomy, *"ensuring it has been road-tested in the market as a useful investment tool"*.[20] This will be based on the EU Taxonomy Regulation, and will be intended to create a shared understanding as to what economic activities are "green" vs what are not for UK purposes.

As regards sequencing: *"Disclosure requirements for corporates will come into force prior to those for investment products, enabling the former to feed into the latter."*[21] This will avoid some of the incredibly difficult timing issues asset managers have faced in the EU, with the roll out of the EU's Taxonomy Regulation.

Relevant firms will have to make disclosures against the taxonomy. This will be introduced via the new UK SDRs (see further detail below), presumably via new FCA rules – and will involve corporate or entity level disclosures. For firms with relevant products, product level disclosures will also be required.

Timing:

Q1 2022	First consultation on draft technical screening criteria (**TSC**) for climate change mitigation and climate change adaption objectives, which will be introduced via statutory instruments
Q2 2022	FCA will consult on initial SDR rules
By end 2022	Final rules on initial policy proposals
Q1 2023	Consultation on expansion of climate TSCs and standards for remaining four environmental objectives

For those who want more detail:

- As part of its Brexit work, the UK onshored aspects of the EU Taxonomy Regulation, but not the parts that said what firms actually had to do or by when. This gap has now been addressed.
- The initiative has involved the creation of a Green Technical Advisory Group (**GTAG**), to provide the UK government with independent advice. It is made up of financial and business stakeholders, taxonomy and data experts, and subject matter experts. One strand of its work will involve considering international interoperability (including the potential for equivalence). Interestingly, it will also explore avenues for influencing international taxonomy development in a "race to the top" and *"analyse the implications of and remedies for risks of international fragmentation"*.[22]
- The TSCs will be the subject of consultation and be introduced via statutory instruments. Criteria for the climate change mitigation and adaptation objectives will be based on the EU taxonomy – these are currently under review, with a consultation in Q1 2022. Legislation is expected by the end of 2022.
- Under the UK SDRs, certain companies will be required to disclose the percentage of their capital expenditure, operational expenditure and turnover that relates to taxonomy-aligned activities. Relevant product providers will have to disclose the extent to which relevant products are taxonomy-aligned.
- Taxonomy-alignment will focus on reported data, rather than projections.
- The UK government has said it plans to focus on delivering the UK taxonomy and ensuring that it has been road-tested by the market before changes or an expansion in scope is considered – eg identifying activities which cause significant harm, or adding further transitional activities. This is welcome.
- An Energy Working Group (**EWG**) has been established, alongside the GTAG, to advise the UK government on key energy issues such as hydrogen, carbon capture, utilisation and storage, and nuclear.

4. FCA climate adaptation report

The FCA has issued a Climate Change Adaptation Report.[23] This is an impressive, wide ranging and insightful report as to how the FCA and the firms it regulates are adapting to climate change, and what the FCA is planning in terms of further work and initiatives in the short to medium term. It also:

– summarises the FCA's climate change and ESG strategy;

– provides a timeline of its proposed major ESG publications for the next c.9 months;

– summarises what the FCA considers to be the main climate-related risks to which financial services firms are exposed;

– summarises how it considers firms to be addressing/adapting to climate-related risks and opportunities; and

– discusses the role of capital mobilisation in financing climate change adaptation/mitigation.

The report includes interesting observations off the back of consumer testing, as well as observations on "Climate risk management & the role of derivatives". The FCA also notes it *"will continue to engage with issuers, advisors and investors to better understand whether the current framework for ESG bonds supports the work led by the Treasury on funding the transition to net zero".*

Regulatory objectives

The FCA is clear on the ESG outcomes it wants to achieve – the points on governance, market pricing and ESG ratings below are noted in particular:

– high-quality climate- and sustainability-related disclosures to support **accurate market pricing**, helping consumers choose sustainable investments and drive fair value;

– promote trust and protect consumers from misleading marketing and disclosure around ESG-related products;

– regulated firms have governance arrangements for more complete and careful consideration of **material ESG risks** and opportunities;

– active investor stewardship that positively influences companies' sustainability strategies, supporting a market-led transition to a more sustainable future;

– promote integrity in the market for ESG-labelled securities, supported by **the growth of effective service providers** – including **providers of ESG data**, **ratings**, **assurance and verification services**; and

– innovation in sustainable finance, making use of technology to bring about change and overcome industry-wide challenges.

What will the FCA look at re individual firms

The FCA has foreshadowed what it will look at using its regulatory and supervisory tools to:

– oversee how firms design/deliver/disclose on ESG products – eg to challenge firms on how well the ESG characteristics of products align with their ESG claims and meet client needs/preferences (in other words, greenwashing risk);

– oversee compliance with the new TCFD based disclosure regime – in particular, to help build confidence in the markets for ESG/sustainable products;

– engage with firms to assess the extent to which they are effectively managing the risks and opportunities from climate change, and integrating these considerations within their culture and governance frameworks; and

– engage with firms to assess the extent to which they are supporting the transition to a net zero economy – and where firms have set climate related targets or made net zero commitments, to consider their delivery plans to achieve them.

Three further practical points we would draw out from its report:

– *"Our main focus will be on larger firms in the sectors where there are more likely to be climate-related risks, such as asset management and insurance, and on firms that particularly hold themselves out as 'green'."*

– *"We are considering new areas of focus for future policy work, including promoting **well-designed**, **well governed**, **credible and effective transition plans** that consider the Government's net zero commitments."*

– *"We have begun integrating net zero across our other functions, including Supervision and Authorisations. This may include **setting net zero expectations at the Authorisations gateway** and **incorporating net zero themes and questions into our supervisory assessments**.*

Although not a consultation, the FCA states that it welcomes feedback.

5. Other UK points

Other points firms may wish to note:

- ESG is now a formal priority for the FCA – eg the UK government has asked the FCA to have regard to its net zero commitment when discharging its functions.[24] The FCA has (in its latest business plan) noted ESG as a priority across the markets it regulates.[25] The CEO has committed it to taking a "lead policymaking role" on climate change, issues of sustainability and good governance, publicly emphasising its role in facilitating the transition to net zero. ESG is also now an FCA Board priority and the FCA has appointed a Director of ESG to drive its ESG agenda forward.
- The FCA has issued a specific ESG strategy.[26] This will include developing a policy approach to ESG governance, remuneration, incentives and training/certification in regulated firms. Target milestone: Begin stakeholder engagement in Q2 2022.
- The FCA will begin to issue its own TCFD report – with the first due in the summer of 2022.
- The FCA has a focus on "greentech" and "regtech", conducting various initiatives in this regard, including a "Sustainability TechSprint" in 2021 and a Green Fintech Challenge. [27] The Green Fintech Challenge is being run to support the development and live market testing of new products and services that will aid the transition to a net zero economy. The FCA is especially welcoming application from firms developing innovative green solutions that require regulatory support to bring their proposition to market, especially as regards innovations in the area of ESG data and disclosure.[28] The FCA has also hosted two international regulatory roundtable sessions on GreenTech, with 59 regulators from 36 jurisdictions discussing challenges and coming up with an innovation 'wishlist'. Finally, the next cohort of the FCA Digital Sandbox Pilot will focus on sustainability and climate change, and it has begun work with the City of London Corporation and industry to help develop solutions to ESG data and disclosures issues via a digital testing environment.[29]

6. Recommendations

It remains early days for a number of the UK initiatives described above. For firms with a pan European presence, relevant implementation work in relation to SFDR and the EU taxonomy will continue, but firms may otherwise wish to consider the following actions:

Get organised	In various comments throughout its recent papers, the FCA has emphasised points around governance. In our view, it is looking to see that firms have organised themselves prudently, with sensible governance arrangements to deal with the impact of climate change on a firm's organisation, together with other ESG risks and opportunities. In our view, it is going to become increasingly important to ensure firms take a 360 degree approach – ie integrating climate change and ESG into all relevant functions within the firm, from product development to reporting to IT and to risk management.
Skills	In its recent papers, the FCA acknowledges that it is having to "skill up" on climate change and ESG – and in our view, it will recognise the same for most firms, as they need to develop the skills internally to identify, manage and report on climate change and ESG related matters.
Ensure you are aware of relevant regulatory priorities	The FCA papers referred to above include an excellent snapshot of the way they are looking at climate change and ESG, and what they will focus on in their regulatory work with firms – including day to day supervisory work. Firms may wish to ensure they understand this, and are managing any new or emerging regulatory issues.
Plug into what the industry is doing	Trade bodies are doing a lot of work to get ahead of the regulatory developments discussed in this bulletin, as well as helping firms understand and adapt to the new world. Where you can, we recommend you get involved in this work and leverage it for your internal teams and projects – also to understand emerging best practice and industry views on interpretation issues.
Training	Focus on staff awareness building and training – some of this will likely need to be built over time. But in areas such as product development, this should reflect the current views and expectations of regulators – eg on greenwashing.
Regulatory developments	We expect the proposals set out in this paper to develop rapidly from this point – as a final but obvious point, we therefore recommend your internal team stay on top of regulatory developments and understand the "direction of travel".

7. How can A&O help?

Please get in touch with your usual A&O contact if you wish to discuss the policy initiatives set out above, or if we can help further in any other way. Please also let us know if you would like copies of our other relevant briefings – eg on SFDR, the EU taxonomy, greenwashing risks and issues, and so on.

Appendix
FCA product labelling and classification system

Categories of products	Key points	EU SFDR equivalent
(1) **Sustainable** Divided into three types:	Products that pursue specific sustainability characteristics, themes or objectives alongside delivering a financial return.	NA
(a) **Impact** (objective of delivering positive environmental or social 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. Note: If additionality (whether financial or non-financial) were one of the necessary criteria for impact products, it is likely that fewer products would qualify for an 'Impact' label than those currently categorised as Article 9 funds under SFDR. This may well be a reason to argue for an additional category of 'Impact' products that would only contain a sub-set of the funds currently categorised as Article 9 under SFDR.	FCA considers this would overlap with a small sub-set of Article 9 SFDR products *Commentary: In principal we agree, except that an Article 9 SFDR product must also meet the "do not significantly harm" (**DNSH**) requirement – this does not seem a factor in the FCA's category. So in fact, we would "map" this category to either Article 8 or 9 SFDR depending on the circumstances.*
(b) **Aligned** (sustainable characteristics, themes or objectives; high allocation to UK taxonomy aligned sustainable activities)	Products with sustainability characteristics, themes or objectives and a high proportion of underlying assets (measured according to a minimum threshold) that meet the sustainability criteria set out in the UK taxonomy (or could otherwise be verifiably established to be sustainable, where a taxonomy is not yet available). **Minimum criteria**: Same as transitioning criteria below, plus minimum thresholds for asset allocation.	Article 8 SFDR
(c) **Transitioning** (sustainable characteristics, themes or objectives; low allocation to UK taxonomy aligned sustainable activities)	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; eg via active and targeted investor stewardship. The expectation, therefore, is that this proportion will rise over time. **Minimum criteria**: Evidence of sustainability characteristics, themes or objectives reflected fairly and consistently in the investment policy or strategy and may include some combination of: – restrictions to the investible universe, including investment limits and thresholds – screening criteria (positive or negative) – the application of benchmarks or indices and expected or typical tracking error relative to the benchmark – the entity's stewardship approach as applied to the product	Article 8 SFDR

Categories of products	Key points	EU SFDR equivalent
(2) Responsible (may have some sustainable investments)	Impact of material sustainability factors on financial risk and return considered to better manage both risks and opportunities and deliver long-term, sustainable returns. No specific sustainability goals. **Minimum criteria**: ESG integration, evidence of ESG analytical organisational capabilities and resources, demonstrable stewardship. Notes: The FCA notes that it expects managers to consider material sustainability risks as part of the risk management of an investment product. However, *"the degree to which managers integrate ESG factors in how they manage their clients' investments varies".* Responsible products may therefore have high, low or no allocation to sustainable investments. The criteria applied would not impose any restriction on the investible universe of such funds; exclusions, tilting or allocation thresholds would therefore not be an expectation. However, the criteria could include demonstrable evidence of ESG analytical capabilities and effective stewardship at entity level, applied in the management of the product.	Article 8 SFDR
(3) A product not promoted as sustainable	Sustainability risks have not been integrated into investment decisions. No specific sustainability goals. Notes: The FCA notes that certain *"investment products do not take sustainability considerations into account, even as a form of risk management".* It also refers to the example of an index tracker with no sustainability-related criteria etc.	Article 6 SFDR *Commentary: This may be a stronger view than we might hear from the EU – in particular, we believe the EU is likely to expect managers to take account of ESG risk in all investment decision making and monitoring subject to limited exceptions only based on the specific nature of the product or asset class – eg perhaps the manager of a FTSE tracker fund, a fund containing only G7 sovereign bonds etc.*

References

1. See https://eur-lex.europa.eu/eli/reg/2019/2088/oj and https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852.
2. HMT "John Glen speaks at the Green Finance Summit" (2 July 2019), available at: https://www.gov.uk/government/speeches/john-glen-speaks-at-the-green-finance-summit.
3. HMT "Greening Finance: A Roadmap to Sustainable Investing" (18 October 2021), available at: https://www.gov.uk/government/publications/greening-finance-a-roadmap-to-sustainable-investing.
4. See HMT fact sheet referred to above.
5. As above.
6. See HMT fact sheet and roadmap referred to above.
7. FCA, "A strategy for positive change: our ESG priorities" (November 2021), available at: https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities.
8. See HMT Roadmap to sustainable investing referred to above.
9. FCA Discussion Paper (DP21/4) on sustainability disclosure requirements (SDR) and investment labels – https://www.fca.org.uk/publication/discussion/dp21-4.pdf.
10. This refers to the Task Force for Climate-Related Financial Disclosures – a private sector led group convened by the Financial Stability Board in 2015 to "develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders and insurance underwriters in understanding material risks". In November 2020, the UK Chancellor announced that the UK intends to make TCFD-aligned disclosures fully mandatory across the UK economy by 2025.
11. See DP21/4 referred to above.
12. See DP21/4 referred to above.
13. See DP21/4 referred to above.
14. See DP21/4 referred to above.
15. See DP21/4 referred to above.
16. See DP21/4 referred to above.
17. FCA Consultation Paper (CP) 21/18 on "Enhancing climate-related disclosures by standard listed companies" (22 June 2021) – https://www.fca.org.uk/publication/consultation/cp21-18.pdf.
18. See HMT roadmap referred to above.
19. See HMT roadmap referred to above.
20. See HMT roadmap referred to above.
21. See HMT roadmap referred to above.
22. See HMT roadmap referred to above.
23. FCA, Climate Change Adaptation Report (28 Oct 2021) – https://www.fca.org.uk/publication/corporate/fca-climate-change-adaptation-report.pdf.
24. HMT, "Recommendations for the Financial Conduct Authority: March 2021" (24 March 2021) - https://www.gov.uk/government/publications/recommendations-for-the-financial-conduct-authority-march-2021/recommendations-for-the-financial-conduct-authority-march-2021.
25. FCA, "Business Plan 2021/2022" (17 July 2021) – https://www.fca.org.uk/publication/business-plans/business-plan-2021-22.pdf . Note also that the Financial Services Act 2021 included a new requirement for the PRA/FCA (when making certain new rules) to have regard to "the target in section 1 of the Climate Change Act 2008 (carbon target for 2050)".
26. See FCA strategy referred to above.
27. FCA Climate Change Adaptation Report (28 October 2021) – https://www.fca.org.uk/publication/corporate/fca-climate-change-adaptation-report.pdf, 6.69 etc.
28. FCA, "Green FinTech Challenge 2021" (18 October 2018) – https://www.fca.org.uk/firms/innovation/green-fintech-challenge.
29. See FCA report referred to above.