Delivering positive change, stopping misleading claims

Creating a clear and effective product labelling regime

Climate change and the transition to a net zero economy is a policy priority both globally and in the UK. The investment market has the potential to play an important role in ensuring this transition happens. It can also support other aspects of positive social change.

While the asset management sector could make an important contribution, there is a danger that parts of the market will make sustainability claims (greenwashing) about investment practices. This would be a barrier to achieving a successful transition and will mislead consumers.

Recent experience shows that undesirable practice of this type has already materialised. The asset management sector's desire to capitalise on demand for sustainable investment has seen firms try to launch products which appeal to investors' environmental concerns when they do not, in reality, have credible sustainability characteristics. As the FCA noted in a letter to Chairs of Authorised Fund Managers,

> *"We have seen numerous applications for authorisation of investment funds with an ESG or sustainability focus. A number of these have been poorly drafted and have fallen below our expectations. They often contain claims that do not bear scrutiny."* (July 2021)

Any FCA sustainability product labelling regime must be clearly structured to prevent misleading product claims. One issue arising is that the current concept of ESG - Environmental, Social and Governance – is very broad. Combining questions of environmental sustainability (e.g. the transition to net zero) with other non-financial objectives means that a poorly structured product labelling system could allow investor confusion to persist. It might also mean product providers make claims in one area (e.g. social impact) which allows them to use a product label which, inadvertently, creates an assumption that the product also offers an environmental/sustainability benefit. An effective labelling system should distinguish between these two issues (sustainability and social impact) to prevent this outcome.

The labelling system must also be based on sufficiently demanding standards. This would ensure that the investment practice/asset allocation underpinning products which benefit from the label make a material contribution to non-financial objectives (e.g. supporting the delivery of net-zero or positive social impacts) in comparison with investment products which do not benefit from these labels.

Therefore, the Association of Investment Companies (AIC) **recommends** the proposed product labelling system must:

1) Clearly distinguish between products with environmental/sustainability features and others which may focus on other positive social issues. This would not preclude a product achieving both labels if they meet both sets of required standards;

2) Require that demanding standards be met which create a material distinction between investment products which benefit from product labels and those which do not;

3) Apply to all investment products available to retail investors to enable comparability between investment products. It should therefore encompass both Undertakings for Collective Investment in Transferable Securities (UCITS) and Packaged Retail and Insurance-based Investment Products (PRIIPs) funds.

The investment company sector

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 360 investment companies, managing assets of over £260 billion on 30 November 2021. Investment companies are closed-ended collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return.

The AIC's members include investment trusts, Venture Capital Trusts, UK REITs and non-UK investment companies. They are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

Investment companies are well placed to offer sustainable/social purpose investment opportunities. They hold a wide range of assets, including listed securities, private equity, debt, property, and infrastructure. Significantly, these also include investment in assets likely to be relevant to investors seeking non-financial outcomes. This is because they are well suited to holding assets such as, renewable infrastructure and social housing. We therefore welcome the introduction of a framework which will allow companies to articulate their sustainability and social purpose credentials clearly and accurately.

Investment companies have independent boards with legal obligations to operate the company in the long-term interests of shareholders. UK investment companies have obligations to have regard to environmental and social stakeholders (under section 172 of the Companies Act). Non-UK investment companies consider the same factors given their obligation to make a comply or explain disclosure in relation to section 172 under the UK Corporate Governance Code. Our members are increasingly mindful that sustainability and social purpose considerations are part of shareholders' investment decisions.

Investment companies are collective investment vehicles which are available to retail investors. They fall within the scope of the PRIIPs regime. They are Alternative Investment Funds, as defined under the Alternative Investment Fund Managers Directive (AIFMD). The Alternative Investment Fund Manager (AIFM) is responsible for various regulated functions, including the preparation of the PRIIPs Key Information Document (KID) which must be provided to retail investors before they are able to purchase an investment company share.

Responses to questions

Q1 What are your views on the tiered approach set out in Figure 2? We welcome views on any concerns and/or practical challenges.

The AIC agrees broadly with the high-level approach of the proposed product labelling structure and disclosure system set in Figure 2. Detailed disclosures on sustainability and other non-financial issues are suitable for institutions and other professional audiences but may be difficult for retail consumers to engage with. It is therefore helpful to consider how less granular disclosures can be made for a retail audience. Creating, standardised, reliable labels could benefit retail investors by providing them with a clear 'signpost' as to whether an investment product is seeking to deliver non-financial objectives (in relation to sustainability or other social purposes) and what these objectives are.

The product labels and disclosures must be sufficiently clear and differentiated to allow retail investors to identify the broad characteristics of products' non-financial objectives and whether they are likely to support the investors investment preferences.

The implementation of this framework must accommodate a broad range of non-financial objectives. Different products should not be labelled in the same way if they seek to achieve very different outcomes. The concept of 'sustainability' should not be stretched so far as to become meaningless.

We agree with the proposal to have disclosures suitable for consumers and intermediaries. Intermediaries and retail investors are unlikely to require (or be able to absorb) the same level of information as institutions. It is commonly accepted that retail investors do not read large amounts of information, particularly where it is technical in nature.

The following principles should apply to the product labelling and disclosure system:

- The product label should be clear and not misleading to minimise confusion for consumers. It may be appropriate to have visual representations included as part of the labelling.

- The Consumer-facing disclosures (Disclosure layer 1) should be short and digestible with minimal jargon.

- The requirements for Disclosure layer 2 should allow greater flexibility to enable the most useful disclosure of relevant information for that particular product to be included. The AIC would be concerned if a standardised approach made it more difficult for institutional investors to source specific information which may be more relevant to their particular circumstances.

- The information in Disclosure layer 2 should also help to increase the amount of accurate information in the market and give greater product and company specific insights.

- The approach should build on current practice and methodologies to deliver compliant disclosure which minimises the cost and complexity of compliance.

Q2 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 product than for others, please provide examples.

Investment companies are an important part of the UK's funds market. They can be a source of competition in the public interest, deliver better returns and help differentiate the UK's financial services industry from other financial centres (the structure is not widely used in other European markets).

Investment companies have the capacity to pioneer new asset classes. Traditionally, they have been some of the first investors in emerging geographic markets and emerging technologies. They are also better suited than open-ended funds to holding a portfolio of less liquid assets. In the last thirty years, investment companies have increasingly provided exposure to asset classes in the UK, such as infrastructure, direct property, growth and venture capital, and private equity. The structure is well suited to emerging asset classes, such as intellectual property rights and investment strategies seeking ESG outcomes, such as renewable energy infrastructure and social housing. The AIC **recommends** that investment companies should be brought into scope of the FCA's Sustainability Disclosures Requirements (SDR) proposals to maximise consumer access to products that might meet their non-financial objectives.

Rather than picking and choosing products to bring into the scope of the regime, the AIC considers that all investment products which can be purchased by retail investors should be within scope. This will reduce the potential for arbitrage and market distortions and enable retail investors to make valid comparisons of different investment products. The AIC **recommends** that the regulator applies the system to all products falling within the scope of the PRIIPs and UCITS funds regimes.

This will create a clear regulatory perimeter. It also offers other benefits. The approach could be designed so that the UCITS provider/AIFM is responsible for any assessment of whether a product label is used. The AIC **recommends** that the product label should be included in the KID or Key Investor Information Document (KIID) (and the successor consumer information disclosures which may replace these disclosures). This would provide a regulatory basis for these labels to be utilised in other parts of the distribution system. That is, if a label was not included in a KID/KIID then it could not be used in other financial promotions etc.

Q3 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?

The AIC considers that the Disclosures and Labels Advisory Group (DLAG) is an appropriate mechanism to help coordinate the work on developing the FCA's system.

Given the AIC's view that investment companies, and other PRIIPs, should be within scope of the classification and product labelling system (see our response Q2 above), wider membership of DLAG should be considered. The AIC would be pleased to participate in this group to offer its insight into the investment company structure and the range of assets held by member companies.

Q4 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.

Whilst we agree with the broad principles adopted, we believe that the labelling and classification system could be significantly improved through two main amendments: the addition of a social purpose categorisation and the removal of the transitioning label so as to create higher and more meaningful hurdles for products to be 'badged' as sustainable.

The FCA's ambition to help *"build trust in the market for ESG/sustainable investment products by helping to combat misleading claims"* (FCA ESG Strategy) is welcome. However, to build trust in the market, the FCA should construct a labelling and classification system that clearly separates sustainability claims from other social impact goals.

It should be clear that sustainability and any other positive labels are high level classifications that are not easily attained. The system should be demanding, in that it sets a high threshold to determine when a product can be said to help contribute to a net zero economy or other sustainability or social outcome objectives. Consumers will expect investments to make a real difference, rather than being a marketing opportunity for product providers. Clear labels, based on demanding standards, will reduce the scope for greenwashing and give consumers confidence.

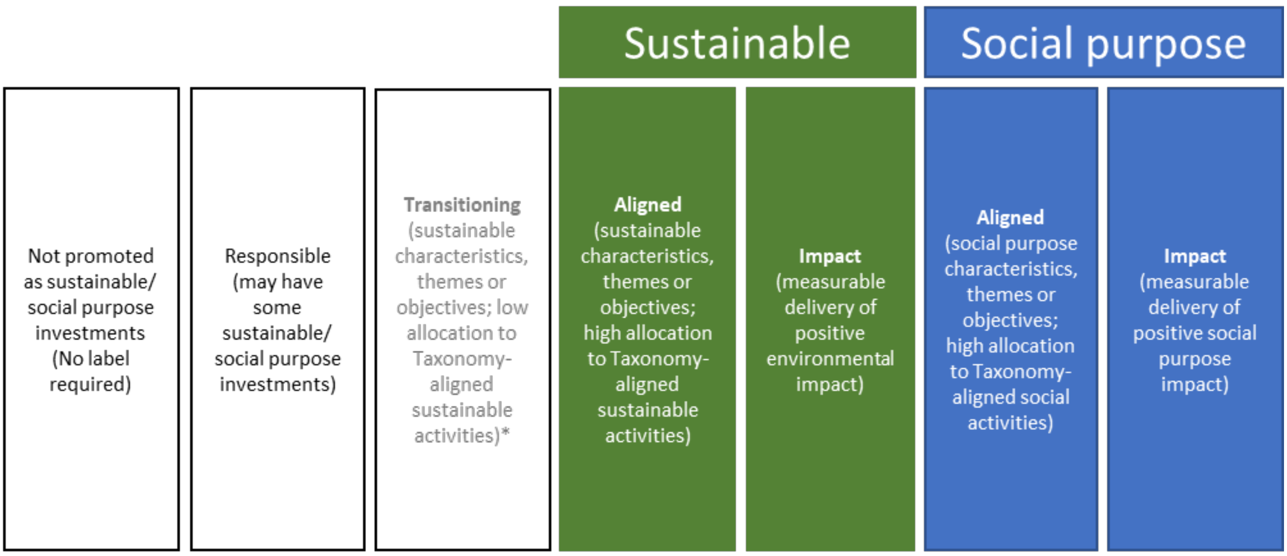
The case for separating sustainability from other social objectives is supported by data from the Financial Lives 2020 survey. This indicates that while investors want their money to do good it may not always be the case that they will always, or only, chose protecting the environment as a way to do this. For example, the data showed that,

- 86% of those surveyed considered that it was important for the vulnerable to be protected;
- More broadly, 71% did not want to invest in unethical investments.

There is likely to be an appetite for labels which identify other social benefits as well as sustainability. This distinction is not properly recognised in the proposed approach.

The AIC **recommends** that the system should have a separate label for Social purpose alongside the Sustainable label. Establishing separate sub-categories for products will help investors have a clearer understanding of the nature of the funds in which they are investing.

Fig 1: Classification identifying Social purpose as well as Sustainable investments.



** Subject to retention of Transitioning sub-category. See our response to Q8*

Q5 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 AIC **recommends** that the Responsible investment category should be adjusted. It should seek to include any investment product which has ESG factored into its investment approach. Therefore, we anticipate this would exclude mainstream trackers which are not constructed with sustainability/social purpose outcomes as part of the methodology.

It should also be clear that a Responsible investment does not have any specific sustainability or social purpose objectives. Any sustainability or social purpose assets would be incidental. The AIC **recommends** that this should be achieved by adjusting the definition of the category as follows "*Responsible (has no specific targets but may hold some sustainable/social purpose investments)*".

In any event, the approach to labelling/classification must minimise the potential for a 'responsible' label to give consumers an inflated view of the non-financial impact of the investment approach.

Q6 What do you consider to be the appropriate balance between principles and prescription in defining the criteria for sustainable product classification? We welcome examples of quantifiable, measurable thresholds and criteria.

The AIC **recommends** that to qualify for a sustainable (or social purpose) label, the product's investment policy should identify relevant factors which are actively considered as part of the investment approach (even if these are not backed by targets or a specific benchmark). This might include, for example, an investment's contribution to achieving net-zero, maintaining biodiversity, reducing pollution etc.

Securing a sustainable/social purpose label should also be dependent on ensuring that relevant holdings are above a threshold of investments which reflect those factors. The threshold should be a majority of assets (i.e. greater than 50%) held within the portfolio when the regime is introduced. However, over the longer term it should be increased. We **recommend** that after five years, the threshold be increased to, say, 70%.

Critics may say that this proposed approach is too demanding, but without demanding thresholds retail expectations will not be met and investment practice will not make a material difference to the non-financial goals that products and investment practice is supposed to support.

Products can still be offered with lower exposure to sustainable/social purpose assets. They would, however, be prevented from trading on a label which represents a 'gold standard' of sustainable/social impact investment.

Q7 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**

These characteristics are features of impact investing. The key challenge is identifying which factors should be used as part of a definition of an impact fund and how this is differentiated from an aligned fund. An impact fund should add value from the investor's perspective. That is, it should go further in terms of achieving the identified non-financial goals.

The AIC **recommends** that a product badged as an 'impact' fund (whether under the Sustainable or Social purpose labels) should have the following criteria:

- Have a clear mandate and objective of contributing actively to the identified non-financial objective (whether focussed on sustainability or social purpose).

- The objective of the fund should allow for a lower financial return to be achieved, if this is required, to meet the non-financial objective.

- The impact of the fund on the identified non-financial objective should be actively measured and relevant disclosures made on a periodic basis.

- The portfolio should hold at least 75% of assets which align with achieving the non-financial objective. Other assets held must not reduce the impact of the fund on achieving the non-financial objective.

Q8 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?

The FCA should ensure that only investments with a significant orientation to identified non-financial goals (whether in relation to sustainability of social purpose) can benefit from a FCA 'badge'. If products without these characteristics are allowed to use a sustainable/social purpose label then the label will be devalued, and the ability of retail investors to differentiate between products will be substantially reduced.

The concept of 'transitioning' in this context is opaque. It has no clear meaning and could mean very different things to different investors. Creating a sub-category of 'transitioning' investments is more likely to confuse than enlighten investors.

Transitioning implies movement and a sense of direction heading towards greater sustainability – transitioning from one state (unsustainable) to another (sustainable). The label as currently defined would seemingly allow investment products to perpetually remain in a 'transitioning' state never really meeting investors valid expectation that by investing in a 'transitioning' product their portfolio may become more sustainable over time. Nothing of course precludes a fund, in the absence of a 'transitioning' label, from stating that its aim is to become sustainable and earn an 'aligned' or 'impact' label once that transition is complete. Unless there is a clear mechanism to drive a change in investment practice there is also a risk that these products will sit in this category without changing their approach or making a meaningful contribution to the identified non-financial goals.

The transitioning badge therefore seems likely to become a source of greenwashing. Creating a Transitioning sub-category is counter-productive to clearly informing investors about whether an investment supports the achievement of non-financial objectives. The AIC **recommends** that the sub-category is removed from the labelling and classification system.

b) possible minimum criteria, including minimum allocation thresholds, for 'Sustainable' funds in either sub-category?

The AIC does not agree that there should be a 'Transitioning' category (see above). If such a category is created, then it must be based on clear, relevant standards.

The FCA states that Transitioning sub-category products would have a low allocation to Taxonomy-aligned sustainable activities. If this figure is set low, the risk is that this sub-category could be open to abuse. For example, products could be offered which meet the bare minimum requirements without ever making further allocation to relevant assets (so never meaningfully transitioning). It is also unclear how these funds would be required to take an active stance in pressing for change in the activities of underlying assets (for example, to transition away from carbon). The AIC does not consider that a Transitioning label can be part of an effective labelling regime for retail investors. This label is likely to appeal to asset managers but has little value in informing investors or changing market practice.

If a Transitioning label is introduced, the AIC **recommends** that products benefiting from it should hold relevant assets of at least 50% and be required to achieve aligned status within a period of 5 years from using the Transitioning badge.

Another possibility is for a Transitioning investment to evidence that it has an active strategy to support its non-financial objectives. For example, that non-aligned assets are themselves actively seeking to transition to support non-financial objectives of the product. These Transitioning products would still have a 50% threshold requirement but would be allowed to remain in this category past the five year period envisaged for other Transitioning investment products.

Q9 What are your views on potential criteria for 'Responsible' investment products?

See our response to Q5.

Q10 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?

The AIC **recommends** that any UCITS or PRIIP should be eligible to use a label/badge created under these proposals as long as they meet the criteria identified. The UCITS provider/AIFM would evaluate if the product is eligible to use a badge, and if so which one. The badge would then be included on the KIID/KID (or their successor disclosures). Once this disclosure has been made, the badge could be used in other suitable contexts, for example, as part of a financial promotion or in the factsheet of an investment company.

Q11 How do you consider products tracking Climate Transition and Paris-aligned benchmarks should be classified?

Only if these products meet the criteria actively managed investments have to achieve to benefit from the proposed labelling regime, should they be allowed to use the labels (as appropriate). The standards set by the regime should apply irrespective of whether a fund is a tracker or not.

Q12 What do you consider the role of derivatives, short selling and securities lending to be in sustainable investing? Please explain your views.

The approach adopted for product classification/labelling should be based on the composition of the portfolio as a whole. If these investments contribute to the non-financial outcomes identified in relation to the product and are used in a way which means they can meet the required thresholds, then their use should not, of themselves, influence whether a product receives a certain label or not.

That said, use of these investment approaches should not be allowed to distort the position of a fund. For example, if a stock has been lent, it should not be considered part of the assets used to get over a threshold of taxonomy-aligned investments. The danger being that if it were used in this way it might be counted twice – in the portfolio of the lender and the borrower.

Q13 What are your views on streamlining disclosure requirements under TCFD and SDR, and are there any jurisdictional or other limitations we should consider?

Where TCFD disclosures are relevant to a product's non-financial objectives, then there should be scope to use these to support the labelling/classification system. However, TCFD disclosures may not be relevant to some products which could make a legitimate case for a product classification/label under the proposed approach, e.g. those with a social purpose objective.

Q14 What are your views on consumer-facing disclosures, including the content and any considerations on location, format (e.g. an 'ESG factsheet') and scope?

The labelling and classification regime should cover funds falling within the PRIIPs KID and UCITs KIID regimes (see our response to Q2 above). The KID/KIID of a product should include the relevant product classification/badge. Where a non-financial claim is part of the product offer the KID/KIID should provide a link to the relevant short form (Disclosure layer 1) consumer disclosure. Once the KID/KIID is replaced by a product disclosure regime applying to both UCITS and PRIIPs, the layer 1 disclosure should be incorporated into that document.

An alternative would be to introduce a new section into the KID/KIID, but this would mean making other changes. Including, for example, allowing the KID to be longer than 3 pages.

The AIC urges policymakers to bring forward the promised review of consumer disclosures and **recommends** that a wholesale review of consumer disclosures is conducted as soon as possible. Our proposals in relation to the sustainability badge would then be applied to the successor to the PRIIPs KID and UCITS KIID.

Q15 What are your views on product-level disclosures, including structure, content, alignment with SFDR and degree of prescription?

The AIC agrees with requiring more detailed disclosures to supplement the information presented in the consumer-facing disclosures. As the FCA's discussion paper acknowledges, the information contained in this disclosure is likely to be helpful for those stakeholders seeking more granular information such as institutional investors. It is less certain that this data would be understood by, or helpful to, most retail investors. The FCA's own consumer research *'Sustainable investing: objective gradings, greenwashing and consumer choice'* found that detailed information is not an influential factor in consumer's decision-making process in choosing ESG funds.

> *"We find that ESG fund images, fund descriptions and fund strategies have no statistically significant effect on how participants invested in our analysis setup. Participants appear no more likely to choose funds based on the factsheet having an ESG attribute compared to a neutral one."*

Intermediaries are a more sophisticated audience and are likely to require a different level of information to retail investors. It is important that they can access additional information, as necessary.

We agree with the proposed information to be included in the product level disclosures although it is possible that the disclosures may need to evolve and improve over time to ensure stakeholders have access to high quality, relevant information that will allow them to make better informed investment decisions.

Q16 What are your views on building on TCFD entity-level disclosures, including any practical challenges you may face in broadening to sustainability-related disclosures?

The AIC has no comments on this question.

Q17 How can we best ensure alignment with requirements in the EU and other jurisdictions, as well as with the forthcoming ISSB standard? Please explain any practical or other considerations.

The AIC **recommends** continued dialogue with the EU and organisations such as IOSCO and the new ISSB, which is expected to become a global set of standards.

Q18 What are your views on the roles of other market participants in communicating sustainability-related information along the investment chain?

The starting point for communication of sustainability/social purpose related information should be the disclosure made by the AIFM/UCITS manager in the KID/KIID. If a label is used in the KID/KIID then other market participants should be able to communicate it along the investment chain. The same would apply to any layer 1 consumer facing disclosure which is signposted from the KID/KIID or included (if the relevant regulations are changed to allow this).

This source material would be provided by a regulated party with obligations to ensure its accuracy and update it as required. This should be sufficient for reliance to be placed upon it by other market participants.

Q19 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?

No. The AIC does not agree that there should be a requirement for third party verification of firms' classification of their products. Clear criteria set by the regulator should allow firms to accurately assess products in relation to the classification's requirements. The regulated AIFM/UCITS provider would then be responsible to ensuring that disclosures are compliant, and any claims made are fair and not misleading.

Q20 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?

The AIC has no comments on this question.

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To discuss the issues raised in this paper please contact:

Guy Rainbird, Public Affairs Director
guy.rainbird@theaic.co.uk

Megan Charles, Policy and Technical Manager
megan.charles@theaic.co.uk