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UK Sustainability Disclosure Requirements – initial considerations for UK AIFMs

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On 28 November 2023, the long-awaited UK regime for the labelling, marketing and disclosure of sustainable funds (Sustainability Disclosure Requirements or "**SDR**") has been published in the Financial Conduct Authority's ("**FCA**") Policy Statement PS23/16.

We summarize here initial key considerations for UK AIFMs and AIFs:

1. **Scope covers UK AIFMs and UK AIFs (but not overseas managers/funds or portfolio managers/advisers):** both full-scope UK and small authorized UK AIFMs will need to consider various elements of SDR in relation to their (authorized or unauthorized) AIFs. However, those with portfolio management or advisory permissions only will not currently be in scope of SDR's labelling, marketing and disclosure rules, with the FCA noting that it plans to consult on portfolio managers in early 2024 and set up an independent working group to consider the role of advisers. The exception to this is in relation to entity-level TCFD and on-demand product-level TCFD reporting which are already implemented by the FCA but will now be considered as part of SDR. These reporting requirements remain applicable to portfolio managers who have the UK regulatory permission of managing investments or alternatively are entities that carry out private equity or other private market activities consisting of either advising on investments or managing investments on a recurring or ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities (as well as AIFMs).
2. **Timing:** the timetable provides space for preparation with key dates including the anti-greenwashing rule (see below) coming into force from 31 May 2024 and firms being able to use the labels from 31 July 2024.
3. **Consumer focus, with parts of the regime applicable for institutional investors:** the FCA sets out that "many of our rules have been developed for retail investors, referred to as 'consumers'. However, part of the regime is also aimed at professional or institutional investors who we call 'clients'". SDR's requirements need to be checked carefully for where 'clients' is used to map the applicable rules and guidance.

4. **Four labels, not three:** an additional label has been added by the FCA in comparison to their SDR Consultation Paper and they use “sustainability” in their title rather than “sustainable” to reflect that some assets may be transitioning or improving in terms of sustainability. The four labels are: Sustainability Impact; Sustainability Focus; Sustainability Improvers; and Sustainability Mixed Goals. They are not designed to be in a hierarchy and it is a choice to use a label.
5. **Label requirements:** if an AIFM chooses to apply a label to a fund, then all labels must meet general criteria, which in summary covers:
    1. Need for a sustainable investment objective;
    2. At least 70% of assets to be invested in accordance with the sustainability objective. Whilst this is reduced from the SDR Consultation Paper which had referenced 80% in practice there is little difference as there is no flexibility to invest in assets which do not pursue the sustainable investment objective, and instead this 30% can be used for liquidity, risk or diversification purposes. There is guidance with private equity/venture capital in focus though, as there is an exception to the 70% threshold whilst funds are building a portfolio over time and are yet to fully invest in assets;
    3. A ‘robust, evidence-based standard’ is the test for the selection of assets that must be the absolute measure for environmental and/or social sustainability, as applicable to each label. ‘Robust’ means that it will stand up to scrutiny and ‘evidence-based’ means that it is derived from or informed by an objective and relevant body of data or other evidence. There is flexibility to choose an external or proprietary standard to meet this requirement;
    4. Firms must obtain or undertake an independent assessment of the robust, evidence-based standard to confirm that it is appropriate – this can be from a third party or in-house provided that the individuals responsible for the assessment are separate from the investment process and in both cases the assessors must be “appropriately skilled”;
    5. KPIs must be set to demonstrate progress towards achieving the sustainability objective and can measure either the performance of the fund and/or individual assets; and
    6. There must be an escalation plan devised which sets out the actions that will be taken if the assets do not demonstrate sufficient performance against the sustainability objective or KPIs, including anticipated timescales.

Each label then has its own specific criteria attached to reflect the differences between ‘Impact’, ‘Improvers’, ‘Focus’ and ‘Mixed Goals’.

6. **Version of “do no significant harm”:** in a development from the SDR Consultation Paper the FCA has added a rule that firms must determine and disclose whether any material negative environmental and/or social outcomes may arise in pursuing the sustainable investment objective in a labelled fund.
7. **Stewardship:** for use of any label firms must identify and apply the investor stewardship strategy and resources needed to support achievement of the fund’s sustainability objective, including the activities the firm expects to undertake and outcomes it expects to achieve. However, there are no prescriptive requirements on how to pursue stewardship as part of a strategy and there is removed from the SDR Consultation Paper the Sustainability Improvers category requirement to demonstrate a causal link between stewardship activities and outcomes.
8. **Firm requirements:** not dissimilar to the EU AIFMD requirements there are requirements on firms to have in place appropriate resources, governance and organizational arrangements commensurate with the delivery of the sustainability objective, and for this to be maintained on an ongoing basis. There are also requirements to ensure that the sustainable investment policy (including but not limited to the robust, evidence-based standard), escalation plan and independent assessment remain valid and that the review of negative outcomes (the SDR version of “do no significant harm”) is monitored on an ongoing basis. Any use of labels must be reviewed every 12 months.
9. **Anti-greenwashing rule:** SDR also introduces a new anti-greenwashing rule that will apply to all communications about financial products or services which refer to the environment and/or social characteristics of those products or services. Such references could be in statements, assertions, strategies, targets, policies, information and images, as examples. This new rule to ensure sustainability claims align with the sustainability profile of products and services and are clear, fair and not misleading will apply to all UK regulated firms (not just UK AIFMs), regardless of any use of labels. The FCA has published, alongside SDR, a consultation paper guidance on the anti-greenwashing rule, requesting feedback by 26 January 2024.
10. **Naming and marketing rules:** these are confirmed to only apply when the sustainability-related terms are being used for products marketed to retail investors.
11. **Interaction with SFDR:** the FCA has set out a summary of the SDR criteria and which requirements under EU SFDR can be used to leverage to meet SDR. However, there is no direct synergy between the four labels proposed and Article

8 or Article 9 of EU SFDR and the FCA notes that all “Article 8 funds would need to level up to qualify for the SDR labels”.

Whilst SDR has been publicized as a “simple, easy to understand regime” there are many key concepts within it that will be open to subjective interpretation, which have the potential to lead to some of the challenges seen under EU SFDR.

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