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Sustainability Disclosure Requirements (SDR) and investment labels:

Discussion Paper

7 January 2022

Introduction

We welcome the FCA's discussion paper DP21/4. We believe the introduction of sustainability disclosure requirements and investment labels represents a milestone for the FCA.

To date, the FCA rules help protect investments from the financial risks associated with climate change – what the European Commission calls "outside in".

If implemented, the disclosures will help align investment processes, and in turn the wider UK capital markets, with the UK government's commitment to net zero greenhouse gas emissions by 2050, with 68% emissions reduction by 2030, based on 1990 levels – what the European Commission calls "inside out", or "double materiality"[1].

This is a shift in approach that we encourage. Research undertaken by Edelman finds that:

> *When asked to what extent, if at all, do [UK savers] feel financial institutions (such as banks, insurance companies, investment managers etc) are culpable in creating the current climate crisis, 69% said culpable with 23% saying "very culpable".*
>
> *When asked which of the following do [UK savers] think is the most influential actor when it comes to enforcing companies to reduce their carbon emissions only 14% said financial institutions.*

The disclosures will address greenwashing concerns, level the playing field, and in our view, most importantly, raise sustainability standards – the extent to which the financial sector positively contributes to the sustainability transition. Put simply, capital markets remain unsustainable, financing activities that are inconsistent with planetary boundaries. While this remains the case, regulatory intervention is necessary.

At Cardano, we've taken a step back, and considered the behaviours that we believe regulation should incentivise such that investors can maximise real-world sustainability impact.

When we invest, we consider two lenses:

1. Risk and return, which includes sustainability-related risks and opportunities (or "outside in")
2. Influence, which includes real-world sustainability impact (or "inside out).

We believe that this is a view that is increasingly shared by institutional investors[2].

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[1] https://eur-lex.europa.eu/resource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF, chapter 3, page 12.

[2] For example:

- Freshfields / PRI's Legal Framework for Impact: https://www.unpri.org/policy/a-legal-framework-for-impact
- Impact Investing Institute and Pensions for Purpose impact principles: https://www.impactinvest.org.uk/publications/impact-investing-four-good-governance-principles-for-pensions/

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In our experience, there remains little clarity on what is meant by influence and real-world sustainability impact, nor how to measure it. Consequently, we have developed a 'model of influence'. This comprises of three key areas of influence, based on how direct an impact these actions have.

Model of influence – tier one

The first tier of influence includes:

- Supplying new capital, debt or equity to a company or government, where this has an environmental or social objective
- Collaborative company engagement on sustainability-related topics, for example through the Climate Action 100+ initiative
- Engaging with public policymaking to create a more sustainable economy, for example engaging to decarbonise the electricity grid or rollout electric vehicles

Tier two

The second tier encompasses two key elements:

- Engaging with companies as an individual investor on sustainability-related topics – this is less impactful than collaborative engagement, but nevertheless has an impact
- Incorporating climate change-related tilts and bespoke mandates, as part of a scheme's investment approach

Tier three

The third tier of influence to achieve real-world sustainability impact is one many institutional investors are already doing. That is integrating ESG factors into buying and selling of securities.

Our model of influence informs our response to the consultation. We set out our views in response to the questions below.

For questions regarding this consultation response, please email w.martindale@cardano.com.

Q1.

We welcome the proposed tiered approach.

Q2.

We think disclosures, and in particular, labels are most relevant for long-dated investments, and less so for short-dated investments such as cash funds. That said, we believe ESG integration must apply to all funds. Our Deputy CIO, Keith Guthrie, co-chairs the IIGCC derivatives and hedge funds work stream (see Q12). We would welcome an opportunity to share the results with the FCA in Q1.

Q3.

We understand the sustainability landscape as follows:

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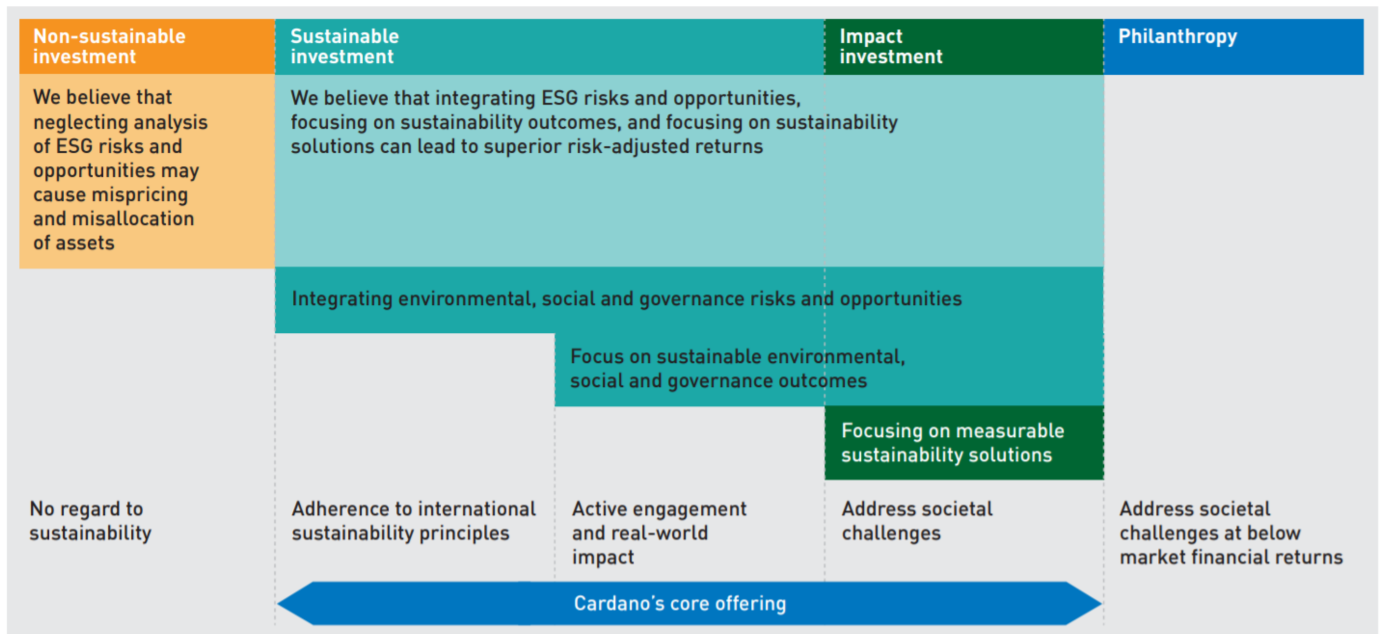

We agree with the resources listed in Box 2 of the discussion paper.

Q4.

We do not agree with the labelling and classification system set out in Figure 3, although we welcome the FCA's attempt to introduce a classification system.

First, our starting point is that all funds must integrate ESG issues, regardless of the strategy. We recognise that ESG issues have a greater impact on some investment strategies than others and that some asset managers are able to exert a higher degree of influence and engagement than others.

For example, managers investing directly in single name equities and credit will have greater focus than managers investing synthetically through derivative instruments. That said, minimum standards should apply to all managers, equivalent to the EU's SFDR article 6.

Second, we do not agree with the distinction between "transitioning" and "aligning", and instead we suggest a single category where the fund promotes sustainability characteristics or has sustainability objectives in addition to risk and return, similar to the EU's SFDR article 8 (promote ESG characteristics) and SFDR article 9 (sustainable investment objective).

It is not clear from the classification system what the fund would be transitioning from and to, nor what the fund would be aligning with.

We agree with the impact category.

The classification system does not include stewardship (which we believe is also a weakness of the EU's SFDR classification). We refer the FCA to our model of influence and the behaviours we believe regulation should incentivise.

We would welcome an opportunity to contribute to a FCA-hosted roundtable or webinar to further develop the classification system.

Q5.

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Here, we repeat our response to Question 4, because we feel strongly that the FCA should clarify that all funds must integrate ESG issues, regardless of the strategy.

Q6.

In response to the FCA's TCFD consultation (CP21 / 17)[3] we said that we do encourage prescription because we believe that, first and foremost, it's important that the categories are well understood by institutional investors clients, and ambiguity may discourage asset owners from sustainable and impact investment (there remains ambiguity with respect to SFDR).

Q7.

Yes, we agree.

We define impact as follows:

- Intentionally strive to have positive real-world impact in investment themes;
- Generate a market rate of return; and
- Measure the impact generated[4]

Q8.

We disagree with the distinction between transitioning and aligned investment products.

We want to incentivise investment in companies that are transitioning their business models to decarbonise, including in hard to abate sectors, such as energy, industry, utilities, and mining.

The risk is that asset managers allocate to companies that are "already low carbon" (a reflection more of the industry and sector, for example, technology) than the quality of the decarbonisation strategy. The behaviours we want to incentivise here are allocations to companies investing in credible, science-based decarbonisation strategies.

We favour Taxonomy disclosure at the level of economic activity. Companies can be complex. For example, the historically most polluting companies may be investing in economic activities that are necessary for the transition, while decommissioning the most polluting parts of their business. This should be recognised in the framework.

We note that there are incentives as part of carbon footprint reporting – and from some campaign groups – to divest from these companies due to their overall high carbon footprints. A more sophisticated approach is to consider a company's capital expenditure and how the company is transitioning away from high carbon activities to low carbon.

Net zero portfolios are not the same as net zero economies, and if investors are to positively contribute to the transition, our focus must be the latter, and the regulatory frameworks should reflect that.

Q9.

See Q4. All funds must integrate ESG issues, regardless of the strategy.

Q10.

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[3] https://www.cardano.co.uk/wp-content/uploads/sites/3/2021/12/CP2117-FCA-TCFD-Cardano-Response-Final.pdf
[4] https://www.cardano.co.uk/wp-content/uploads/sites/3/2021/12/Cardano-Annual-Sustainability-Report-2021.pdf, page 19

No, we disagree. All funds must integrate ESG issues, regardless of the strategy. All funds should disclose against TCFD, regardless of the strategy.

Q11.

This question is no longer relevant if the FCA accept our view that the “transitioning” and “aligning” should be a single category.

We understand Paris-aligned benchmarks as being 50% lower carbon emissions than their equivalent benchmark, with a 7% per annum reduction.

In addition, we would encourage:

1. The introduction of a ‘hard to abate’ score, given our view that we should incentivise investment in companies with credible, science-based decarbonisation strategies in historically high emission sectors.
2. Clear stewardship expectations.

Q12.

Our Deputy CIO, Keith Guthrie, co-chairs the IIGCC derivatives and hedge funds work stream. The workstream intends to publish a discussion paper in Q1 2022. Cardano, and we would anticipate, other members of the IIGCC group, would welcome an opportunity to share the results of our work with the FCA in Q1.

Q13.

Our view is that TCFD is a baseline. TCFD is a financial risk framework to better understand climate change-related risks and opportunities (“outside in”)

Our interpretation of SDR is that it goes beyond TCFD to understand the extent to which the product contributes to sustainability objectives (“inside out” or “double materiality”).

We also believe that a net zero portfolio should not necessarily be considered impact; rather it is a strategy that invests in line with the best available science. A strategy that invests in companies or assets with environmental or social impact objectives, such as nature-based solutions should be considered sustainability impact.

Q14.

Yes, we support this.

Q15.

When investing, we consider both the sustainability of the asset manager and the investment portfolio, assessing sustainable investment beliefs and policies, ESG integration including real-world sustainability impact, stewardship including collaborative stewardship, and reporting including TCFD reporting. In 2022, we will assess the sustainability of the underlying securities, including carbon footprint.

As such, we believe product-level disclosures should align with entity-level disclosures. We refer the FCA to our answers to Q4 and Q8.

Q16.

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Yes, we support this. TCFD reports should include disclosure of alignment metrics and target setting. We believe sustainability disclosure requirements should expand the scope beyond climate change, to include other environmental and social issues. For further information on our views on social issues, please see our response to the DWP's consultation[5].

Q17.

We strongly recommend international alignment, in particular, with the European Commission's Strategy for Financing the Transition to a Sustainable Economy, SFDR and EU Taxonomy. To date, the European Commission has been a source of leadership on sustainability topics. Practically, many UK-based investors will be subject to European regulation, and vice versa.

We also encourage the FCA to work with overseas regulators, particularly in the US and China. Ultimately, the goal should be harmonised international disclosures, and ISSB should help here, however, international alignment should not be at the expense of UK ambition.

Q18.

We think this is a great question. We find regulators tend to focus on their area of regulation (understandably), but given the FCA's remit, we do encourage the FCA to consider the sustainability of the wider financial system, in conjunction with Treasury, DWP, FRC and Bank of England.

We note asset managers' reliance (and potentially, dependency) on ESG data providers, the growth of and role of sustainable benchmarks, and the growth of (which we welcome) sustainability stewardship services. We encourage the FCA to consider how service provision is supporting asset managers to invest sustainably.

If not already, the FCA should review the PRI's Sustainable Financial System programme and CISL's Centre for Sustainable Finance.

About Cardano

Founded in 2000, Cardano Group is a privately-owned, purpose-built risk and investment specialist.

We are widely recognised as a market leader in the provision of specialised services to private-sector and collective pension schemes in the United Kingdom and the Netherlands. Our c. 500 professionals strive to deliver better and more secure financial outcomes.

See https://www.cardano.co.uk/who-we-are/.

[5] https://www.cardano.co.uk/wp-content/uploads/sites/3/2021/12/DWP-social-risks-and-opportunities-consultation-Cardano-Final.pdf