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Sustainability Disclosure Requirements (SDR) and investment labels

Consultation response CP22/20

About us

Founded in 2000, Cardano is a privately-owned, purpose-built pensions advisory and investment specialist with a leading-edge sustainability offering. 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 500 professionals strive to deliver better and more secure financial outcomes.

- Advisory: A pensions covenant, investment, sustainability, corporate finance and risk advisory business serving approximately 400 scheme and corporate clients. Our scheme clients have aggregated assets of over £370bn (€430bn)
- Investment Management: A purpose-built asset and fiduciary management provider, with a leading-edge sustainability offering, serving pension schemes, insurance companies, banks and distribution partners with £50bn (€60bn) of assets under management
- Defined Contribution (DC) Pension Provision: We manage over £15bn (€17.5bn) in DC assets across the UK and the Netherlands. In the UK, we operate NOW: Pensions, an award-winning UK workplace pension provider, serving 2 million members and tens of thousands of employers from a wide range of industry sectors

Our world deserves better financial solutions – that are more resilient and sustainable. At Cardano, we bring a distinct approach to advisory and investment management that challenges the status quo. By bringing together cognitively diverse teams with a mix of perspectives and skill sets, we reduce blind spots and open up new possibilities, delivering tailored solutions for our clients.

In January 2022, Cardano acquired ACTIAM, a sustainable investor, with 30 years' sustainability-related experience, and a dedicated team of sustainability professionals with expertise in sustainability issues, environmental, social and governance (ESG) data and research, and stewardship. ACTIAM was one of the first asset managers in the world to invest sustainably, considering concepts such as planetary boundaries and social foundations, which we have incorporated into a combined sustainability policy.

Cardano invests in different ways – directly as an asset and fiduciary manager and indirectly via third-party managers. Our combined sustainability policy – which informs this consultation response – applies across our group.

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Our response

First and foremost, we believe that the FCA's proposed way forward for SDRs is elegant and well done. We thank the FCA and their staff on their consultative approach.

Conceptually, we are in agreement with the FCA's approach. Our comments are intended to ensure the framework is investable for a range of institutional investors and therefore to allow for sufficient capital flows to support sustainability goals.

We focus our response on Qs. 4, 5 and 6, including:

- Definition of additionality. We think additionality itself is hard to define. Rather, the FCA should regulate:
  - The investor's disclosure of intentionality (stated theory of change)
  - Provide clarity on the qualifying criteria for "sustainable companies" for the focus label and "impact companies" for the impact label
  - The investor's processes in place to maximise investor influence.
- Use of multiple channels in combination within each label.
  - In practice, companies are complex and will not necessarily neatly be defined as a 'focus' company, an improver, or an impact company. As such, investors' additionality will include multiple channels.
  - A mutually-exclusive approach to the labels will also limit investments to portfolios with high tracking-error, which we believe will curtail capital flows to sustainable investments.

Definition of sustainability impact label. We believe the definition is too narrow and the FCA should remove reference to "new capital", "underserved markets" and "market failure" in defining this label. The distinction between sustainable focus label and impact label is not the channel, but the qualifying criteria for the underlying company.

In addition, the FCA should clarify:

- Use of benchmarks for sustainability focus and improvers labels.
- Guidance on approach to concentrated vs. non-concentrated portfolios, and in particular, the sustainability improvers label with respect to number of companies engaged (we favour quality of engagement over quantity, even in the case of a non-concentrated portfolio).
- Potential unintended consequence of concentration of ESG data providers in leading to asset manager size bias.

On terminology, while we use "companies", we use this as short-hand for all investment opportunities, including companies, governments, supranationals, and projects.

For any questions, please get in touch with Will Martindale, co-head of sustainability, w.martindale@cardano.com.

Q1. Do you agree with the proposed scope of firms, products and distributors under our regime? If not, what alternative scope would you prefer, and why?

Yes, we welcome the regulation and agree with the proposed scope. Standardisation rewards first-movers, raises minimum standards, levels the playing field, addresses greenwashing, and we believe, can lead to market efficiencies.

As such, we welcome widespread adoption, in particular, application to both institutional and retail investment.

Q2. Do you agree with the proposed implementation timeline? If not, what alternative timeline would you prefer, and why?

Yes, we agree with the proposed timeline, bringing forward anti-greenwashing requirements to 2023, but with a more than 12-month lead time for pre-contractual disclosures in 2024. We believe this is proportionate. We also believe it is reasonable for the largest asset managers, those with more than 50 billion GBP in assets under management, to disclose first.

Q3. Do you agree with the proposed cost-benefit analysis set out in Annex 2. If not, we welcome feedback in relation to the one-off and ongoing costs you expect to incur and the potential benefits you envisage.

The FCA's proposals require that an investor's definition of a sustainable company is independently assessed (para 4.30).

While we conceptually agree, we believe most investors will interpret this as a requirement to source third-party data, which can incur considerable costs. In turn, an unintended consequence could be that only the largest asset managers are in a position to offer sustainable products.

We believe the FCA should take steps to ensure the competitiveness of ESG data provision.

With that exception, we agree with the proposed cost-benefit analysis.

Q4. Do you agree with our characterisation of what constitutes a sustainable investment, and our description of the channels by which positive sustainability outcomes may be pursued? If not, what alternatives do you suggest and why.

We broadly agree. We have the following comments:

Channels

Box 3 (para 4.10) sets out three channels of investor influence. We note that the channels are closely connected to, but not the same as, the three proposed labels, and one label may include multiple channels.

Active investor stewardship and engagement: We agree with this as a potential channel, indeed, we believe stewardship is essential for all investments. In particular, we consider collaborative stewardship (with other investors) to be more powerful than individual stewardship. While, to an extent, Box 3 speaks to "system wide initiatives", we believe collaborative stewardship on systemic risks could be further emphasised.

Influencing asset prices and the cost of capital: We agree with this as a potential channel, but we think the degree of influence is in most cases limited and attributing to a single investor difficult to prove directly. That said, in aggregate (along with other investors) and over an extended period, we agree that this channel has influence.

Seeking a positive sustainability impact by allocating capital to underserved markets or addressing market failures: We think the description of the third channel should be reworded to: "Directing capital to projects and activities that offer solutions to environmental or social problems with the explicit aim of achieving a positive, measurable sustainability impact". (We note that this is the channel, we also have comments in Q6. on the sustainable impact label.)

With regard to this channel, we believe that the FCA should:

- Remove the reference to "underserved markets" and "market failures". While these are specific cases of impact investing, they are not needed to define this channel.
- For the same reasons, remove the requirement for "new" capital. We agree that financing new solutions to environmental or social problems is positive sustainability impact, we think that this channel should also include refinancing, as well as, capital expenditure decisions by company management.
- Remove the reference to "a stated theory of change". A theory of change describes how an investment strategy leads to real-world sustainability outcomes. As such, a stated theory of change (or intention), will apply in all channels, to describe the link between the investment strategy and real-world sustainability outcomes.
- Remove the reference to "non-concessionary prices" or "explicitly concessionary". While concessionary capital is a form of impact, it is not a necessary condition for an investment to have positive impact.

Para 4.20 sets out to distinguish between the three suggested product labels using "intentionality", alongside each of the primary channels of influence.

We don't think that the primary channel of influence should exclusively define the label for reasons we explain below. Instead, we think all three channels should be used to maximise the investors influence to achieve their stated intention. In other words, we think investors will use a combination of channels (and should be encouraged to use a combination of channels), and form a view (with FCA guidance) as to which label is most relevant based on the use of each channel.

Sustainability Impact Label

In Table 2, 4.23, the FCA proposes that sustainable impact label is "often in underserved markets or to address observed market failures". We believe this will be interpreted as "new capital" to underserved markets or to address market failures.

We do not believe that new capital is a requirement of positive impact. Other channels can also create positive impact.

We believe that, qualifying positive impact by "underserved markets" or "market failures", could unintentionally curtail "sustainable impact" investments. For example, renewable energy is not an underserved industry, nor does it constitute a market failure, but investment (and indeed, reinvestment) in renewable energy does have a positive impact. Rather, we think investment in “underserved markets” or “market failures” is one aspect of sustainable impact investment (among others).

Rather, we believe that the FCA should more clearly define the activities that constitute sustainable impact (for example, activities that “offer solutions to environmental or social problems”, per GIIN), and then regulate disclosure of the investor’s intention, the processes in place to achieve the intention, and the activities that constitute impact.

Q5. Do you agree with the proposed approach to the labelling and classification of sustainable investment products, in particular the emphasis on intentionality? If not, what alternatives do you suggest and why?

We think that the proposed labels are clear and helpful in explaining to investors the purpose of the product and what it is expected to achieve.

While we welcome the emphasis on the “intentionality” of the investor, **we believe the FCA should more clearly define “intentionality”**.

We believe the FCA should clarify its expectations for how the investor discloses their intentionality. This should include a statement of the investor’s theory of change. This approach should apply to all three categories, not restricted only to “sustainable impact”.

In addition, we believe the investor should describe:

- How they will use the various channels to achieve real-world impact
- The “additionality” of the investor or investment strategy to the company that is delivering real-world impact

We believe that “intentionality” can be used to distinguish between the three labels more clearly:

Sustainable improvers label: Here, the investor’s intention is to engage with companies or governments that are having a negative impact on the environment or society, in order to drive change. The aim of the engagement is to reduce the negative impact, to transition the companies or governments towards operating as sustainable.

Sustainable impact label: Here, the investor’s intention is to accelerate a positive impact on the environment or society in a measurable way. As stated in our answer to Q4., we believe this does not require new capital allocation.

Sustainable focus label: Here, the investor’s intention is to support businesses that are already operating sustainably. We note that there should be a clear distinction between companies that operate sustainably (the company’s operational “footprint” is sustainable) and those that have a measurable positive impact (the company’s products contribute to environmental or social solutions, where the operational footprint does no harm).

In Para 4.20, we do not believe that the primary channel of influence should define the label. This could define some strategies too narrowly. We believe clear intentionality (the real-world sustainability impact that the investor is intending to achieve) should be the primary defining characteristic of the label.

The definitions in Para 4.24 / Table 23 broadly match our views.

We particularly welcome the emphasis on measurable improvements for the sustainable improvers strategies.

We would remove the emphasis in sustainable impact strategies on “underserved” and “market failure”. These are areas that need impact investing but impact investing is not limited to those areas. (See Q6c)

Q6. Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? If not, what alternatives do you suggest and why? In particular, we welcome your views on:

- a. Sustainable Focus: whether at least 70% of a ‘sustainable focus’ product’s assets must meet a credible standard of environmental and/or social sustainability, or align with a specified environmental and/or social sustainability theme?
- b. Sustainable Improvers: the extent to which investor stewardship should be a key feature; and whether you consider the distinction between Sustainable Improvers and Sustainable Impact to be sufficiently clear?
- c. Sustainable Impact: whether ‘impact’ is the right term for this category or whether should we consider others such as ‘solutions’; and the extent to which financial additionality should be a key feature?

Yes, we agree with most of the proposals for sustainable improvers and sustainable focus, subject to the following comments. On sustainable impact we disagree with several of the current suggestions, as described below.

In response to 6a. Sustainable Focus:

We welcome this category.

We believe that:

- The investor should determine the methodology for what constitutes sustainable, as long as it is robust, evidenced-based and transparent.
- The FCA should clarify what constitutes a sustainable focus investment for index tracking investments, including what constitutes a sustainable benchmark.
- That, if the FCA wants to achieve a “selective effect” (to influence cost-of-capital), then the percentage of sustainable investments should be above 70%. Or potentially require that anything in the remaining 30% be actively engaged (improvers). While we understand the desire for “mutually exclusive” definitions, if 30% of the strategy is in companies that do not meet the definition of what’s sustainable, this should require stewardship (subject to the sustainable improver strategy).

As set out in Q3., the FCA’s proposals require that an investor’s definition of a sustainable company is independently assessed (para 4.30). While we conceptually agree, we believe most investors will interpret this as a requirement to source third-party data, which can incur considerable costs, in turn, an unintended consequence could be that only the large asset managers are in a position to offer sustainable products.

We believe that:

- The FCA should take steps to ensure the competitiveness of ESG data provision. We also believe that the FCA can achieve the same outcome through regulatory disclosure requirements of companies. We believe the FCA should engage BEIS (and overseas securities regulators) to enhance corporate ESG disclosure requirements and set out an oversight mechanism that is not disproportionately expensive for particularly smaller asset managers.

In response to 6b. Sustainable Improvers:

We welcome this category.

We believe the FCA should:

- Clarify what constitutes a sustainable improvers investment for index tracking investments, including what constitutes a sustainable benchmark.
- Allow for a category of sustainable investing that combines focus and improvers, where stewardship is focused on improvers, and the strategy is labelled improvers. This will allow investors to limit tracking error (an important consideration for many institutional investors) while pursuing a sustainable investment, where stewardship is the primary channel.
- Distinguish between a concentrated sustainable improvers strategy, and a non-concentrated strategy, where stewardship is focused on a subsection of companies in the non-concentrated strategy (we favour quality of stewardship over quantity).
- Clarify the disclosure requirements if you combine a focus (with 70%+ sustainable) and improvers strategy, where the strategy meets both sets of requirements.

In response to 6c. Sustainable Impact:

The distinction between focus and impact is not the channel, but criteria for the underlying company. As such, the FCA should clarify how it determines an impact company.

Focus may include impact companies, but it also includes companies that, while operating sustainability, do not generate impact.

In our view, the FCA should take care not to define impact companies too narrowly, so as to allow for sustainable impact strategies in public markets, and therefore, be accessible to institutional investors.

While we do not feel strongly, we prefer “impact” as opposed to “solutions”, as some important forms of positive impact come, not from products or services, but supply chain management (particularly in industries such as food and agriculture). "Solutions" are usually taken to mean the products or services of the company.

Definition of impact and requirement of financial additionality in the form of new capital

We think that the definition of sustainable impact should be the GIIN definition of impact investing: “the intention to generate positive social and environmental impact alongside financial returns”.

In 4.39, the FCA states: “To achieve this, a sustainable impact product will invest in sustainability solutions to environmental and/or social problems, often in underserved markets or to address observed market failures”.

In 4.41, the FCA states: “To ensure the ‘impact’ label has meaning, we think it is important that a firm can stand behind any claims it makes regarding positive sustainability outcomes. A firm will typically be better able to demonstrate and measure the additionality of its contribution to real world outcomes if it is investing new capital – either via private or primary markets."

While we accept that these criteria create more certainty "that a positive impact will occur as a result of the investment", we believe these restrictions create too narrow a definition of sustainable impact. It defines too narrowly the channel (primary market capital allocation) and adds too many caveats to the definition ("underserved markets" and "market failures").

We believe that many pension schemes and retail investors will want to access sustainable Impact investments. However, private markets are not an option for them (due to fees, liquidity restrictions or product access criteria).

We believe there is a risk that specialised illiquid impact investors will be the only funds with this label, limiting the capital available to sustainable impact strategies.

Rather, we believe that the FCA should define how to achieve sustainable impact in public markets and ensure that it is a category that is broad enough for pension schemes and retail investors. The key is to define this broadly enough to allow several different channels to achieve positive impact but emphasise measurability and reporting to ensure that there is still a high enough standard of proof to avoid greenwashing. We believe it is still possible to prove that investments in public markets are having a positive real-world impact even if the investor additionality is less direct than in private markets.

In particular, we believe that the majority of "new capital" decisions are not taken by investors but by company management when they make capital expenditure and R&D decisions and award contracts to their suppliers.

We believe that it is possible to define a sufficiently high standard to ensure that the public market investment is indeed having a positive real-world impact (and does no significant harm). In support of this view a positive impact business will not suddenly cease to be positive impact when the business moves from private to public markets (or indeed, if it becomes private again).

Furthermore, allocating new capital to a private investment or new debt issuance does not necessarily guarantee new capital is going towards positive impact – it may be going to buy out the previous owners or pay out a dividend.

In public markets:

- The primary channel of influence (the additionality) of the investor is likely stewardship, but the focus of the company engagement would emphasise growing the positive impact of these companies (and reporting on that impact) rather than engaging to improve the negative as is the case with sustainable improvers.
- The secondary channel would be new capital allocation as and when these companies need additional capital to continue to grow, either at IPO, through secondary rights issues or when issuing debt financing.

We do agree that it is important to address:

- "Depth of impact", for example, through supplying capital to underserved markets and in cases of market failure. But we see this as only one dimension of impact investing.
- "Scale of impact", for example, investing in renewable energy in developed markets.

These are not "either/or" decisions but "both/and" decisions.

While, it is possible to argue that renewable energy in developed markets is underserved in that, not enough public capital is allocated to it, by that definition any unmet need is an underserved market, so it is not a method of useful differentiation for what qualifies as impact.

Additionality

We do think that investors should articulate their "additionality" (across all three labels), and that this should be part of their product description, description of their intent and their stated theory of change. However, we think it is unproductive to overly focus on attempting to measure and prove investor additionality. It is not possible to prove "what would have happened if we did not make this investment?"

For example, in our model of influence we emphasise policy engagement[1] as a lever to achieve real-world sustainability impact. While it is hard to determine an individual investor's contribution to policy change, when it does happen it can have considerable impact.

To avoid greenwashing, investors should report on what they are doing to maximise their influence ("are they acting as they promised in their stated theory of change?") while avoiding "overstating" their contribution to the outcomes.

Instead, the FCA should regulate:
- Disclosure of intentionality (stated theory of change)
- Disclosure of processes in place to maximise influence across relevant channels
- Provide clarity on characteristics of "sustainable companies" and characteristics of "impact companies".

Additionality is an important dimension to understand all sustainable investment labels. For sustainable impact, the main qualifier is that the economic activity has a positive impact that can be measured.

Q7. Do you agree with our proposal to only introduce labels for sustainable investment products (ie to not require a label for 'non-sustainable' investment products)? If not, what alternative do you suggest and why?

Yes, we agree. While we expect additional fees associated with the three sustainable investment categories, we believe the competitive dynamics are strong enough in favour of sustainable investments.

We believe the FCA (as it proposes) should require all investors to incorporate ESG risks and opportunities in investment decision-making, and that this should be disclosed.

Q8. Do you agree with our proposed qualifying criteria? If not, what alternatives do you suggest and why? In your response, please consider: • whether the criteria strike the right balance between principles and prescription • the different components to the criteria (including the implementing guidance in Appendix 2) • whether they sufficiently delineate the different label categories, and; • whether terms such as 'assets' are understood in this context?

Yes, we welcome the proposed qualifying criteria, in particular, sustainable improvers investments (noting

[1] See: https://www.cardano.co.uk/wp-content/uploads/sites/3/2022/10/Cardano-ACTIAM-Sustainability-Policy.pdf

that the FCA will undertake further consultation on KPIs / qualifying criteria).

Q9. Do you agree with the category-specific criteria for: • The 'Sustainable focus' category, including the 70% threshold? • The 'Sustainable improvers' category? Is the role of the firm in promoting positive change appropriately reflected in the criteria? • The 'Sustainable impact' category, including expectations around the measurement of the product's environmental or social impact? Please consider whether there are any other important aspects that we should consider adding.

We have nothing further to add.

Q10. Does our approach to firm requirements around categorisation and displaying labels, including not requiring independent verification at this stage, seem appropriate? If not, what alternative do you suggest and why?

Yes, we agree that it is important to assess both the asset manager and the investment strategy, in other words, to assess whether the fund manager has commitments to sustainable investment, that go beyond the individual investment strategy.

Q11: Do you agree with our proposed approach to disclosures, including the tiered structure and the division of information to be disclosed in the consumer-facing and detailed disclosures as set out in Figure 7?

Yes, we agree with the proposed approach to align disclosures across pre-contractual reporting, sustainability product reporting and consumer-facing reporting. We welcome the proposal for consumer-facing factsheets.

Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?

While we welcome international alignment, we believe the FCA's proposals (and European Commission's proposals) allow for double-materiality, where investors manage to dual objectives: to maximise risk-adjusted returns and to maximise (positive) real-world sustainability impact. The ISSB is more of a single-materiality les – the first of the dual objectives.

ISSB (for now) and TCFD is a disclosure framework for financial material risks and opportunities, with respect to climate change, whereas SDR is broader, and includes sustainability, and the investor's contribution to sustainability impact.

Q13: Do you agree with our proposals for consumer-facing disclosures, including location, scope, content and frequency of disclosure and updates? If not, what alternatives do you suggest and why?

Yes, we agree.

Q14: Do you agree with the proposal that we should not mandate use of a template at this stage, but that industry may develop one if useful? If not, what alternative do you suggest and why?

Yes, we agree with the proposal to not mandate a template. We encourage the FCA to work with industry associations in the development of a template.

Q15: Do you agree with our proposals for pre-contractual disclosures? If not, what alternatives do you suggest and why. Please comment specifically on the scope, format, location, content and frequency of disclosure and updates.

Yes, we agree.

Q16: Do you agree with our proposals for ongoing sustainability-related performance disclosures in the sustainability product report? If not, what alternative do you suggest and why? In your response, please comment on our proposed scope, location, format, content and frequency of disclosure updates.

Yes, we agree. We believe the FCA could explore technology disclosure solutions, to allow investors to update where there is an update, to avoid unnecessary annual reporting obligations.

Q17: Do you agree with our proposals for an 'on demand' regime, including the types of products that would be subject to this regime? If not, what alternative do you suggest and why?

We have nothing further to add.

Q18: Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.

We have nothing further to add.

Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?

We have nothing further to add.

Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?

We have nothing further to add.

Q21: Do you agree with our proposed product naming rule and prohibited terms we have

identified? If not, what alternative do you suggest and why?

Yes, we particularly welcome this.

Q22: Do you agree with the proposed marketing rule? If not, what alternative do you suggest and why?

Yes, we particularly welcome this. For non-sustainable investments, the FCA may wish to allow a description of the investor's approach to ESG integration.

Q23: Are there additional approaches to marketing not covered by our proposals that could lead to greenwashing if unaddressed?

We have nothing further to add.

Q24: Do you agree with our proposals for distributors? If not, what alternatives do you suggest and why?

We have nothing further to add.

Q25: What are your views on how labels should be applied to pension products? What would be an appropriate threshold for the overarching product to qualify for a label and why? How should we treat changes in the composition of the product over time?

The SDRs are primarily aimed at asset managers to categorise sustainable investment strategies.

That said, we want to encourage standardisation across the intermediation chain, and so, subject to proportionality, and other pension fund disclosure requirements, we believe that the FCA should consider extending to pension funds within its jurisdiction, perhaps at a time lag to asset managers, and to work with DWP and TPR to consider pension funds outside its jurisdiction.

Q26: Do you consider the proposed naming and marketing rules set out in Chapter 6 to be appropriate for pension products (subject to a potentially lower threshold of constituent funds qualifying for a label). If not, why? What would be an appropriate threshold for the naming and marketing exemption to apply?

We have nothing further to add.

Q27: Are there challenges or practical considerations that we should take into account in developing a coherent regime for pension products, irrespective of whether they are offered by providers subject to our or DWP's requirements?

We have nothing further to add.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie do you foresee any challenges or concerns in making

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consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports?

We have nothing further to add.

Q29: Do you agree that the approach under our TCFD-aligned product-level disclosure rules should not apply to products qualifying for a sustainable investment label and accompanying disclosures? Would it be appropriate to introduce this approach for disclosure of a baseline of sustainability-related metrics for all products in time?

We have nothing further to add.

Q30: What other considerations or practical challenges should we take into account when expanding the labelling and disclosures regime to pension products?

We have nothing further to add.

Q31: Would the proposals set out in Chapters 4-7 of this CP be appropriate for other investment products marketed to retail investors such as IBIPs and ETPs. In your response, please include the type of product, challenges with the proposals, and suggest an alternative approach.

We have nothing further to add.