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SDR Labels and Policy
Financial Conduct Authority
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By email: cp22-20@fca.org.uk

25 January 2023

Dear SDR Labels and Policy Team

Re: BVCA response to CP22/20 Sustainability Disclosure Requirements (SDR) and investment labels

The BVCA is the industry body and public policy advocate for the private equity and venture capital (PE/VC) industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK-based PE/VC firms, as well as their professional advisers and investors. Between 2017 and 2021, BVCA members invested over £57bn into around 3,900 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ over two million people in the UK and 90% of the businesses our members invest in are small and medium-sized businesses.

Summary and key comments

We support several aspects of the FCA's proposals regarding sustainable investment labels, in particular the labels' voluntary nature, relatively demanding qualifying criteria and focus on retail investors. However, we are concerned that certain of the qualifying criteria will make it inherently difficult for closed-ended, blind pool funds that invest in illiquid assets, such as equity stakes in unlisted companies, to qualify for a label, even where a sustainability objective is central to such a fund's investment approach. We believe it would be unfortunate if it were relatively more difficult for PE/VC funds to adopt the labels under the proposed rules, simply because of the way they work.

This is because PE/VC fund managers' active ownership model means their funds often achieve important sustainability outcomes amongst unlisted SMEs, a constituency of the real economy that other types of investment fund cannot easily influence. We feel that any effective sustainability disclosure framework should make this kind of activity more visible to investors seeking to make a difference, so it should be no more challenging for this type of fund to qualify for a sustainable investment label than it is for any other type of fund. Our responses to the consultation questions therefore identify the aspects of the labels we think are challenging for PE/VC funds to meet and, as discussed with the FCA, we will offer suggestions under separate cover on how the FCA could adjust the qualifying criteria so that sustainability-focussed PE/VC funds are not by their very nature excluded from or disadvantaged in adopting a label.

We also support many aspects of the proposed disclosure, naming and marketing rules. We feel that the retail focus is, again, appropriate and that the regime affords firms a degree of flexibility around metrics that is appropriate for the evolving sophistication of the market for sustainability data across different asset classes.

However, certain elements of the proposed framework would cause significant problems for most PE/VC funds (where they are marketed to retail investors). Many if not most PE/VC funds are unlikely to qualify for a label, because sustainability outcomes will not be a binding objective, but nonetheless drive important sustainability outcomes through 'ESG integration' and specific norms- or sector-based exclusions. In particular, we believe that the proposed marketing rules are unnecessarily restrictive and would make it difficult for firms to paint an accurate picture of their often extensive sustainability screening and stewardship activity or sustainability-driven exclusions, whilst reducing the interoperability of SDR with rules in other jurisdictions, to the detriment of products targeting a global investor base, and hence also to the detriment of UK investors and UK

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competitiveness. Our responses to the consultation questions therefore also suggest how the marketing rules could be adjusted to: (i) ensure PE/VC funds can continue to describe their sustainability approaches accurately to give investors a full and accurate picture; and (ii) avoid imposing unnecessary extra compliance burdens on global firms marketing in UK.

Overall, we think the SDR proposals have the potential to develop into an effective sustainability disclosure regime. However, any framework of this nature is necessarily complicated, broad-ranging and of great importance, not least because its effectiveness will dictate the role of UK sustainability regulation in an international context. We believe some fundamental policy and scoping issues remain unresolved, alongside points of technical detail, and urge the FCA to take the time required to make SDR as effective as possible at the first attempt. In particular, we think it would be extremely valuable to UK financial services regulation for industry to have the opportunity to provide feedback on a further iteration of the rules before the regime is finalised.

BVCA responses to specific consultation questions

We have responded only to the consultation questions on which our members have specific views.

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?

We generally agree with the proposed scope under the regime and welcome the retail focus. We note that the proposed application of the SDR rules to PE/VC firms largely, but not entirely, mirrors the scope of the FCA's TCFD rules for asset managers (in the ESG sourcebook) i.e. the SDR proposals will apply to UK AIFMs and MiFID firms that provide ongoing / recurring advisory or portfolio management services related to private equity investment or marketing activities. Notwithstanding this, we have the following concerns in relation to the scope of firms and products:

Funds closed to new investors should be out of scope

We believe that the proposal that only funds that have made no investments after 22 July 2013 are out of scope (as per the definition of "sustainability product" and "TCFD product" in the draft rules) is unworkable for closed-ended funds that have held their final close and are no longer marketing ("closed funds").

The underlying purpose of the SDR regime is to prevent greenwashing through product labelling, marketing and disclosure rules. However, in the case of closed funds, the fund's total size is fixed, the marketing and fundraising stages are complete and investors will already have invested on the strength of the investment policy, strategy and ESG disclosure terms that were promoted during the fundraising stage.

We feel it would be confusing and bring disruption and costs to investors, with no associated benefit, if these funds were required to update historic pre-contractual marketing documents. Investors have already committed to the (typically) 10-12 year term of the fund (with no redemption rights) and will have negotiated their own ESG disclosure terms with the fund manager. Since all relevant contracts will already have been entered into, the documents can no longer be described as "pre-contractual" and, unlike in an open-ended fund, investors are unlikely to be able to act on the basis of the amended disclosures.

In many cases, particularly given the 10-year length of the proposed retrospective application of the rule, closed funds will have deployed most of the capital committed by investors during fundraising, and stopped making new investments (i.e. completed their investment period), or will have invested substantial amounts of their fixed amounts of committed capital already. ESG information rights are agreed with portfolio companies at the moment of investment, and firms are not in a position to negotiate further rights from portfolio companies they have already invested in. As investee companies will not have been under any obligation to track or provide the fund manager with sustainability performance against KPIs, the required data may simply not exist. This is particularly problematic for PE/VC funds because of the lack of publicly available sustainability data relating to

unlisted companies. As a result, closed and partly or fully deployed funds will struggle to meet SDR's ongoing reporting requirements as well.

We therefore believe closed-ended funds that are closed to new investors and no longer being marketed should be excluded from the scope of SDR altogether (including in relation to naming and marketing rules, pre-contractual disclosures and ongoing reporting as discussed further in our answers to Q15, Q16 and Q21 below).

<u>Overseas funds</u>

Voluntary opt-in for the labels

In our view, it is not clear whether the rules include or exclude non-UK AIFs managed by a UK AIFM. We have assumed that they are out of scope, but we would ask the FCA to clarify its intention. In any event, we encourage the FCA to consider a voluntary opt-in labelling regime for overseas funds at least, including for non-UK AIFs manged by UK AIFMs, to ensure a level playing field and to limit confusion amongst UK investors.

In this regard, we note that many of our members currently market funds to UK investors that are managed by a Luxembourg or Irish (or other EU) AIFM, and these would not currently qualify for a label. This will severely limit the usage and recognition of the UK labelling scheme by UK-based PE/VC funds.

Group exemption

We also feel the FCA should give further consideration to introducing a group exemption. This would exclude the mandatory application of SDR to a UK-regulated entity in relation to advice or portfolio management services provided to a non-UK group affiliate. In the context of the UK private equity industry, there are a number of entities located in the UK which provide services solely to other group entities which are themselves fund managers of global/European funds. These services are typically provided in relation to the potential UK or broader European investments which may be purchased by the global/European fund. In some cases, particularly where there is a global fund that invests in several different jurisdictions, total investments the UK or European investments that the UK firm advises on may form a relatively small part of the overall fund. Furthermore, these services are provided intra-group and the affiliates are best placed to determine how to achieve their data and disclosure objectives, which may be driven by the regulatory requirements of the non-UK jurisdictions in which the fund and/or fund manager are located. We think this kind of arrangement should be out of scope of SDR in order to ensure interoperability with other jurisdictions and maintain UK competitiveness as a base for the European aspects of global fund strategies.

Suitability of UK standards for global products

If the regime is extended to overseas managers in future, certain UK standards should not be imposed on non-UK managers. In particular, the FCA is considering suggesting that funds with the Sustainable Improver label might use the Transition Plan Taskforce outputs in their KPIs (para 4.35), while core principle 5 (Stewardship) page 61 and paragraph 17 of the non-handbook guidance suggest that managers should disclose whether they are a signatory of the UK Stewardship Code 2020. The TPT outputs remain uncertain and might not be recognised by non-UK firms, whilst the Stewardship Code may not be suitable for non-UK assets and non-UK managers (and indeed may not be fully relevant for those private equity and venture capital funds that are exempt from the requirement to disclose against it under COBS 2.2.3).

<u>Adviser-arranger firms</u>

We would appreciate further clarity on the application of the rules to "advisers". UK firms providing the regulated activities of advising on investments and arranging (bringing about) deals in investments to another group entity, often based in the EU or US (known in the industry as "adviser-arrangers"), are broadly within the scope of the TCFD rules (ESG 1), so adviser-arrangers appear to be in scope of ESG 3 and 4 by virtue of ESG 1.2.4, which applies limited parts of ESG 3 and 4 to firms undertaking portfolio management. However, the FCA also states that it will consider rules for "financial advisers" (and how they should take sustainability matters into

account in their investment advice) at a later date, which seems to conflict with the above. Clarification on this point would be helpful.

Portfolio management services

We request further clarity on the extent to which portfolio management services such as separate managed accounts provided by firms to individual institutional investors are intended to be in-scope of the proposed rules. We believe such arrangements should not be within scope of the rules because these products are typically available only to institutional investors, which are generally able to negotiate their own, bespoke ESG-related disclosure terms with firms, so we query what the FCA's rules would add here. This seems to be the conclusion from the draft rules, but we would be grateful for an explicit confirmation.

Listed investment trusts

A number of BVCA members manage listed investment trusts. We recommend the FCA should make it clear (for the purposes of ESG 3.3.2R(1)(a) ("undertaking sustainability in-scope business in relation to retail clients") and ESG 4.2.1R ("for retail clients")), that the AIFM of a listed investment trust shall not be deemed to undertake relevant business for retail clients solely because the investment trust's shares are listed and capable of being traded by the general public on the secondary market.

We suggest that the FCA should follow the approach it takes for the Consumer Duty i.e. acknowledge that, whilst the manager of an investment trust may technically be in scope of the rules, their application to the manager will be correspondingly limited where the board of the trust itself continues to take key decisions. We believe the retail-related requirements of SDR should only apply where an AIFM markets an AIF directly to retail clients with the FCA's approval to do so, not simply because an investment trusts' shares are listed.

We also believe that the rules generally do not reflect that an authorised firm may not have overall responsibility for an entity it manages. In particular, listed investment trusts / investment companies have independent boards (and the company and its board are primarily responsible for setting the company's investment policy and for its public disclosures, including any prospectus and public reports). We suggest the FCA makes it clear that that the anti-greenwashing and marketing rules only apply to documents under the control of the authorised firm i.e. those it issues itself or approves as a financial promotion. For example, they should not apply to documents issued by an investment company in respect of which the firm is the external manager but is not necessarily in control of the document. Clarification on a manager's responsibility (if any) for documents that it does not issue would be very helpful. In addition, to the extent that a rule relates to "marketing", we request further clarity on what this means (noting the challenges that have arisen in the context of the EU's approach to defining "marketing" under AIFMD). In the particular case of listed investment companies, if the FCA's policy intent is to control disclosures by those firms, we suggest that the better place and means of that control would be through the Listing Rules and, potentially, the London Stock Exchange's rules for the Specialist Fund Segment.

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

We broadly agree with the proposed implementation timeline, but note that certain other frameworks underpinning significant aspects of the FCA's SDR rules (including the UK corporate aspects of the broader SDR framework set out in the Green Finance Strategy, the UK Taxonomy, the ISSB standards and the work of the Transition Plan Taskforce) are not finalised and are currently subject to unclear timelines. In particular, the current absence of clear policy development or implementation timelines for the SDR regime for UK companies, which was envisaged in the Green Finance Strategy, means that there will likely be significant data gaps even for large UK companies. We urge the FCA to coordinate closely with the relevant government departments and take into account any delays to other frameworks connected to SDR when implementing the rules and supervising firms under SDR, as appropriate.

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.

This is an important issue and plays to a bigger question of implementation challenges. Firms are currently considering what capacity (internal, and third-party) will be needed to build out the evidence and processes to assure credibility and robustness in labelling. The increased popularity and regulatory support for TCFD reporting has generated a major new service industry for management and environmental consulting firms. We urge the FCA to carefully assess the assumptions it is making around firms' need and ability to implement capacity building (amongst firms via CFA and related qualifications) and externally (service providers / advisors / management consultants) to ensure effective and credible delivery of SDR.

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 with the characterisation and with the descriptions of the channels for pursuing sustainability outcomes.

We are particularly pleased to see that the FCA acknowledges the importance of "stewardship" as a channel. However, as mentioned further below, it is important that this term is understood in a broader sense and not specifically linked to the Stewardship Code. For our member firms, "stewardship" is often the most important way in which they affect sustainability outcomes, but this will be through a variety of mechanisms, including insistence on certain policies and practices and appointment of designated non-executive directors to the board (and may not be, for example, through the mechanisms outlined in the Stewardship Code and adopted by investors in listed securities).

Furthermore, the Consultation Paper describes the stewardship channel as involving "asset managers' influencing the environmental or social performance of assets through active engagement, the exercise of voting and other rights, shareholder activism, or through participation in system-wide initiatives". We note that in the context of a portfolio company whose business inherently generates positive sustainability outcomes (for example in clean energy sectors) PE/VC funds' contribution may come through helping the business to succeed and grow.

We are also pleased to note that there is some flexibility regarding the definition of sustainable investment with proprietary standards permitted, as long as they are credible, fully disclosed, rigorous and evidence-based. Since there is currently no international, third-party standard that is useable by smaller, unlisted companies, this flexibility is crucial for our members.

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 believe the FCA has set a relatively high bar for the labelling of sustainable investment products and we support both this and the retail focus of the regime. We consider it appropriate that the labels require sustainability objectives to be a clear, explicit, binding requirement of a fund's investment policy which has the potential to foster certainty and a level playing field whilst reducing greenwashing.

We also welcome the proposal for the labels to remain optional given that investors in PE/VC funds typically make their investment decisions based on extensive due diligence and maintain inherently close and long-term relationships with the managers of the funds they invest in. This means that communication through labels designed for retail investors will often be less relevant for institutional investors in PE/VC funds. Experience from SFDR suggests that some institutional investors may favour labelled funds and we expect certain firms seek to establish funds that qualify.

However, we are concerned that the majority of traditional PE/VC funds, often managed by firms that take sustainability factors extremely seriously on principle (for themselves and their investors) and integrate them

across their businesses (not "solely" to manage financial risk and drive value creation, as important as these are), will find it challenging to qualify for any of the labels. We believe that the positive impact on sustainability issues of the large majority of PE/VC funds that are typically engaged in this kind of 'ESG integration' should not be viewed as less important for sustainability outcomes in the real economy than that of the minority of funds that have an explicit sustainability objective.

Investors will continue to allocate significant amounts of capital to PE/VC funds that are carrying out activity that is extremely important 'sustainability improver' activity in relation to thousands of UK and overseas companies, principally SMEs, but whose investment policy does not include this as a specific, measurable objective. These PE/VC funds (likely the majority) will therefore not qualify for a label, and so the marketing rules will apply where these products are marketed to retail investors (which, for the PE/VC industry typically means relatively sophisticated high net worth individuals, rather than the mass market). In this context, we have significant concerns about how far the application of the proposed marketing rules would, by prohibiting certain terms to describe their approach, prevent firms marketing PE/VC funds to high net worth and sophisticated retail investors from accurately describing their products. In addition, because such unlabelled funds will typically be categorised as Article 8 when marketed to EU investors, we are concerned about the possible conflict between the FCA marketing rule and the mandatory disclosure requirements of the SFDR.

We also suggest that the labels do not sufficiently accommodate the fact that PE/VC funds execute a small number of proportionately large transactions in unlisted securities that are inherently illiquid. This means that a fund's alignment with any taxonomy or standard will change considerably with each transaction and cannot easily be rebalanced. We are developing suggestions on how the labels might accommodate this feature of PE/VC funds and will provide these under separate cover (as agreed with the FCA).

Further, although a key feature of the private capital fund model is the fund manager's significant influence or control over portfolio companies, it is relatively common, particularly (but not only) amongst venture capital funds, for the fund to take minority stakes in investee companies. This feature when combined with the paucity of publicly available sustainability data relating to private companies means that reliable taxonomy assessments will often be difficult or impossible to obtain, especially on an ongoing basis. For these reasons, we recommend that the FCA carefully consider whether taxonomy alignment is a workable labelling requirement for PE/VC funds and consults in detail before incorporating the UK taxonomy (once developed) into SDR and the labelling rules. We recommend that in any case taxonomy alignment should always remain optional under the labels.

We support the FCA's approach to intentionality, because we agree that it is a firm's communication of its intentions vis-à-vis a product that should be regulated, as opposed to any sustainability outcomes, which, as for financial outcomes, cannot be guaranteed.

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:

We welcome the distinguishing features and the relatively demanding criteria to qualify for a label, to allow investors to identify products with genuine sustainability characteristics. We also welcome the FCA's statement that there is no hierarchy between the proposed labels.

However, we have concerns that many strategies will qualify for more than one product label. We are concerned that this overlap risks creating a hierarchy between the labels e.g. the Sustainable Impact label appearing better to an investor than the Sustainable Improver label, given firms have the freedom to choose their labels.

We also have concerns about the accessibility of the labels to PE/VC sustainability-focussed funds. These may have strong sustainability credentials because they make a combination of impact investments, improving investments and sustainable investments (for example a climate change-focussed fund may invest in both transitional and impact assets). Despite this, they may not qualify for a label because they do not meet the minimum 70% requirement (in the case of Sustainable Focus) or will struggle to show an overall sustainable focus, impact or improving objective. We therefore suggest the FCA amends the proposals to accommodate

such products. We think there are different ways this could be achieved, for example: (i) by making one of the label categories more permissive to accommodate funds/portfolios investing in a mix of impact, sustainable and improving assets; or (ii) by allowing firms to apply the criteria for the three labels in parallel and then select the label that represents the greatest proportion of assets within the fund; or (iii) by allowing firms to use more than one label where, in fact, a fund qualifies for more than one label e.g. all a fund's investments might meet a credible standard (to qualify for the Focus label) but the fund manager might also seek to improve the assets further (and qualify for the Improver label), or an Impact fund might also qualify for the Focus label.

We also fear that sustainability-focussed PE/VC funds may struggle to qualify for any label because it is difficult for the manager of a blind pool fund to establish comprehensive and specific sustainability KPIs before it knows exactly what unlisted companies the fund will invest in. A wide variety of different KPIs will be appropriate for different portfolio companies, and the right metrics for each company are rightly set when the fund manager develops a good understanding of each company during its specific due diligence and acquisition process, rather than speculatively proposed by the fund manager when raising the fund. We fear that the latter approach may lead to the selection of overly generalised KPIs and de-incentivise ambition as regards sustainability outcomes. We are discussing potential alternative approaches for PE/VC funds with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

As a more general point, we think it would be helpful for the labelling regime to specify consequences and options for products where continuing non-compliance with a chosen label cannot be restored, beyond the general requirement to take action to restore compliance as soon as reasonably practicable, having regard to the interests of investors. Where the continued holding of an asset causes a PE/VC fund not to meet the standard it has committed to, the fund will not be in a position to divest (as the assets are illiquid) and investors cannot redeem (because the fund is closed-ended). We therefore request guidance from the FCA that firms will in this instance meet the requirements of the rules where they set out a clearly defined procedure (such as to use reasonable efforts to continue to meet the standards, for example by engaging with the company board, assisting with remedial action plans etc.), which would be extremely helpful. This guidance should also have regard to the fact that divestment is not always a helpful outcome from a sustainability perspective (as the focus of sustainability regimes should be to enable managers to work with companies to address deficiencies, hold them accountable and improve their sustainability generally, rather than divesting when a company encounters sustainability issues).

Below, we explain the specific challenges of applying each labels to PE/VC funds. We will provide suggestions under separate cover about how we believe these challenges could be surmounted (as agreed with the FCA).

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?**

We welcome the requirement for 70% of a fund's assets to meet a "credible standard" in order for a fund to qualify for the Sustainable Focus label. However, we have the following concerns regarding the operation of the 70% threshold in relation to blind pool funds investing in unlisted assets:

<u>1. 'Lumpiness' of PE/VC fund portfolios</u>

If the 70% threshold when applied to PE/VC funds is an absolute requirement that a fund must consistently maintain, funds that in principle should qualify for this label will in practice struggle to do so. PE/VC funds make a small number (typically 10-20) of large investments in unlisted companies, staggered over an 'investment period' of typically five years. For each company, the firm will execute individual business plans under which each portfolio company will be sold at a different time over the remaining five to seven years of the fund's 10-12 year life.

A hypothetical PE/VC fund that invested simultaneously in 10 companies of equal value, seven of which met the standard and three of which did not, should in principle qualify for this label. However, in

practice, it typically takes around five years before a PE/VC fund's portfolio construction is complete. During the early years of the investment period, a single acquisition of a company not initially meeting the credible standard could lead the fund to breach the 70% requirement until it acquired further companies qualifying as sustainable investments (which could 'offset' the earlier acquisition and bring the portfolio back above the threshold). The same is true in reverse, as the fund sells its portfolio companies over several years.

Decisions on the timing of transactions in this context should be based on a firm's judgement as to the best time to acquire or sell an asset to maximise returns to investors, rather than on whether the fund's 70% sustainable investment condition is maintained at all times. To allow PE/VC funds to qualify despite this inherent 'lumpiness' of changes in portfolio composition, we are discussing potential alternative approaches with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

2. Basis of calculation of the threshold

The proposal for compliance with the threshold to be measured against the total value of a fund's investments is also problematic, because periodic valuations of portfolio companies post-investment will vary, are difficult to predict and cannot be 'corrected' via acquisitions or disposals (as the fund's assets are inherently illiquid). A portfolio could, as with the example above, meet the threshold at the outset, but a later relative increase in value of one particular company that did not meet the standard could cause the portfolio as a whole to fall below the required threshold. The key difference here for PE/VC funds relative to funds investing in liquid assets is that, as the unlisted companies in which PE/VC funds invest are fundamentally illiquid, there is no scope for a PE/VC fund to 're-balance' its portfolio by selling assets that do not meet the criteria in order to replace them with ones that do.

To resolve the above two issues, we are discussing potential alternative approaches for PE/VC funds with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

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?

As mentioned above, we welcome the intent behind the inclusion of the concept of active stewardship in the objective of this label: the PE/VC investment model requires firms to take a very active role in growing and increasing the value of companies, as a primary lever for generating returns for investors. However, we believe the FCA's emphasis on stewardship as defined in the Stewardship Code (which is principally focussed on listed entities) as the primary lever for effecting change is too narrow and could limit the availability of the label for private market investors. Depending on product and circumstance there is a range of tools that can be powerful levers for change in the context of unlisted companies (e.g. insistence on certain environmental and social action plans and policies, and involvement in setting them, selection and placing of non-executive directors and covenants) that all merit consideration. For investors outside public equity markets these are often much more significant and should be built out as part of a broader "effecting change" mindset that goes beyond stewardship as defined in the Stewardship Code. That is particularly important because these methods of effecting change are often more effective than (for example) exercise of shareholder voting rights, engagement with policymakers and participation in industry wide initiatives.

In a similar vein, and as noted above, the FCA suggests that firms should disclose whether they are a signatory of the UK Stewardship Code 2020. This code might not be suitable for non-UK assets and non-UK managers and indeed may not be relevant for those private equity and venture capital funds that are exempt from the requirement to disclose against it under COBS 2.2.3. This should be reflected in

the requirements for PE/VC funds using this label. We are discussing this issue with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

Potential conflicts for overseas funds

The Sustainable Improvers label requires firms to provide projections of changes in the sustainability profile of the product over several years. Fund managers in other jurisdictions, such as the US, are subject to restrictions on the use of 'hypothetical' (including projected) performance in their marketing and fund documents. Therefore, if this requirement was included in the regime for overseas funds, it might make it difficult for any US manager to qualify for this sustainable investment label. Combined with the 'naming rule' this might prevent US managers offering US products with sustainability-related terms in their name in the UK retail market. We are discussing this issue with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

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?

Under the "Sustainable Impact" category, the FCA requires firms to disclose a "theory of change", to set out an explicit aim to achieve a positive and measurable sustainability impact. In practice, it will be extremely difficult for funds with a broad impact strategy to commit to a detailed "theory of change" to apply to each of their investments. Similarly, a closed-ended fund with a broad investment policy may not be able specifically to define the "real-world" outcomes targeted under the Sustainable Impact label prior to selecting investments, although it will indicate examples of the types of outcomes it is targeting.

The FCA states "A firm must, in specifying KPIs, apply enhanced impact measurement, and reporting based on industry best practices". We note that the non-handbook guidance on page 124 of the Consultation Paper refers to 'enhanced impact measurement' but further clarification by way of examples would be helpful.

In relation to the FCA's potential inclusion of "additionality" as a criterion (i.e. "whether a proposed activity will produce some 'extra good' in the future relative to a specified baseline, typically the counter-factual in which the investment has not taken place"), we note that we are not aware of any existing impact measurement framework that specifies additionality as a criterion for impact investing, nor any industry endorsed reference point for "financial additionality". We are discussing potential alternative approaches for PE/VC funds with our members, and will provide the FCA with suggestions under separate cover (as agreed with the FCA).

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

We agree with the proposal which we think takes a pragmatic and proportionate approach.

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?**

Please see our discussion at Q6, in particular our feedback regarding multi-strategy products.

With respect to managed portfolios, we think the 90% threshold is too high and would make the labels potentially unattainable for most portfolio management firms, and should mirror the 70% threshold proposed for Sustainable Focus funds.

We believe the distinction between Sustainable Improver' and 'ESG integrator' is subject to a degree of uncertainty, which may result in confusion amongst investors. We think further clarification is needed on whether a fund can qualify for the Sustainable Improver label on the basis of meeting the qualifying criteria for a single environmental or social improvement objective, notwithstanding that the chosen objective may be common in the market (e.g. reducing GHG emissions) and the fund may have no regard to other sustainability metrics or impact (given the absence of an equivalent to SFDR's "do no significant harm" test). We will include further feedback on this point in our separate submission covering our suggestions for the labels, as agreed with the FCA.

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 any other important aspects that we should consider adding.**

Please see our discussion at Q6. As mentioned, we have concerns that some of the category-specific criteria may make it difficult for PE/VC funds to qualify. Many Article 8 SFDR products will also not be able to obtain a label because their strategy will involve ESG characteristics / features rather than a sustainable objective. To this end, we recommend changes be made to the marketing rules as discussed in our response to Q22.

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?

We agree with the FCA's proposed approach. Independent verification, especially in what remains a relatively nascent field with a limited population of appropriately-specialised service providers, would add significant cost to investors, without clear benefit. This would also risk creating an un-level playing field, as verification is likely to be considerably more straightforward and less expensive for larger funds and those investing in listed instruments (about which significant levels of public information are likely to be readily available to firms undertaking external verification exercises) than for smaller funds and those investing in illiquid, unlisted instruments, whether debt or equity, such as those managed by many BVCA member firms.

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?

We agree with requirement for summary disclosures for retail investors and more detailed pre-contractual disclosures for labelled products and products where sustainability-related features are integral to the investment policy and strategy.

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

We agree with the approach and welcome the proposal to build from the TCFD-aligned disclosure rules, which we feel will capture the right sorts of content (systems, governance, capacity, training etc.).

We welcome the FCA's recognition, in line with the Government's Roadmap to Sustainable Investing, of the potential for the ISSB Standards to set a much-needed global baseline for sustainability reporting. Equally, we note that the ISSB Standards remain in development and once finalised may or may not be mandated in different jurisdictions. We therefore strongly recommend the FCA consults further on the interaction between the ISSB Standards and SDR once the former are finalised so that they can be incorporated into UK regulation in an effective manner, taking into account the contours of different jurisdictions' sustainability regulation at that point.

We also urge the FCA to monitor carefully the development of other standards from an interoperability standpoint, especially the European Sustainability Reporting Standards being developed by EFRAG, and in corporate these into any future evolution of SDR. We would also encourage the FCA to communicate any intention it may have to require nature related disclosures, for example under the developing TNFD framework.

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

We understand that the consumer-facing disclosures only apply in relation to products sold to retail investors. We consider the retail focus here to be appropriate and proportionate and would have concerns if the consumer-facing pre-contractual disclosures were to apply to institutional products. We recommend the FCA state explicitly that the consumer focussed rules do not apply to products marketed only to institutional investors, to avoid confusion amongst non-UK investors in particular. Although Rule 4.2.1 refers to 'retail clients', explicit guidance on this point might be helpful. We believe the consumer-facing disclosures should remain optional for institutional products.

We do not see why an in-scope firm marketing to retail investors that does not use a label needs to make the summary consumer-facing disclosures specified in ESG 4.2.7R. The FCA states that the consumer-facing disclosures are intended to "complement the labels" but if a product has no label there is nothing to complement. This results in the product disclosure being "no sustainable label" and "N/A" for the relevant disclosures. We do not see this as helpful to consumers and would argue that they are not meaningful disclosures. We would instead suggest a disclosure based on the following be required: "This product does not have a sustainable investment label as described in the FCA's ESG sourcebook".

We also note that the FCA will expect a summary of the pre-contractual disclosures for "ESG integral" products (required by ESG 4.3.4R) in the consumer-facing disclosure (para 5.32). This obligation does not seem to appear in ESG 4.2.2R and we recommend a specific reference be added for clarification and that the interaction with the marketing rule be clarified.

Q14: Do you agree 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?

We agree with the proposal to not mandate the use of a template at this stage.

Q15: Do you agree with our proposal 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.

We do not agree with requiring pre-contractual disclosures to be updated for a closed-ended fund that is closed to new investors and that ESG 4.1.2R should be amended accordingly. Once a fund has closed to new investors, the 'pre-contractual' disclosures have served their purpose. We believe that funds closed to new investors should be out of scope of SDR entirely, as per our answer to Q1.

We note that the absence of a "do no significant harm" test, alongside the absence of a definition of "sustainable", risks allowing the emergence of products that generate negative sustainability impacts alongside positive ones. We believe that such products should not qualify for a label. We will include further feedback on this point in our separate submission covering our suggestions for the labels, as agreed with the FCA.

For ESG integration strategies, we feel it is unclear what "integral part" means. We note the guidance in 4.3.5 (2) but further explanation by way of examples would be helpful. Given a significant number of private fund products may remain unlabelled, should a disclosure requirement similar to that in ESG 4.3.4R apply to all unlabelled sustainability products (as relevant for the specific product)?

We also believe that governance should be removed from the Glossary definition of "sustainability characteristics", as we agree with the FCA's statement that governance is an enabler rather than an end in itself.

Q16: Do you agree with our proposal 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.

We do not agree with requiring ongoing sustainability related performance disclosures for closed-ended funds that are closed to new investors and suggest the rules be amended accordingly. Investors in such funds have already negotiated and agreed the terms of such funds, including in relation to ongoing sustainability reporting, and having already invested would not benefit from pre-contractual disclosures. Applying SDR to such funds would be costly, disruptive and of little benefit to investors. We believe that existing funds that are closed to new investors should be out of scope of SDR entirely, as per our answer to Q1.

Q17: Do you agree with our proposal 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 agree with the on demand proposal, but request clarification on the precise requirements (e.g. re scope, requirements and methods of complying) for portfolio managers, in particular that the required disclosures can be made by compiling an index of the disclosures made by underlying investments that are "sustainability products".

We also note that ESG 4.5.14R(4) uses the definition "on-demand sustainability report" but this term is not defined in the current Glossary or the amendments to the Glossary in Annex A to CP22/20 (and is not used anywhere else in CP22/20). We suggest that the FCA consider whether this term should be defined.

Q18: Do you agree with our proposal 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 broadly agree with the proposal. However, it seems that, whilst sub-threshold AIFMs (i.e. less than £5bn AUM) will be exempt from all TCFD reporting requirements (entity level and product level), these firms will only be exempt from the entity level and not the product level SDR disclosures. We do not see a policy rationale for this difference in approach and recommend that SDR be aligned with the approach taken by the TCFD rules, to avoid disproportionately burdening the majority in number of BVCA firms that will fall below this threshold. However, despite being exempt from entity level reporting, it seems that a sub-threshold firm could opt to use a label, which we welcome, but we recommend explicit confirmation of this in the rules.

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 welcome the FCA's recognition, in line with the Government's Roadmap to Sustainable Investing, of the potential for the ISSB Standards to set a much-needed global baseline for sustainability reporting. Equally, we note that the ISSB Standards remain in development and once finalised may or may not be mandated in different jurisdictions. We therefore strongly recommend the FCA consults further on the interaction between the ISSB Standards and SDR once the former are finalised so that they can be incorporated into UK regulation in an effective manner, taking into account the contours of different jurisdictions' sustainability regulation at that point. More broadly, we welcome the FCA's intention to keep SDR under review as international standards and frameworks are developed.

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

We agree that sustainability disclosures, as is the case for disclosures generally, should be fair, clear and not misleading, and we welcome the FCA's focus on this area. However, we are concerned that the proposed re-statement of the existing position, and its description as an (apparently new) "anti-greenwashing rule", suggests that the rule in relation to sustainability disclosures is different to the general rule (which we understand is not, in fact, the FCA's intention). Further, we note that the term "greenwashing" implies a focus on environmental issues and could be read as not covering the social and governance elements of ESG.

Our view is that "greenwashing" (or "sustainability washing" more generally) can be tackled using the existing requirements for firms to act honestly and in the best interest of investors, and be clear, fair and not misleading in their communications with investors. Greenwashing falls within the scope of these general principles and can be treated in the same way as other misleading or incorrect information provided to investors or the public (e.g. on the type of investments, investment restrictions, allocation of returns etc.). The effects of greenwashing for investors and the market are no different in substance to other instances of incorrect or misleading market information. Although we support the objective of creating a reliable disclosure regime for sustainable finance we think that the FCA should emphasise that its existing rules apply to sustainability-related disclosures and that it will, as an enforcement matter, be focusing resources on addressing greenwashing using those existing rules and the new ones included in the SDR and labelling regime.

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?

We generally agree with the proposal, but request the FCA clarifies that terms such as "healthcare", "water" etc. which describe the asset / sector focus of the fund are not captured as potential restricted terms, or guidance is provided which confirms that the use such terms is permitted if representative of the fund's investment strategy.

Additionally, we strongly recommend the rules should not apply to closed-ended funds that are no longer marketing or admitting additional investors. Changing the name of existing closed funds would seem to serve little purpose from a greenwashing perspective, would cause cost and disruption for investors as well as confusion in the market. As per our answer to Q1 above, we think closed closed-ended funds should be out of scope of the framework entirely.

We do, however, believe that more clarity is needed as to the specific terms that are not permitted under the naming rule, via an exhaustive list. We do not think it is helpful to include a "catch-all" provision ("any other term which implies that a sustainability product has sustainability characteristics") because it will be very unclear when that rule is engaged. There are many terms (for example, "water", "waste", "forestry") which to some people might imply a sustainability characteristic, but which may not meet the requirement for a label. We believe it would be sufficient for the FCA to re-confirm that, alongside the requirement to avoid terms that appear on the exhaustive list, the name of a product needs to comply with the "fair, clear and not misleading rule" and that, given the importance of the name in giving investors an impression of the characteristics of the product, the FCA will, in enforcing that rule, expect firms to pay particular attention to names that could give a misleading impression to investors.

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

Whilst we fully support the general requirement that firms' sustainability-related communications must be clear, fair and not misleading, we do not agree with the proposed prohibition on certain sustainability wording for products that do not use a sustainability label, and the additional restrictions that apply to managed portfolios in draft rule ESG 3.3.3R (which impose a further 90% threshold requirements for managed portfolios that don't use a label). Below we have explained our concerns with the proposed marketing rule and suggested some solutions for how these might be mitigated by amending the draft rules.

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BVCA members’ concerns with the marketing rules

We welcome the FCA’s proposals to address some of the issues firms are experiencing in complying with similar sustainability-related disclosure regimes, such as SFDR. However, we have concerns about how SDR maps across to other regimes (e.g. SFDR and the SEC’s proposals). In the case of the SFDR, many Article 8 and Article 9 products will not meet the criteria for an SDR sustainable label under the current proposals, given the qualifying criteria for labels are narrower. It is important that the FCA’s proposed marketing rules do not prevent non-labelled Article 8 and 9 products from accurately describing their approach to sustainability. This approach may be materially important to the performance of the fund and therefore fundamentally a necessary part of any consumer-facing documents and disclosures. Comments made by the FCA in paras 6.15 – 6.16, that firms can proportionately and factually describe sustainability-related policies and strategies that are integral, suggest that this was not the policy intention but the actual drafting of the rule in ESG 3.3.2R onwards appears to be much more restrictive.

For example, where a fund is an Article 8 or Article 9 SFDR product, it may not meet the criteria for a sustainability label, but is nevertheless likely to include sustainability wording in marketing material and in fact is required to do so under the EU rules. Under the FCA’s proposed marketing rules, it is not clear if this kind of product can include sustainability-related wording in marketing documentation. This may result in a fund being unable to use EU marketing materials in the UK, or require forced deletions of certain texts which could have adverse impacts, such as asymmetric disclosures for UK investors, or between institutional and retail investors, who would receive less information on ESG because of the prohibition. This may also mean that a fund cannot properly describe its investment policy and strategy to investors where it involves sustainability considerations. This may give rise to issues with regards to a fund manager’s fiduciary duties, as if the fund cannot properly describe its investment policy and strategy, it may be limited in how it follows this strategy to avoid breaching its fiduciary duties.

The marketing rule also risks misleading investors. The labels should not be viewed by investors as necessarily providing the only credible ‘stamp of approval’ from an ESG perspective. There is a real risk that mainstream fund products that have strong ESG credentials but do not adopt a label (for whatever reason) may come to be stigmatised by UK investors as being ‘dirty’ products, despite the fact that they are far from such, purely because they do not have a label (similarly to how SFDR Article 6 products are viewed by some investors). That outcome would mislead investors and misdirect capital genuinely sustainable activity, hindering the system-wide success of sustainability disclosures in preventing greenwashing and promoting sustainability outcomes. The possibility of that outcome arising further reinforces how important it is that SDR allows firms to describe mainstream fund products accurately, by using sustainability-related terms where, in fact, those terms accurately represent a fund’s approach to sustainability.

In order to qualify for a label, global PE/VC firms wishing to market overseas funds to UK retail investors as part of a global investor base would have to either redesign their global fund products to meet the qualifying criteria or establish separate bespoke products for UK investors. Either route to a label could significantly increase costs for investors and fund managers and so we think relatively few non-UK firms are likely to seek labels if/when they become available, at least at the outset. As a result, overseas funds, if/when the rules are extended to them, will be subject to the marketing rules in the same way as UK firms, but with potentially even less flexibility than UK firms might have to comply with the marketing rules by avoiding certain language. This is due to the parallel application to their products and activities of non-UK law and sustainability regulation that may push in different directions (the FCA seems understandably focussed on the EU and the US, but should be mindful that sustainability disclosure regimes are likely to proliferate around the world in the coming years). In this context, we feel that the eventual application of the proposed marketing rule to overseas products may produce a compliance burden that ultimately will mean less choice for UK investors, through a reduction in the number of global fund products that are marketed in the UK.

We note that the rule in ESG 3.3.2R(1) includes certain carve outs from the marketing prohibitions but we believe these do not go far enough to address the practical issues we have raised. This is because the carve outs only

extend to mandatory SDR and other regulatory disclosure documents and not to general marketing materials. In our view, this overlooks the point that the marketing materials are intended to provide a fair and accurate picture of the product's investment strategy and so would need to include a reference to integral ESG aspects.

As noted above, in the context of managed portfolios, we do not think the higher 90% threshold in ESG 3.3.3R is appropriate, as it has been pegged too high. Additionally, the criteria in ESG 3.3.3R appear to be more restrictive than the label requirements for managed portfolios in ESG 3.1.1R(2). This is because ESG 3.1.1R(2) suggests that a managed portfolio can use one of the labels if 90% of its investments *meet the criteria* for the label, whereas the rule in ESG 3.3.3R requires 90% of the investments of the portfolio to *actually use* the label.

Proposed solutions to resolve these issues

To address these concerns, we recommend that the FCA remove the marketing prohibitions and rely on the general 'anti-greenwashing' rules and naming rules proposed (as well as the FCA's strengthened financial promotion rules in COBS 4), which we think are sufficient to achieve the policy aim of preventing greenwashing. We also propose that marketing materials using such terms should have a disclaimer, such as a warning and link to the FCA rules, that the use of such terms does not imply or import an investment label under the SDR. We believe these rules would provide sufficient protection for consumers.

Please also see our comments on the need for clarity, and our concerns about a "catch-all provision", in our response to Q21 on prohibited terms in the proposed naming rules, which would apply equally to the prohibitions described for the marketing rules.

Further, we would seek to clarify the scope of the rule for existing funds that are in their fundraising period. While the rule may be more manageable to apply for new products, we have concerns with how marketing would be impacted for existing products that will potentially already include prohibited terms. Again, we believe that closed fund products should be out of scope of this rule.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor ttaylor@bvca.co.uk / Nick Chipperfield nchipperfield@bvca.co.uk).

Yours faithfully,

Tim Lewis, Chair, BVCA Regulatory Committee