ICAEW
REPRESENTATION 6/23

CP 22/10: SUSTAINABILITY DISCLOSURE REQUIREMENTS AND INVESTMENT LABELS

Issued 26 January 2023

ICAEW welcomes the opportunity to respond to Consultation Paper CP 22/10: Sustainability Disclosure Requirements and Investment Labels, published by the Financial Conduct Authority on 25 October 2022, a copy of which is available from this link.

For questions on this response please contact ICAEW Financial Services Faculty at representations@icaew.com quoting REP 6/23.

While the ICAEW membership is broad we have taken this opportunity to respond from the perspective of assurance providers. We believe assurance providers have an important role to play in sustainability disclosures and labelling, and for which views are potentially underrepresented within the current ESG landscape.

- Overall, we welcome the proposals for labelling of sustainable investment products with the aim of increasing consistency in the operation of sustainable investment products and enhancing understanding and transparency for consumers via the labelling and disclosure rules.
- Assurance has an important role in the cycle of measuring, monitoring, reporting, and disclosing sustainability-related information, which is then used in investment decision making. Independent assurance builds trust in reporting, promotes comparability and consistency, and plays a part in reducing the risk of greenwashing, a key concern of the FCA and of the consultation paper.
- We recognise sustainable investing is complex and, in some areas, highly subjective, and that you have designed the regime with this in mind. It is also true that the development of the regime has not been in a vacuum and has to retain flexibility as other international standard setters and governments develop relevant policy for sustainability investing and reporting.
- Co-ordination with international rules and guidance on assurance and other regulators is vital to help develop a consistent approach and to reduce the complexities that arise when different jurisdictions have different rules, standards and requirements relating to reporting and assurance. As these proposals and the regulatory regime is developed, an understanding the pathways of other international regulatory development, from an assurance standpoint, will need to be considered.
- We have focused our attention on Question 10, where alternative views are sought on the labelling regime and on whether independent verification should be mandated. We have provided suggestions for how the topic of assurance could be taken forward, considering

the intended users of any assurance opinions, the underlying components of the labelling regime proposals, and existing assurance practices in the industry.

ICAEW is generally of the view that some form of independent third-party assurance which can be shared publicly with all potential investors and advisors is beneficial, and there are existing market practices that already provide assurance over certain elements of sustainable investment products. However, we agree with the FCA’s decision in paragraph 4.79, that the current regime should not be subject to mandatory independent assurance. This is primarily because the current proposals do not create a regime that is capable of being assured to a sufficient standard or being assured consistently across products and different providers.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. Our vision is that ICAEW Chartered Accountants enable a world of sustainable economies. In pursuit of this, ICAEW works with governments, regulators and businesses and it leads, connects, supports, and regulates around 165,000 chartered accountant members in over 147 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical, and ethical standards.

ICAEW established the Financial Services Faculty to support and deliver its overall vision and individual objectives within the financial services sector in the UK and overseas countries. The Faculty’s activities are primarily organised around three sectors: banking, insurance and investment management. The Faculty comprises more than three thousand members working within the financial services sector. The members are individuals working in business or professional services firms or are corporate members. The Faculty convenes its members and engages with relevant regulatory, advisory and governing bodies to develop and provide insight and technical support across all matters relevant to financial services.

DETAILED OBSERVATIONS

Question 6: Do you agree with the proposed distinguishing features, and likely product profiles and strategies, for each category? … In particular we welcome your views on:

a) Sustainable focus: whether at least 70% of a sustainable focus products assets must meet a credible standard of environmental and/or social sustainability or align with a specified environmental and/or social sustainability theme.

1. We were unclear on the basis for choosing 70%, as a reason is not set out in the consultation paper. We recognise there may be instances when 100% compliance may not be possible, but simplistically 70% allows for a significant investment in non-sustainable assets. We would therefore like to understand the rationale for selecting 70% or whether there were any scenarios that necessitated the chosen percentage. We were also unclear on how to interpret 70% of a firm's assets (for example by number, by nominal value, by market value). We note that market value may fluctuate and could be volatile (especially if assets are illiquid as might be the case with long term green investments), which could create cliff edge moves.
2. In paragraph 4.30 (and draft rule 3.2.6) it is proposed the sustainable focus assets must meet a credible standard or align with a specified environmental theme. The consultation indicates the UK Green Taxonomy (when developed) may be a way of demonstrating the assets meet a standard but does not prescribe a standard or theme (at this stage). It does however indicate that the standard or theme should be robust, independently assessed, evidenced based and transparent.
   - ICAEW would appreciate further clarification of what is meant by some of these terms - for example what are the FCA's expectations for robust or independently assessed? What does an assessment entail and against what is the assessment to be undertaken? We presume any independent assessor should have the necessary competence to make an assessment. What are the expectations on a firm to consider the attributes for an accepted third party developed standard such as the UK Green Taxonomy?
   - We would also recommend further guidance is provided to highlight what would constitute an acceptable credible standard. In our view a benchmark for what is 'sustainable' should include that the underlying criteria to determine eligibility must be clearly defined, measurable and capable of objective assessment by the portfolio manager, and (if required) capable of independent objective assurance by a third-party assurance provider. As set out under Question 10, we do not think the current proposals create a regime capable of being consistently assured.
3. The terms 'meet a credible standard' and 'align with a theme' seem to have equal standing, yet the term 'align with a specified theme' suggests a less rigorous or objective standard. We also note that draft rule 3.2.6 requires the credible standard to be independently assessed but not the specified theme. We are unclear if this is intentional or not given paragraph 4.30, which suggests both standards should be subject to assessment. We presume the intent is that the sustainable focus assets should be of the same quality whether they are selected on the basis of a standard or a theme. We would appreciate further clarification on the difference between the terms and think extra guidance might be needed to ensure there is not a double standard when it comes to selecting assets, and which might facilitate greenwashing.
4. Some of these comments may also apply to the sustainable improvers and impact categories.

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?

5. The proposals in paragraph 4.32 to 4.37 do not specify any form of time frame over which the sustainability profile of the assets should improve (similarly for sustainable impact in paragraphs 4.38 to 4.43). It is for the firm to determine. We note that there must be a clear

and measurable target for improvement, and which must be reflected in the KPIs. This helps hold firms to account if performance lags the target. We also recognise the range of potential assets and strategies that have an environmental and / or social effect makes it impractical to prescribe time-based targets in the regulatory requirements. We would however note that the current approach would seem to allow firms to acquire assets and set long dated targets before any real benefit is achieved. This may be appropriate for some assets but may also provide scope for greenwashing. Effective oversight to ensure the spirit of the regime is implemented properly will be important in this regard.

Question 10: 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 would you suggest?

6. ICAEW agrees with the FCA's decision in paragraph 4.79, that the current regime should not be subject to mandatory independent assurance. This is primarily because the current proposals do not create a regime that is capable of being assured to a sufficient standard or being assured consistently across products and different providers.

Verification v assurance review

7. Firstly, we are unclear what type of review is intended by use of the term 'verification' in paragraph 4.79. There is a distinction between verification and assurance reviews. Assurance reviews are well known and there are publicly available assurance standards (with further sustainability assurance standards being developed). That is not the case with verification reviews and absent a framework being defined, a user may not understand what confidence they can take from such a review. In practice a verification type review also provides less comfort than an assurance review.

Intended users of assurance

8. When considering the value of assurance, it is important to think about the intended users or beneficiaries of the assurance. In this case, it is retail investors, and advisors who are recommending or selling investment products to individual investors. Investors and advisors need to have confidence in the sustainability-related claims of investment products they recommend. We are therefore generally of the view that some form of independent third-party assurance which can be shared publicly with all potential investors and advisors is beneficial.
9. The requirement for assurance may also improve the quality of data, as firms typically implement more rigorous and robust processes to facilitate assurance.

Analysis of the underlying components of the labelling regime

10. The CP22/20 proposes that a label is claimed by the manager of a product, based on a self-assessment of whether a wide range of requirements, principles and qualifying criteria contained in the proposals have been met. The requirements include:
    - the appointment of appropriately skilled and experience teams;
    - the implementation of various internal processes and controls in relation to sustainability performance monitoring;
    - the establishment of clear and measurable sustainable investment objective, policy and strategy for each labelled product;
    - a set of key performance indicators to demonstrate the execution of the strategy, the sustainability performance of the investments and the extent of alignment of investments with the chosen sustainability criteria or framework; and
    - extensive and prescribed disclosures to communicate: (1) the investment manager's approach to running sustainable investment products, (2) the selected label, (3) to provide full transparency about the products sustainable investment strategy, and (4) information on sustainability performance and progress with the strategy.

11. ICAEW believe that obtaining assurance over these requirements would be very onerous for the investment manager. We also think there are some challenges to providing assurance consistently across firms and products, and that the proposals would need to be further developed to provide more specific criteria to set out the exact conditions under which a label could be claimed: the underlying criteria to determine eligibility with the framework must be clearly defined, measurable and capable of objective assessment.
    - The firm sets out the sustainability objective and investment policy and strategy (and the credible standard for sustainable focus products). Within these matters, there is a risk that the firm does not define suitable criteria to enable assurance (eg the chosen criteria are biased, incomplete or unreliable – eg they emphasise the positive social benefits but ignore negative environmental factors). It also seems likely that different firms will define the criteria differently. So even if assurance is possible, it may not be possible to provide assurance consistently across all products in the market.
    - With the sustainable improvers and impact categories the assurance assessment would have to make significant judgements about the future and a firm's intentions as part of its stewardship (eg the potential to deliver improvements (sustainable improver)). This creates a significant inherent risk to any review and one that is difficult to mitigate (if possible). The future and intentions are highly subjective (and potentially only knowable to management) and for which there might be very little evidence of adequate quality to support an assurance opinion.
    - It is not clear at this stage whether an equal weighting should be applied to each of the principles, requirements and qualifying criteria and what elements of non-compliance (individually or in aggregate) would amount to ineligibility with the regime.

Possible interim measures

12. The primary objective of the proposals is to increase transparency in relation to sustainable investment strategies – including how assets are selected (using sustainability criteria) and the activities taken by the firm to achieve the sustainability objectives of the product. The proposals require the introduction of firm defined KPIs to demonstrate each of these elements. Focusing assurance on the KPIs, at least in the short term, would result in assurance being provided over the most relevant underlying information from an investor's perspective. As there are existing and emerging methodologies for calculating and reporting on certain KPIs (GHG emissions for example) this approach would not require further development of the proposals and can be taken up immediately. An increasing number of sustainable and impact products already obtain assurance over key sustainability and impact KPIs. As the ISSB develops sustainability reporting standards there will be more prescribed KPIs with consistent definitions and methodologies available to the market, which will help to drive consistency and comparability.
13. Assurance over the reported KPIs would provide investors, advisors, management and product boards with some comfort that the sustainability strategy is being implemented and that the sustainability performance and outcomes being reported are correct. For the sustainable focus strategy, assurance over a KPI showing the proportion of assets that comply with the selected sustainability criteria would provide comfort that the criteria are being applied consistently in investment decision-making processes and that compliance has not been over-stated.
14. Furthermore, assurance over KPIs will also help to ensure allocation of capital to the best performing products through the identification and correction of any errors in the performance KPIs.
15. ICAEW believe however that assurance of KPIs is only an interim measure. Assurance over limited aspects of the regime including KPIs can mislead retail investors as to the extent of any vetting or compliance with the regime. Because KPIs and respective targets are set by the fund manager, there is a risk that the measures identified are not complete and omit key indicators of harm. Or that the targets set are not stretching. An assurance provider's opinion would cover the accuracy of KPIs and an asset's compliance with them but may not deal with whether the right KPIs have been selected.

16. We have seen an expectation gap emerge in other types of assurance engagements where the findings for narrowly defined agreed upon procedures review had the effect of providing legitimacy to the entirety of the regime. This risk can be managed to some extent through appropriate disclosures but remains, nonetheless.
17. Finally, consideration should also be given to enhancing the role of internal audit in reviewing management's approach to labelling. They could be given an explicit role within principle 4 (resources and governance). An early and rigorous supervisory review of firms' implementation of the proposals would also help identify firm approaches that do not meet the FCA's expectations.

Existing market practices

18. There are already number of different approaches to assurance in the sustainable and impact investment industry, including:
    - Key performance indicators: there is a growing demand from institutional investors for independent assurance over the sustainability or impact performance of investment products.
    - Internal processes and controls: the Operating Principles for Impact Management, a framework developed by the IFC and with 169 signatories globally, requires annual disclosures from managers of impact investment products describing how impact is integrated into the end-to-end investment decision-making process, strategy and operation of the product. Periodic assurance (at least every 3 years) is required for all signatories, to check that the impact framework, as described by the manager, is being implemented across the relevant products.
    - Labels: there are a number of labelling schemes that exist for sustainable investment products. These typically require an independent governing or approval body to be established (eg LuxFlag, Climate Bond Initiative), and the label is awarded by the governing body based on an application from the manager that requires review and approval of an application and an independent assurance or verification report provided at set up and then annually, to check it is operated in accordance with the label requirements.