U.K. SDR Through the Looking Glass

An early analysis of what the U.K. sustainability-labeled funds market may look like.

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Executive Summary

On Nov. 28, 2023, the United Kingdom's Financial Conduct Authority unveiled its long-awaited Sustainability Disclosure Requirements and investment labels regime for investment products. The SDR policy statement includes a substantial package of measures aimed at improving the trust in, and transparency of, sustainable investment products and at minimizing greenwashing.

These measures include four consumer-focused sustainability labels that asset managers will be allowed to use from July 31, 2024. The labels are "Sustainability Focus," "Sustainability Improvers," "Sustainability Impact," and "Sustainability Mixed Goals."

In this paper, we explore the four labels and provide early insights into what the landscape of U.K. sustainability-labeled funds may look like by the end of the year. Our analysis is based on conversations with a selection of asset managers and our data and knowledge of the U.K. fund market. We also discuss the pros and cons of using labels. Finally, we attempt to answer several questions that asset managers and other market participants have raised in recent weeks.

Key Takeaways

- We estimate that about 300 U.K. open- and closed-end funds will opt for a label by year-end. This is an optimistic scenario. Labeled funds may represent 8% of funds domiciled in the U.K. and less than 3% of all funds available for sale in the U.K.
- "Sustainability Focus" will likely be the dominant label, followed by "Sustainability Mixed Goals," then "Sustainability Improvers," and "Sustainability Impact."
- Equity funds may represent over half of the labeled product universe, while fixed-income and passive funds will be significantly underrepresented (each accounting for less than 10% of labeled products). There should be more options in the labeled allocation funds space by virtue of the introduction of the "Mixed Goals" label.
- Reasons for using labels include investor demand, competitive pressure, and the benefit of clarity, among others. But some managers will consider the requirements too constraining. Some will take a cautious approach and wait and see how the market of U.K. labeled products develops.
- It's likely that funds with similar aims could elect different labels, highlighting that labels can only be one indicator for investors, to be analyzed in conjunction with other fund data and information.

What Is SDR, and Why Is It Important?

On Nov. 28, 2023, after two years of extensive consultation, the U.K.'s Financial Conduct Authority published the Sustainability Disclosure Requirements and investment labels Policy Statement, detailing the rules that will apply to sustainable funds domiciled in the U.K. It may be expanded later to pension products, portfolio management, and insurance-based investment products. Overseas funds are not in scope.[1]

The policy statement contains a substantial package of measures aimed at improving the trust in, and transparency of, sustainable investment products and at minimizing greenwashing, including:

- **An anti-greenwashing rule**—to ensure claims are fair, clear, and not misleading
- **Four sustainability labels**—to help consumers navigate the product landscape and enhance trust
- **Naming and marketing rules**—to ensure the use of sustainability terms is accurate
- **Consumer-facing information**—to make it easy to understand sustainability product features
- **Detailed information**—to support all investors seeking more detail
- **Requirements for distributors**—to ensure product information is available to consumers

As shown in the timeline below, the anti-greenwashing rule will come into force from May 31, 2024, while asset managers will be permitted to use the labels from July 31, 2024. They will need to ensure that all their naming and marketing is updated by Dec. 2, 2024.

Exhibit 1 Implementation Timeline

Source: SDR policy statement.

SDR is important because it will affect how sustainable funds are built and how they are sold to investors.

1 The FCA "will continue working with HMT to understand the options for extending the regime to overseas recognised funds, including those marketing under the Overseas Funds Regime. The extension of SDR to overseas funds is a matter for HMT."

Within the next few months, asset managers will be reviewing their product ranges to consider which funds should be labeled and which ones can be amended to qualify for a label. Advisors, distributors, discretionary fund managers, and those who work in pensions will also need to be familiar with SDR and understand how this could potentially affect them and their underlying clients.

Moreover, SDR will have implications beyond the U.K. as other jurisdictions look to implement similar regulatory frameworks. SDR has already influenced the European Commission as evidenced by the proposed sustainable product categories in its recent SFDR consultation paper.[2, 3]

A Brief Introduction to the Four Sustainability Labels

As part of the raft of new measures, the FCA created four sustainability labels to help consumers differentiate between products with different sustainability objectives and investment approaches. The labels are Sustainability Focus, Sustainability Improvers, Sustainability Impact, and Sustainability Mixed Goals. A brief description of each label is provided in the table below. For more details, please refer to the section "Label Requirements."

Exhibit 2 Sustainability Labels—for Use From July 31, 2024

Sustainability Focus™	Invests mainly in assets that **focus on sustainability** for people or the planet
Sustainability Improvers™	Invests mainly in assets that may **not be sustainable now**, with an aim **to improve** their sustainability for people or the planet over time
Sustainability Impact™	Invests mainly in **solutions** to sustainability problems, with an aim **to achieve a positive impact** for people or the planet
Sustainability Mixed Goals™	Invests mainly in a **mix of assets** that either focus on sustainability problems, aim to improve their sustainability over time, or aim to achieve a positive impact for people or the planet

Source: SDR policy statement. Morningstar Research.

Use of labels is voluntary. Funds that claim sustainability characteristics won't be forced to opt for a label, but if they don't use a label, they will have to explain why, and they will still be required to provide the same sustainability disclosures as labeled funds.

The four labels, which are not designed to be in a hierarchy, are only for products seeking positive sustainability outcomes, which means that only a subsegment of funds that use environmental, social,

2 SDR itself was also heavily influenced by SFDR, which came into force in March 2021.

3 Consultation document - Targeted consultation on the implementation of the Sustainable Finance Disclosures Regulation (SFDR) (europa.eu).

and governance factors in their investment strategy can qualify. Funds that just employ exclusions, negative screening, ESG integration, or basic ESG tilts alone will not qualify for a label.

Finally, by "positive sustainability outcomes," the regulator refers exclusively to positive outcomes for people and planet, so the E and S of ESG, but not the G. Governance is an enabler of environmental and social outcomes, rather than an end in itself. So, products investing in assets with good governance alone would need to do more to qualify for a label.

The Intersection of Labels With the Sustainable Disclosure Requirements

As referenced above, both the use of a label and/or the use of sustainability terms in fund names and marketing material come with equivalent product disclosure requirements. First, a clear and concise consumer-facing document of no more than two pages must be made available. It should incorporate details about the label, or why the product doesn't have a label, together with the investment policy, including what it will and will not invest in, and relevant metrics with signposting to more detailed information.

Second, detailed precontractual disclosures must be made available by Dec. 2, 2024, or from the date a label is first used, if earlier. The documents should broadly include information related to the relevant label criteria (discussed later in this paper) or, for unlabeled products, information about the investment policy together with related metrics. A parallel ongoing disclosure with up-to-date key performance indicators must be published annually thereafter.

Product distributors will incur a responsibility to communicate labels and disclosures to their clients and to make clear that overseas products are not subject to the labeling and disclosure requirements.

An Attempt to Predict What the Labeled-Funds Market Will Look Like

As previously mentioned, asset managers can start using the new sustainability labels from July 31 and must ensure all funds' naming and marketing is updated by Dec. 2.

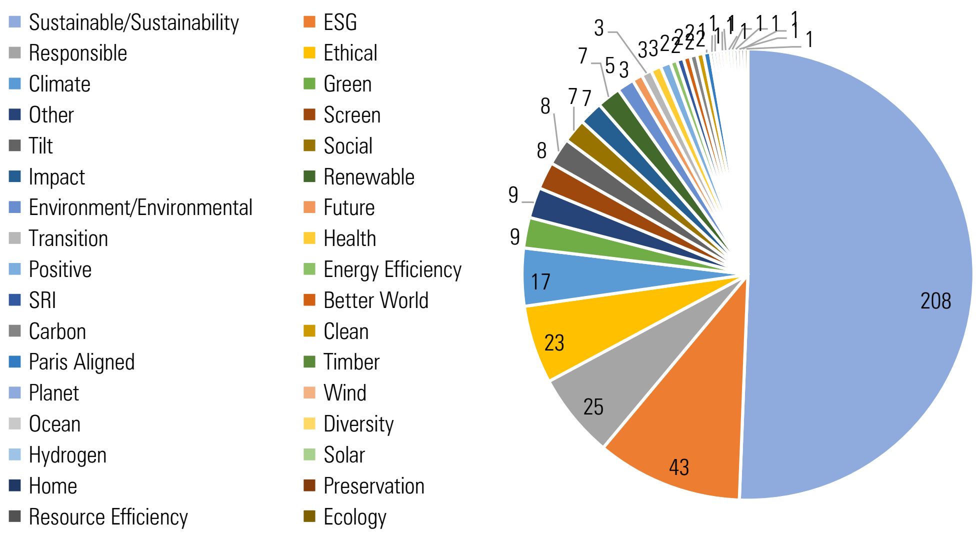
Within the next few months, asset managers will be reviewing their product lines to consider which funds would qualify for a label. In this paper, we attempt to predict which funds will be labeled and which labels will be used. The purpose of this exercise is to assess what the market of U.K. sustainability-labeled funds may look like by the end of the year.

To assess the size and makeup of this future market, we first searched the Morningstar fund database for funds in scope of the regulation with sustainability-related terms in their names (names only, not investment objectives or marketing materials). We identified 410 such funds, including 378 open-end funds, 31 closed-end funds, and one exchange-traded fund. These 410 U.K.-domiciled funds represent about 23% of funds available for sale in the U.K. with sustainability-related terms in their names[4].

4 We identified about 1,780 funds available for sale in the U.K. with sustainability-related terms in their names, including about 1,370 overseas funds.

Exhibit 3 shows the distribution of the 410 U.K. funds per sustainability-related term.

Exhibit 3 Count of U.K. Funds With Sustainability-Related Terms in Names Only



Source: Morningstar Research, Morningstar Direct. Data as November 2023. Funds with key terms are counted only once. For example, funds with both "Sustainable" and "Responsible" in their names are included only in the "Sustainable/Sustainability" group and funds with "Climate Transition" in their names are included only in the "Climate" group.

We can see that "Sustainable" and "Sustainability" are the most common terms, being used by 208 U.K. funds, followed far behind by "ESG" (43), "Responsible" (25), "Ethical" (23), and "Climate" (17). The word "Impact" is employed by only seven funds.

After scoping out the universe, we interviewed 15 asset managers actively marketing funds in the U.K. When we spoke to them, most said they were still at the early stage of reading and interpreting the rules before moving to the next stage, which is assessing their product ranges, reviewing their strategies against the new regulatory guidance, and performing gap analyses. Despite the fact they were still early in the process, some managers were able to share the number of funds they believed would qualify for a label and which label they would prefer to use for each fund. Others were not able to share any details but discussed their initial interpretation of the rules, general intentions on opting or not opting for labels, and the challenges they will face in their decision-making and investment processes.

Based on these conversations and our knowledge of the strategies and the firms, we estimated which funds would opt for a label and which label they would use.

We believe that practically all the U.K. funds carrying the words "sustainable," "sustainability," or "impact" in their names would opt for a label. We think that commercial interest and the risk of being accused of greenwashing, among other factors (see "Pros & Cons of Using Labels" section), will prompt the firms offering these funds to meet the requirements of one of the labels so they can keep the key words in the fund names. We also think that very few funds not currently carrying a sustainability-related word in their names would opt for a label.

For all funds using sustainability-related terms in their names, we analyzed the ESG-related language in investment strategies and policies to assess how likely they are to use a label and which one they would use.

In total, we estimated that about 300 would opt for one of the four labels. We think it is the most optimistic scenario. By comparison, the FCA estimated in its policy statement[5] that around 280 funds that currently have key sustainability-related terms in their name or objectives will use a sustainability label.[6] Like the FCA, our estimates don't take into account new funds that will be launched this year and that may opt for a label.

The 300 funds we identified as potentially opting for a label would represent just over 8% of funds domiciled in the U.K. and less than 3% of all funds available for sale in the U.K.[7] In terms of assets, they would amount to around GBP 110 billion[8].

Focus and Mixed Goals Will Likely Be the Dominant Labels

Based on our assessment of these 300 funds, we predict that Focus will be the dominant label, representing almost half (46%) of labeled products, followed by Mixed Goals (31%), Improvers (12%), and Impact (11%).

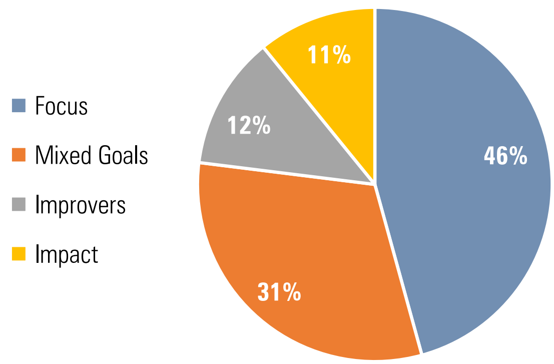
5 Page 81 - Point 12: 24. 'We estimate the number of UK-based funds affected by the labelling and naming and marketing rules to be at least approximately 630. This figure was estimated by (i) filtering Morningstar fund data for key sustainability-related terms in their name or objectives (eg, 'sustainable', 'ESG') and (ii) limiting the sample to funds that are actively marketed in the UK. This estimate is based on a sample of existing funds in Morningstar data which may not have full market coverage. […] We assume that 45% (sub-population A1) of the products (and corresponding firms) that currently have sustainability-related terms in their names and marketing materials will use the investment labels under our rules, and the remaining 55% (sub-population A2) will be subject to our naming and marketing rules.'

6 According to the FCA, 630 U.K.-based funds could be affected by the labeling and naming and marketing rules because they have key sustainability-related terms in their names or objectives (for example, "sustainable," "ESG"). And of these 630 funds, the FCA estimated that 45% (around 280 funds) could use a sustainability label, while the rest (55%, 350 funds) would still be subject to the same disclosure requirements and explain why they're not using a label.

7 Both universes include open- and closed-end funds and ETFs.

8 As of November 2023.

Exhibit 4 Expected Representation of U.K. Labeled Funds by End of 2024



Source: Morningstar Research.

Of the four labels, it appears that asset managers have the best understanding of the Focus label and the type of strategy that will qualify for this label. Managers we spoke to drew a parallel with SFDR, and despite questions about what constitutes a "robust and evidenced-based standard" (see "Key Questions & Answers" section at the end of this paper), many were confident that strategies meeting the criteria for Article 9, portfolios with high sustainable investments as defined under SFDR, as well as thematic strategies would meet the requirements for the Focus label.

Several managers also acknowledged the attractiveness of the new Mixed Goals label because of the flexibility it offers. It should allow them to slice portfolios and create as many allocations to sustainability objectives as they see fit as long as 70% of the overall assets are aligned with the criteria of at least two of the other three labels. In fact, managers keen to have an Impact sleeve in a portfolio may decide to opt for the Mixed Goals label instead of Focus. Similarly, managers of portfolios that don't meet the 70% threshold of sustainable assets required for the Focus label may want to create a separate sleeve of assets that will align with the criteria of the Improvers label.

Improvers and Impact Will Be Important, but Smaller, Universes

When the FCA unveiled its proposed labels in 2022, the Improvers label was hailed as a great idea, recognizing the need to build portfolios for sustainability-oriented investors that reflect the current state of the world: one that houses few companies that are sustainable but many more that are transitioning and aspiring to be sustainable one day. According to our preliminary analysis, we don't expect the number of Improvers labeled funds to be among the largest because, as described above, managers may prefer to hold a mix of assets that have different sustainability strategies, including an Improvers sleeve. We predict Improvers funds will represent only around 14% of labeled products, although this proportion may be higher if more funds end up setting improvement KPIs at product-level (as opposed to KPIs for individual assets) such as portfolio decarbonization targets. Managers may also be tempted to test the limit of the label's requirements by setting low improvement thresholds.

Finally, perhaps unsurprisingly, we expect only a small number of funds will use the Impact label. Despite having relaxed the initial rules (most notably the removal of the "additionality" and "real-world impact" requirements), the FCA has maintained strict criteria. Managers of Impact-labeled funds will have to demonstrate a theory of change at both the investor level (through engagement, for instance) and asset level. It will therefore remain a challenge for managers to show evidence of impact in the listed market. We identified very few U.K. funds targeting impact in the listed equity market (mainly those already publishing detailed impact reports). Strategies for which it will be easier to show evidence of impact are those focused on bonds with use of proceeds (for example, green and social bonds) as well as those investing in private assets, including direct property and infrastructure, which are more suited in a closed-end investment trust format.

For more details on the types of funds that we might expect under each label, please read Question 4 of the last section of "Key Questions & Answers."

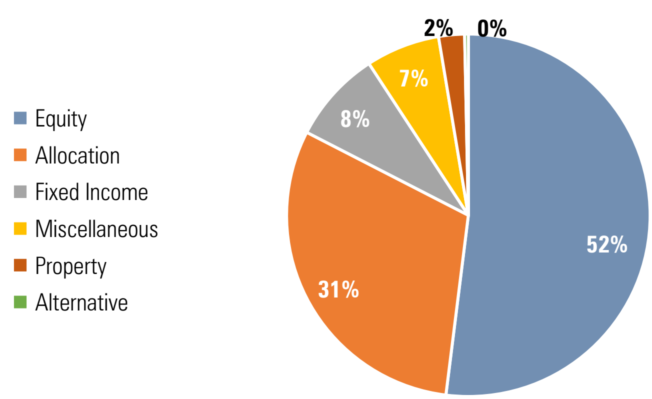
Diving Into the Universe of Labeled Funds

In this section, we dive deeper into the universe of the approximately 300 U.K. funds we identified as potentially using a label by the end of the year. We look at their exposure in terms of asset class and Morningstar Category, as well as their management style (active versus passive).

Equity Will Dominate. Fixed Income Will Be Underrepresented

As shown in Exhibit 5, just over half (52%) of the 300 labeled funds would offer exposure to equity markets, while about 31% would be allocation funds. Fixed income would account for only around 8% of labeled funds. By comparison, the overall U.K.-domiciled fund market includes 42% of equity funds, 39% of allocation funds, and 11% of fixed-income funds. When considering all funds available for sale in the U.K., equity funds represent 48% of the market, allocation funds only 18%, and fixed income 22%.

Exhibit 5 Expected Representation of U.K. Labeled Funds by End of 2024 — Broad Asset Classes



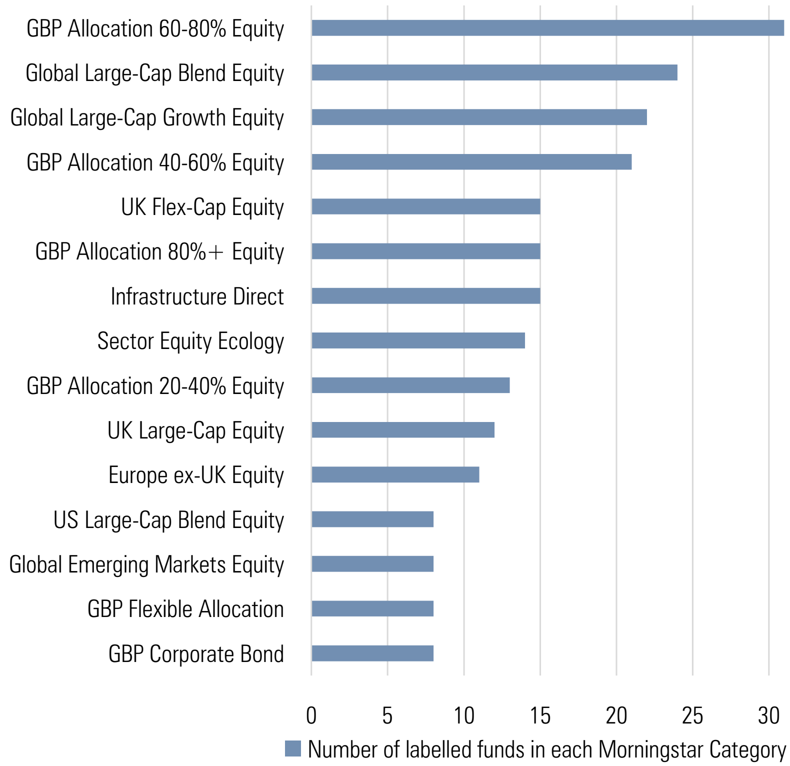
Source: Morningstar Research.

Biased toward equity, this distribution of labeled funds shouldn't therefore come too much as a surprise. Moreover, equity remains the asset class where it is easier to integrate ESG factors. ESG integration in fixed-income strategies faces multiple issues, including data availability and quality. There is also the issue with evidencing sustainability outcomes in the case of sovereign debt.

Allocation and Global Large-Cap Equity Categories Will Offer Most Choice

The exhibit below lists the 15 most popular Morningstar Categories we may see represented in the universe of labeled funds. We see two GBP allocation categories and two global large-cap equity categories featuring in the top five.

Exhibit 6 Expected Representation of U.K. Labeled Funds by End of 2024—Morningstar Categories

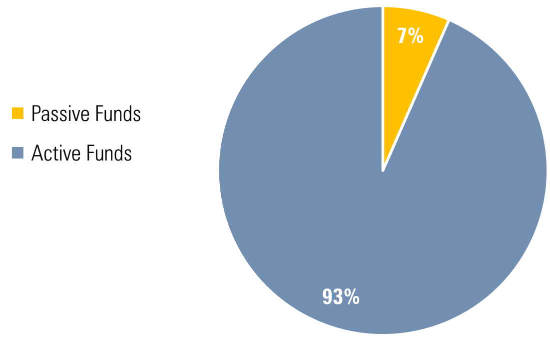


Source: Morningstar Research.

Passive Funds Will Be Significantly Underrepresented

Out of the 410 U.K. funds with sustainability-related terms in their names, only about 50 are passively managed, and of these, we predict that less than half will opt for a label, as the majority of U.K.-domiciled passive funds are exclusionary or tilted strategies. Most passive funds available for sale in the U.K. (1,960 in total) are overseas exchange-traded funds, typically domiciled in Ireland or Luxembourg, which are currently out of scope. The limited number of labeled passive funds will reduce the choice offered to sustainability-oriented investors in the U.K.

Exhibit 7 Expected Representation of U.K. Labeled Funds by End of 2024—Active vs. Passive



Source: Morningstar Research.

Label Requirements

To use a label, products must meet general requirements and label-specific criteria on an ongoing basis.

The **general qualifying requirements** relate to:

- *Sustainability Objective*. All labeled products must have a sustainability objective to improve or pursue **positive environmental and/or social outcomes**.
- *Investment Policy and Strategy*. **At least 70% of the product's assets** must be invested in accordance with its sustainability objective, with reference to a **robust, evidence-based standard** that is an absolute measure of environmental and/or social sustainability. The remaining assets should not conflict with the sustainability objective, and any that could be considered as doing so should have their purpose in the portfolio explained.
- *Key Performance Indicators*. Firms must **identify KPIs to measure progress** against the sustainability objective (either at product or individual asset level).
- *Resources and Governance*. Firms must ensure there are appropriate resources, governance, and organizational arrangements to support delivery of the sustainability objective.
- *Stewardship*. Firms must identify and disclose the **stewardship strategy** needed to support the delivery of the sustainability objective (including activities and outcomes).
- *Escalation Plan*. Action to be taken if assets do not demonstrate sufficient progress (including anticipated timescales for addressing insufficient progress).

The **key specific criteria** for each label are:

Sustainability Focus

- The sustainability objective must be consistent with an aim to invest in assets that are environmentally and/or socially sustainable.
- The product may invest according to themes, provided that all the general requirements above are met.

Sustainability Improvers

- The sustainability objective must be consistent with an aim to invest in assets that have the potential to improve environmental and/or social sustainability over time.

- Firms will need to identify the period of time by which the product and/or its assets are expected to meet the standard, including short- and medium-term targets. They must also obtain robust evidence that the assets have the potential to meet the chosen standard.
- The methodology or approach to select assets may be a relative measure or approach—for example, selecting the "best-in-class" for a particular sector.
- Firms' investor stewardship strategy should support delivery of the objective and help to accelerate improvements in sustainability over time.

Sustainability Impact

- The sustainability objective must be consistent with an aim to achieve a predefined positive measurable impact in relation to an environmental and/or social outcome.
- Firms must specify a theory of change setting out how they expect their investment activities (for example, engagement, IPO participation) and the product's assets to achieve a positive impact.
- Firms must specify a robust method for measuring and demonstrating the positive impact of both the assets the product invests in and the firms' investment activities.

Sustainability Mixed Goals

- This is for products with a sustainability objective to invest at least 70% in accordance with a mix of the sustainability objectives for the other labels.
- Firms must identify (and disclose) the proportion of assets invested in accordance with any combination of the other labels. Requirements for each of the other labels must be met.

Pros & Cons of Using Labels

Asset managers have no time to waste as they need to decide whether to opt for or against a label before the naming and marketing rule comes into force on Dec. 2, 2024. This decision will depend on a number of factors, some of which are highlighted below.

Reasons for opting for a label:

- Investor demand. Multiple surveys show continuous appetite for sustainable investments among retail investors.
- Competitive advantage. A firm with sustainable investing as a strategic focus will feel compelled to offer a range of labeled products. Many asset managers will see SDR labels as a positive commercial opportunity.
- Risk of greenwashing accusations. Firms offering products that carry the words "sustainable," "sustainability," or "impact" in their names but choose not to opt for labels and are forced to drop these key terms from their product names risk being accused of having been greenwashing and not being truly committed to sustainable investing.
- Simplicity and clarity. Unlabeled funds with other sustainability-related words[9] in their names will be faced with the same ESG disclosure requirements as labeled funds. Having to disclose ESG information and explain why a fund isn't labeled may prove cumbersome and lead to investor confusion. Labeling a

9 Words other than "sustainable," "sustainability," or "impact," as only labeled funds will be allowed to use these three words.

fund with sustainability characteristics may be considered simpler, with the added benefit of bringing clarity to the end investor.

Reasons for not opting for a label:

- No client demand. Firms primarily serving institutional investors or retail clients that have no interest in sustainability may not see the appeal of using labels.
- Strategy and portfolio changes. Many funds opting for a label will likely need to make adjustments to their strategy and/or portfolio composition to align with the requirements of the labels. Potential changes and additional constraints may be considered too significant and/or not in the best interests of fundholders.
- Wait-and-see. Having faced many interpretation challenges with SFDR, which resulted in reclassifications and methodology changes, some asset managers may want to take a wait-and-see approach with SDR. Firms offering their U.K. strategies into other EU markets may decide to await further directional information from the European Commission regarding a European labeling regime to avoid conflicting requirements or multiple rounds of portfolio and literature changes. At first then, firms may choose to only comply with the naming and marketing rule and wait and see how the market of labeled products evolves. Gradually, they may make changes to existing funds to meet the requirements for a label. They may also choose to launch new funds that will qualify for a label instead of labeling existing funds.

The success of the FCA's labeling regime will lie in the quantity and quality of the labeled products. The creation of a fourth label (Mixed Goals), from just three originally, is evidence that the regulator would like to see as many labeled products as possible. In its policy statement, the FCA notes that the Mixed Goals label will increase overall label uptake, and with more funds using labels, there will be an increased provision of standardized sustainability-related information compared with the initial proposals. As a result, more firms will take a consistent approach to categorizing their products, and consumers will be able to better navigate a wider range of products in the sustainable investment.

We expect the first wave of implementation—that is, between July 31 and Dec. 2—to determine how the market of labeled products will shape up. Firms will learn from the early adopters.

Key Questions & Answers

We have listed below a number of questions that came up in our conversations with asset managers. We have attempted to provide answers to these questions.

What is a robust evidence-based standard of sustainability?

The FCA is not prescriptive and doesn't attempt to define what constitutes a sustainable asset. It leaves that responsibility to asset managers. Firms can choose any standard they like to select assets that are or have the potential to be sustainable as long as the standard is robust (it can stand up to scrutiny) and evidence-based (it is derived from or informed by an objective and relevant body of data or other evidence).

The SDR policy statement specifies that a robust, evidence-based standard must be an absolute measure of environmental and/or social sustainability. Firms should select assets using a methodology or approach that is applied in a systematic way based on an authoritative body (for example, a government or regulator), industry practice (for example, a third-party data provider), or a proprietary methodology (developed in-house by the firm). Examples include:

- General environmental and/or social criteria. For example, the standard may set a minimum threshold for the percentage of revenue or the percentage of expenditure on operations, capital, or research and development associated with environmental or social matters relevant to the product's sustainability objective.
- Taxonomy-based, such as the EU taxonomy for sustainable activities or a future U.K. Green Taxonomy.
- Emissions profiles. For example, the standard may set a minimum absolute threshold of greenhouse gas emissions or carbon intensity for assets.
- For the Improvers label, standards may include forward-looking metrics, transition plans, strategies, or other credible information that demonstrates those assets are on a pathway to becoming more sustainable.

Many managers we spoke to said they will use their proprietary sustainability research and/or scoring system as standard for the active funds they're planning to label. Some will leverage the work they have done for SFDR. They will evaluate the methodology they're using to measure sustainable investments under SFDR and see how it translates into a robust and evidence-based standard. One manager said it will use its current screening approach, which sets at 25% the minimum revenue that a company must generate from specific sustainable themes. A minimum percentage revenue exposed to one or several themes can be considered as an absolute measure of sustainability. While asset managers often produce quantitative measures (for example, scores) to sum up a company's sustainability profile, which may or may not include qualitative input, some firms do not operate with a scoring system and instead rely exclusively on their qualitative framework to select companies. A couple of firms we spoke to are planning to use their qualitative research framework as their standard.

The label-eligibility of specific scenarios—for example, best-in-class strategies—is largely left to firms' own determination within the context or confines of "a robust, evidence-based standard that is an absolute measure of sustainability." Consequently, we anticipate taking some time and trial and error to converge on some level of generally accepted consistency.

SDR requires an independent assessment of the standard to confirm it is fit for purpose. It may be obtained from a third party or undertaken by the manager itself provided that the chosen method is independent from the manager's investment process. A few managers said they already have an independent monitoring process in place (for example, third-party audits, investment risk committees) to prove the robustness of their approach.

What KPIs can be used?

Firms must identify KPIs to measure progress against the sustainability objective (either at product or individual asset level). The FCA has not prescribed any KPIs but encourages firms to use industry frameworks and best practice to the extent relevant for their products' sustainability objective.

When setting KPIs, firms may face data and methodology challenges. While corporate sustainability reporting is improving by virtue of other industry and regulatory initiatives, challenges remain with consistency, comparability, and comprehensiveness, both in the case of listed companies and even more so in the private company arena.

For physical green assets, like wind and solar, a commonly used metric is renewable energy generated (for example, kilowatt-hours of electricity), but for transition assets, there aren't any standards. A manager may want to report on avoided carbon, but there are different approaches to measure avoided carbon. Managers will have to be transparent and clear about their calculation methodologies. For real assets under construction or development, finding metrics would be an even bigger challenge because the assets are not producing anything yet. Creating industry standards would help reduce regulatory risks in a space where more capital is needed to grow faster.

Finding KPIs will prove easier for asset managers investing in listed markets, where data and metrics are more easily available and managers can turn to third-party data providers. Yet, even in the listed space, data may remain a challenge, particularly on social issues and in emerging markets, where many companies have yet to develop the same data-reporting capabilities of many companies in developed markets.

Do all retail products with sustainability-related terms in the name and/or marketing material have to comply with the naming and marketing rule even if they don't have a sustainability objective?

We expect so. In its policy statement, the FCA provides a list of sustainability-related terms, which includes "ESG," "environment" (or "environmental" or "environmentally"), "social" (or "socially"), "climate," "sustainable" (or "sustainability"), "green," "transition," "net zero," "impact," "responsible," "sustainable development goal(s)" (or "SDG(s)"), and "Paris-aligned." This list is far from exhaustive, and the FCA isn't expected to provide one. Exhibit 3 in this paper offers a longer list of terms we consider related to sustainability.

Sustainability-related references can be present not only in product statements, strategies, targets, policies, and general information but also in images. While greenwashing has been identified by the FCA as a risk to mitigate (that's the purpose of the anti-greenwashing rules), *greenhushing*[10] is also a risk that the naming and marketing rules should address. Unlabeled products that carry a sustainability-related term in their name or marketing will be required to include sustainability-related information in the annual product report, regardless of whether they have a sustainable objective. In our view, all products that target a sustainable theme, even if their sole objective is financial returns, will fall under

10 Greenhushing is the practice of avoiding or downplaying the discussion of one's environmental impact or sustainability goals, often for fear of backlash or criticism.

the naming and marketing rule. We think the 17 United Nations Sustainable Development Goals can be used as a guide for identifying a sustainable theme.

Unlabeled funds with sustainability-related terms in their names or marketing will have to explain why they have not opted for a label.

What types of funds might we expect under each of the labels?

In its policy statement, the FCA offers a number of examples, which we compile below.

- A climate solutions product investing in companies that offer climate solutions may go for a Focus label.
- A clean energy or water and waste management fund could qualify for a Focus label.
- A global renewables index fund that tracks an index designed to reflect the performance of a global range of companies that produce or provide activities or services to support the production of energy from solar, wind, hydrogen, and other renewable sources may also seek a Focus label.
- A climate solutions product that invests in companies with credible transition plans may go for an Improvers label.
- Aligned and aligning strategies are most likely to be found in Improvers products. Both strategies direct financing to assets issued by companies that are still in transition. Therefore, even in the case of an aligned financing strategy, the investment is unlikely to already meet a reasonable investor's threshold for sustainability.
- Products tracking a Paris-Aligned and Climate Transition Benchmark may form part of the asset-selection approach in an Improvers product, where that product is directed toward a future 1.5-degrees Celsius emissions profile for assets.
- A climate solutions product dedicated to scaling up investment in new climate solutions technologies may qualify for an Impact label.
- A multi-asset green energy fund, which intends to invest around 30%-40% of assets in equities and bonds focused on companies already predominantly producing renewable energy and around 40%-50% of assets in equities and bonds supporting activities to increase renewable energy production may qualify for the Mixed Goals label.

Could we expect similar strategies to use different labels?

We can expect to see a number—albeit limited—of strategies that follow the same sustainability approach under different labels. For example, two funds investing in listed companies whose revenues are aligned to the U.N. Sustainable Development Goals may end up using a Focus and an Impact label. The manager opting for Impact may feel more confident in its ability to demonstrate a theory of change at both the investor and assets level. The difference might mostly be in the level of reporting details.

What are the rules for index-tracking products to qualify for a label?

As seen earlier, the number of passively managed products domiciled in the U.K. is small. Also, most employ only negative screening. To qualify for a label, these strategies will need to be enhanced and track an index that includes a sustainability objective. In its policy statement, the FCA clarified that where a product tracks an index, firms must only use an index that has a methodology aligned with the product's sustainability objective and the general and specific criteria. Fund managers can choose not to name their product after the index it tracks if it does not meet the requirements, or it should satisfy itself that the index name meets the requirements.

Managers of passive products should also consider the most appropriate KPIs to track the performance of the product toward the sustainability objective. This may require a deeper assessment and understanding of the index methodology to identify KPIs that can be repeatably produced and fairly reflect the performance of the product against its sustainability objective. Managers may consider either productwide or asset-specific KPIs to be most appropriate to demonstrate the performance of index-tracking products.

Which types of strategies will need to be amended to qualify for a label?

In its policy statement, the FCA noted that investment strategies such as exclusions, negative screening, ESG integration, or basic ESG tilts alone would not be enough to qualify for a label. Funds just employing one or several of these approaches will need to enhance their strategies by adding a sustainability objective, setting relevant KPIs, and meeting other requirements specific to each label.

What are the advantages of the Mixed Goals label?

By introducing the Mixed Goals label, the FCA is accommodating for products with mixed strategies, and multi-asset strategies in particular, thus providing greater flexibility to asset managers. This, as a result, will increase overall label uptake, without undermining the added challenge of having to clearly explain the different strategy allocations and how these may evolve over time.

In the case of funds of funds, which will be required to take a look-through approach, it is the manager at the top that will be responsible for choosing the label. While funds of funds are likely to opt for the Mixed Goals label, we may see funds holding the same assets labeled differently, resulting in different allocations. This is because managers will use their own standards and datasets to analyze the underlying assets. But funds of funds aren't any different from other types of funds. A company could be classed as an Improver under one manager's standard but as Focus or even Impact under another manager's standard. Asset managers can't be expected to have the same views on the sustainability characteristics of companies, just as they don't have the same views on company valuations.

The FCA doubled down on Improvers with the Mixed Goals label, as it will allow managers to have an allocation to improving investments. Funds that are not quite there yet in terms of sustainability (for example, not reaching the 70% of sustainable assets) may want to hold a sleeve of improving companies and thus qualify for the Mixed Goals label.

Can we expect funds to change labels over time?

Asset managers will be required to review their labels every 12 months, so we can expect funds to change labels over time, although this should be limited partly because of the cost of rewriting product documents. For example, a product can start investing predominantly in assets that meet the criteria of the Improvers label, alongside a sleeve of assets that meet the criteria of the Focus label. Gradually, the fund may decrease the Improver sleeve if it doesn't sell the companies that have met their targets for improvements. The Focus sleeve would increase as a result. As such, over time, a Mixed Goals-labeled fund could become a Focus fund. In theory, many years from now, as more companies become sustainable, we could expect to see fewer Improvers funds and Mixed Goals funds with an Improvers sleeve and more Focus funds and Mixed goals funds with Focus or Impact sleeves.

Will there be an approval process for labels?
In its policy statement, the FCA specifies that if a firm chooses to label a product, the firm remains responsible for its classification and ensuring the label is appropriate. The FCA's fund authorization team will review, and may challenge, the application of any new fund submitted for authorization or amendments to existing funds. However, this will not be an approval of the label.

The following six questions and answers were part of the IA and FCA webinar[11] on Dec. 11, 2023.

What are the requirements for unlabeled funds between May 31, when the anti-greenwashing rule starts applying, and Dec. 2, when the naming and marketing rule comes into force?
Asset managers will have to comply with the anti-greenwashing rule by May 31, if not already doing so, but they can continue to use "sustainable," "sustainability," and impact" in their product names from that date, provided that they do satisfy themselves that the use of these terms is clear, fair, and not misleading under the anti-greenwashing rule. But from Dec. 2, they will need to meet the additional naming and marketing rules, and therefore, if they're not using a label on that date, those terms would need to be removed. Managers will also need to produce the relevant disclosures and statement if they are continuing to use sustainability terms from that day.

How do sovereign bonds fit into each of the three labels? Should they be treated in the 70% threshold or the remaining 30%?
The FCA hasn't been prescriptive on this topic on purpose. It will be up to asset managers to decide how they want to treat sovereign bonds. Some will consider that sovereign bonds have the potential to meet a standard of sustainability and therefore will account for them in their sustainability objectives, whereas others will consider sovereign bonds to be used for other purposes within the product and therefore treat the bonds within the 30%. Both approaches will be acceptable provided that the rules are met, there is sufficient transparency around what is held in the product, and, if it is not meeting the objective, why. It's the same for derivatives.

Can a Mixed Goals-labeled fund of funds invest in unlabeled funds, including overseas funds?
Funds of funds will take a look-through approach, which means that they won't have to only be invested in labeled funds. They can be invested in U.K. or non-U.K. funds, and they themselves will need to make the assessment as to whether that product and the assets that product invests in can meet the criteria and then therefore qualify to use a label. The disclosures will need to be made at the level of the fund of funds and not at the level of the underlying funds. Therefore, if the underlying is a non-U.K. fund and it doesn't have the disclosures, it may be a challenge for the fund above, as it is at that level that the

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disclosures will need to be made. The disclosures for the Mixed Goals label include the proportion of assets that are allocated to each of the three other categories.

Does a strategy with portfolio-level KPI improvement targets such as Paris-aligned benchmarks qualify for the Improvers label?

The FCA has clarified that products within the Improvers category are aiming to improve their sustainability over time, and that means having the potential to meet a robust standard for sustainability over time. While that standard would need to be an absolute standard of sustainability, it can be overlayed with an approach or methodology that is relative. For example, managers can use a best-in-class approach. Firms might select assets within a particular sector that they consider able to demonstrate the most potential to improve over time. Aligned and Aligning to net zero are strategies that are most likely to be found in Improvers products. This includes products tracking Paris-Aligned and Climate Transition Benchmarks. So, these types of products might form part of the asset-selection approach in an Improvers product. The approach would be one where the product is directed toward a 1.5-degree target emissions profile.

Can a sustainability objective be secondary to financial performance, or do both have to be equal?

The FCA has said that the sustainability objective must be part of the investment objectives. It hasn't been prescriptive about the weighting of any particular objective, provided that it is clear to consumers what the goal of a product is. There is a rule that requires firms to disclose whether their sustainability strategy and approach could result in material financial risk and return implications.

Do the naming and marketing rules apply to institutional funds?

All firms are subject to the anti-greenwashing rule, so retail and institutional, but the naming and marketing rules apply only to asset managers marketing retail funds.

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