SDR has arrived - but are we ready?

The FCA's Sustainability Disclosure Requirements and labelling regime is upon us. While it has been a long time coming, Julia Dreblow explains that questions remain about how prepared the industry is for these changes

Protecting clients and building trust are at the heart of the new regime, which is in part thanks to the 2020/21 ESG boom when the fact 'clear, fair and not misleading' applies to environmental and social references was all too often overlooked.

I have always tried to explain that poor practices were not necessarily intentional, however it was clearly time for the regulator to act – as many in the industry were calling on them to do. However, responding is one thing – building a cohesive and constructive landscape is quite another. Combining 'sustainability' and 'investment' effectively and efficiently is tough.

Greenwash rule

The anti-greenwash rule was the first aspect of the SDR to go live in part because it is simply a clarification of existing rules, and as such, it lays the foundations for every other aspect of SDR.

The rule applies to all regulated entities and by now everyone should have reviewed, or at least, be in the process of reviewing both published text and imagery that references environmental and/or social issues.

The rule matters for a number of reasons, most notably trust, client outcomes and ensuring the market functions properly. Taken to the n'th degree, if the ever-growing number of people and clients who care about sustainability don't trust fund managers, and their money is not invested as they intend, supply and demand-led market mechanisms fail.

The most common form of miscommunication, whether intentional or not, has been around funds that simply analyse asset-level environmental, social and governance risks (often with backward-looking data) being promoted as addressing sustainability challenges (forward-looking). This difference was not lost on Elon Musk and others - and has fuelled the ESG backlash.

Being able to differentiate between funds that only do additional risk management and those that set out to build a better future (or at least not destroy it) is therefore vital. The SDR separates these by referencing 'ESG characteristics' and 'positive sustainability outcomes'. Only funds focused on the latter can apply to use labels.

The FCA's thankfully short and accessible paper 'Finalised non-handbook guidance on the anti-greenwashing rule', published in April, leans heavily on these differences giving examples of what is and is not acceptable. It includes a graphic on page 7, summarising the need for sustainability references to be:

- correct and capable of being substantiated
- clear and presented in a way that can be understood
- complete – they should not omit or hide important information and should consider the full life cycle of the product or service
- comparisons to other products or services are fair and meaningful.

While useful as prompts, these bullets, like some other parts of SDR, do not deal particularly well the with the realities of sustainable investing – as they hide complexities and unknowns.

For example, individual assets have both positive and negative attributes, things change over time and assets are traded for financial (and other) reasons. Likewise, environmental and social risks are now widely understood, but tipping points are hard to put dates on. So, taken to extreme, words like 'correct' and 'complete' risk offering false assurances, as do some datapoints – and should be handled with care.

Alongside this is the fact that sustainable fund managers will select assets for different reasons. Some will be 'acceptable on balance' (meeting published criteria) whereas others will be leaders and problem-solvers. And things happen that a fund manager can neither predict nor influence. For example, a supplier to an investee asset may have hidden the existence of slave labour - or a new CEO may roll back on previous commitments.

The point being that no sensible number of objectives or KPIs can measure or manage every conceivable scenario a broad-based sustainable funds may encounter. And that talks to why such funds only rely on data when it makes sense to do so, and often lean most heavily on policies and processes.

Indeed, many do not rely heavily on third party data as managers are often closer to investee assets than typically backward-looking data providers. Active managers have, by necessity, had to develop the skills and processes that enable them to deal with the shifting situations, while meeting client needs and being viable.

In other words, the real world is messy, so different strategies need to be described differently.

Where are we now?

At time of writing (late June) the fund approvals' process for the use of sustainable fund labels is, anecdotally, getting off to a sluggish start. My suspicion is that the issues described above may have something to do with it. And this should perhaps not be a great surprise. These are new rules and it is very early days. Fund managers and regulators may have to take time to work things through in order to find out what works best.

Demanding too much reporting from a fund that is designed to consider all aspects of sustainability risks it becoming uneconomic to run and confusing for clients – while setting the bar too low risks the rules becoming meaningless. Both extremes would result in poor client outcomes and damage a sector that the UK has been rightly proud of for some years.

Striking the right balance therefore means combining metrics and vocabulary carefully. Both matter - as do images - and the balance will be different from fund to fund.

Which is why the SDR is principles-based. So, all we need to do is work out what 'principles-based' means in practice, noting that client needs vary, things change and fund managers cannot control everything their assets do!

Which is why the idea that SDR must focus on setting 'guardrails' is spot on, in my view. Sustainable fund managers should indeed 'say what they do and prove it' in ways that individual clients understand. Meaning that, those involved in SDR-related activity should always look through the eyes of an interested client' in order to stay true to the purpose of SDR. This means, no baffling jargon or multi-page lists of technical objectives and KPIs, no pretending data is perfect - or that the world is predictable. No 'one size fits all'. Instead, it means focusing on articulating what a fund is designed to do, how decisions are made and what happens when things go wrong.

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And it is in this context that I believe SDR risks underplaying the benefits of negative screening. As well as being widely used, relatively cheap and liked by clients because they understand it, exclusions can help direct capital away from companies causing harm and towards better companies. Measuring its ability to impact asset values or deliver positive change is, from a client perspective, therefore largely 'academic'. We can't be sure when or if stewardship activity will deliver benefits either - but that should not stop investors from trying.

But most importantly, focusing on clients, we know that people who are interested in sustainability often want to avoid certain types of companies. Their preferences vary of course – and for those who don't want exclusions – there are plenty of funds with excellent stewardship policies. Seeing negative exclusions as 'positive' is however, almost by definition, not easy.

So, where next?

The labelling regime goes live from 31 July, when managers will have the option to label their funds as 'Sustainability Focused', 'Sustainability Impact', 'Sustainability Improvers' or 'Sustainability Mixed Goals'. Fund managers can not use labels before then. Only approved funds can use these labels, and doing so requires preparing client-facing disclosure documents also. Other documentation will also need to be updated, as fund objectives will probably change. Fund platforms will also need to display labels and 'CFDs' as soon as practicable after this date.

However, there are gaps; notably SDR does not apply to offshore funds yet, so fund pickers beware. This and other factors may be fuelling some fund managers' interest in the SDR's 'intentionally unlabelled' option – at least in the short-term. However, it is important to be aware that all relevant funds that mention environmental and/or social issues are still impacted by the new disclosure, naming and marketing rules.

This incompleteness also has a knock-on effect for portfolios, which are likely to be expected to broadly align to the fund rules pretty soon. The recent consultation on extending SDR closed on 14 June, and we will hear more on this in due course.

So, are we ready? It can easily be argued that we are not ready, but having been in this area for three decades, I can say with some confidence that if the regulator had not started the ball rolling we would probably never would be 'ready'.

There are challenges on all sides, and delays may occur for good reason. But, as with much in sustainability and sustainable investment, the key is to keep moving forwards. We need to learn to recognise and respond to bumps in the road, take advice from people who clearly care, work together to raise the bar as swiftly as possible. And where necessary 'repeat'.

If we are to succeed in both giving clients what they want and addressing systemic risks like climate change, not that they are different, speed is of the essence - as is looking at the big picture. SDR is for retail investment clients, other regulation covers other related challenges as no single policy can do it all. And ready or not… we are up and running!

The opinions represented here are my own ...

The FCA is issuing regular clarifications and answering SDR related questions via this link: https://www.fca.org.uk/firms/climate-change-and-sustainable-finance/sustainability-disclosure-and-labelling-regime

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