ARTICLE SERIES 3 OF 5 - SPOTLIGHT ON SDR: SEEING ESG CLEARLY

The ABCs of SDR for IFAs

Asset managers have a lot of work to do to ensure their sustainable funds meet the requirements of the FCA's Sustainability Disclosure Requirements (SDR), but financial advisers will also have a crucial role in implementing these new measures.

Amassing the level of knowledge required to navigate the world of sustainable investment can feel like a herculean task for advisers, so the prospect of greater transparency and better disclosures from fund managers is a godsend.

'Just now we often find ourselves trying to compare two funds that are wholly different but share the same title,' said Peter McGahan, chief executive of Worldwide Financial Planning.

'Clearer labelling and a crackdown on greenwashing will give us the confidence that we're comparing apples with apples – or at least fruit with fruit – rather than fruit with goats.'

Today, financial advisers already devote time and effort to help their clients navigate the confusing world of sustainable funds. In its SDR consultation paper, the FCA announced plans to formalise the crucial role advisers will play in incorporating investors' sustainability preferences in their investment advice.

As financial advisers typically act as link between providers and investors, their understanding of funds' sustainability-related information and ability to make sure this is easily accessible to their clients is paramount.

While we await the full implications of SDR for financial advisers, the regulator has provided an early indication of the direction it may take by including a requirement for financial advisers in its consultation paper. We explore this alongside the other proposed measures below.

The four key components of the FCA's proposals are:

- **Classification and labelling** to help investors distinguish between different types of sustainable investment product;
- **Disclosures** that fund managers must make in relation to products to which they assign a sustainable label;
- **Rules** around the naming and marketing of these products – and others that do not qualify for a label;
- A **requirement** for distributors, including advisers, to convey sustainability-related information to investors.

The labelling system will compel fund managers to categorise sustainable funds in one of three ways: focus, improvers and impact.

Consumer-facing disclosures must provide the most salient sustainability-related information in an accessible way, including the sustainability goal, approach and metrics linked to achieving the objective.

An important feature of the SDR is the focus on strengthening transparency across the investment management industry to build trust with investors. One of the ways SDR endeavours to do this is through the requirement to disclose a summary of 'unexpected investments'.

Specifically, firms will need to disclose what might be viewed as 'surprising', i.e., the types of holdings that consumers may not typically associate with a sustainability objective. An example may be the inclusion of an oil and gas company in an improvers fund.

'Disclosing why these companies are included, and how we scrutinise and engage with them as a firm, will help investors to understand the role that leading companies in this sector have to play in the energy transition, both in terms of setting ambitious emissions reduction targets and diversification to low carbon growth segments,' said Alexander Burr, ESG policy lead at LGIM.

The FCA hasn't stopped there on its drive to bring credibility and rigour to disclosures. It is proposing an 'additional tier' of 'qualifying' disclosures: investment managers must be able to demonstrate their activities and strategies against five key 'principles' to even qualify any of their funds as sustainable.

'The fifth principle on stewardship stands out to me. It means that if firms are wanting to classify any of their funds as sustainable, then they are going to have to "walk the talk" on their stewardship activities. Linking to investment management companies comprehensive reporting against the FRC's 2020 Stewardship Code is very welcome,' said Burr.

A general anti-greenwashing rule will seek to ensure that sustainability-related claims made by all regulated providers are clear, fair and not misleading, and a product and naming rule will prohibit the use of sustainability-related terms, including ESG, sustainability, responsible, green, SDG and Paris-aligned, by products that do not qualify for and choose to use one of the three labels.

Lastly, distributors such as advisers and investment platforms will be expected to prominently display sustainability labels in fund information and provide access to the accompanying consumer-facing disclosures.

The FCA has proposed this should be done on a relevant digital medium, for example, product website or page on a mobile app. Distributors must not use a sustainable investment label for a product other than the label assigned by the provider, and they must also keep the relevant digital medium and marketing communications updated with any changes a provider may make to the labels and disclosures.

ONGOING ASSESSMENT

While the onus will remain on advisers to properly assess sustainable investments before recommending them, the SDR should make that task a little easier.

'We still need to do our research and due diligence to ensure the investments we are recommending to our clients are – and remain – suitable,' said Görkem Gokyigit, chartered financial planner at London-based Lubbock Fine Wealth Management.

> **"Clearer labelling and a crackdown on greenwashing will give us the confidence that we're comparing apples with apples – or at least fruit with fruit – rather than fruit with goats."**

'That said, we believe standardised product classification and labelling would add structure to our research, which could make the fund comparison clearer.'

Advisers note, however, that the labelling system proposed by the SDR is self-assessed, and although the FCA requires disclosure of credible and robust sustainability frameworks alongside its usual monitoring and challenging – where necessary – procedure, it has taken the decision not to 'approve' each label that has been categorised by a fund manager.

'The proposals seem fairly sensible with the only mild criticism being that fund managers are again allowed to mark their own homework,' said Ben Yearsley, investment director of Plymouth-based Shore Financial Planning.

Nevertheless, the strong focus on transparency that will underpin the labels promise to provide a good starting point. And advisers will need to have a good understanding of the frameworks and methodologies fund managers have used.

For example, with sustainable focus funds, advisers will need to assess how fund managers are defining assets that meet credible standards of environmental and social sustainability.

‘Credibility is something that an adviser will need to assess from their own perspective and on behalf of their clients,’ said Amelia Tan, head of responsible investment strategy at LGIM.

‘Does the asset manager’s methodologies for aligning assets to environmental and social sustainability themes make sense?’

In the sustainable improvers category, advisers will need to assess the criteria fund managers are using to identify assets as worthy of improving or demonstrating an improvement.

For Worldwide’s McGahan, the job of the adviser is ultimately to assess real-world outcomes.

‘That is deep granular work, and whilst Bo Derek did it with 10, Pythagoras did it for construction, architecture and two-dimensional travel as well as space travel, the real skill will be in ascertaining just how a fund will affect sustainability,’ he said.

‘That is deep qualitative research and therein lies the need for a bespoke research team in an IFA.’

MEETING CLIENT NEEDS

Advisers need to understand the investment products they are recommending to their clients, but before they can do that, they must understand the client and their sustainability preferences.

The FCA has not yet instituted or proposed how advisers should do so, but it has indicated this will be covered in a subsequent consultation paper.

‘While a clearer set of standards will help in making fund choices, regulators are likely to require detailed documentation of the choices made,’ said Fahad Hassan, CIO of investment consultancy Albemarle Street Partners.

‘As the FCA enhances its regulations around ESG investing, advisers will need to demonstrate a greater understanding of client needs and the variations in thematic, ESG and impact approaches to fund selection.’

It is an area in which many advisers are already making moves. Prosperity IFA in East Sussex uses a specific sustainability questionnaire alongside its standard attitude-to-risk questionnaire.

Tees Financial has adapted its fact-finding process and conducts ongoing due diligence with fund managers on their firm-wide sustainability credentials.

‘We use tailored questions about where and how they invest,’ said managing director James Appleby. ‘This gives our advisers the confidence to recommend the funds that are best aligned to their clients’ own values and beliefs.’

For Tan at LGIM, Appleby raises an important point: the opportunity for greater partnership between advisers and fund managers.

‘There’s a real partnership that we can build with advisers by exchanging on the sustainability issues their clients care about and advances in sustainable investing capabilities to build new solutions that could help advisers meet their clients’ requirements.’

For professional investors only. Not to be distributed to retail clients. Capital at risk.

Important Information

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Views expressed are of LGIM as at 16 November 2022. The Information in this document (a) is for information purposes only and we are not soliciting any action based on it, and (b) is not a recommendation to buy or sell securities or pursue a particular investment strategy; and (c) is not investment, legal, regulatory or tax advice. Legal & General Investment Management Limited. Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272.

This article was provided by Legal & General Investment Management and does not necessarily reflect the views of Citywire