FCA FINANCIAL CONDUCT AUTHORITY

12 Endeavour Square
London
E20 1JN

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

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Dear AFM chair,

Authorised ESG & Sustainable Investment Funds: improving quality and clarity

The growth of investment funds whose strategy focuses on Environment, Social & Governance (ESG) themes has the potential to contribute meaningfully to addressing climate change and other sustainable investment goals. Consumers are placing significant value on ESG-related investment opportunities.

It is therefore essential that funds marketed with a sustainability and ESG focus describe their investment strategies clearly and any assertions made about their goals are reasonable and substantiated. We have seen numerous applications for authorisation of investment funds with an ESG or sustainability focus. A number of these have been poorly drafted and have fallen below our expectations. They often contain claims that do not bear scrutiny. Also, we would have expected questions raised at the authorisation stage to have been asked (and addressed) in the product design phase. Such applications are likely to fail to meet the applicable requirements as set out further in the annex to this letter. We expect to see material improvements in future applications. We also expect clear and accurate ongoing disclosures to consumers where funds make ESG-related claims, and we want to see funds deliver on their stated objectives and/or strategy. We include in this letter a set of guiding principles that explains our expectations in this area.

Building trust in the market

ESG and sustainable investment funds are currently the fastest growing segment of the European funds market, reflecting increasing investor appetite for these investments. Authorised Fund Managers (AFMs) have responded to this demand. We have seen a high volume of applications for authorisation of funds with an ESG focus in addition to a number of existing funds amending objectives, demonstrating that the market is evolving quickly. There is now a wide spectrum of ESG and sustainable investment funds, reflecting different objectives, investment strategies and characteristics. We welcome innovation within the ESG and sustainable investment market that offers consumers funds that meet their needs and preferences. Equally, we recognise that innovation and the rapid pace of change present the industry with challenges (such as improving ESG-related data and metrics) and that ongoing work is taking place to meet these challenges.

Against this backdrop, we are concerned by the number of poor-quality fund applications we have seen and the impact this may have on consumers. This must improve.

As the ESG and sustainable investment market grows, we have a role as the regulator to build trust in this segment of the market. We expect firms to play their part in this too; we want them to be putting consumers at the heart of their businesses, offering products and services that are fit for purpose and which they know represent fair value. Additionally, a well-functioning ESG and sustainable investment market is important for the proper allocation of capital in pursuit of a net zero economy. There are serious long-term consequences if the market does not function properly in the face of the global challenge with which we are presented.

Where consumers find it difficult to assess whether authorised funds meet their needs and preferences (at the point of purchase and on an ongoing basis), there is potential to undermine trust and deter consumers from this segment of the market. This in turn could result in a lack of effective competition between the firms providing ESG or sustainable investment funds. As investor appetite for these investment funds grows, we expect these concerns also to grow.

What we are seeing

We have set out below a number of stylised examples of applications for authorisation of investments funds with an ESG/sustainability focus that have fallen below our expectations:

- A proposed passive fund had an ESG-related name that we found misleading as it was looking to track an index that did not hold itself out to be ESG-focused. It also had very limited exclusions from the index, based on high-level ESG criteria.

- A fund application claimed to have a strategy to invest in companies contributing to 'positive environmental impact'. The fund intended to invest predominantly in companies that, while reporting low carbon emissions, would not obviously contribute to the net-zero transition. We had expected to see a measurable non-financial objective alongside the financial objective or strategy with information on how that impact would be measured and monitored.

- Instances where it was challenging to reconcile the fund's proposed holdings with statements made setting expectations for consumers. One example was a sustainable investment fund containing two 'high-carbon emissions' energy companies in its top-10 holdings, without providing obvious context or rationale behind it (eg, a stewardship approach that supports companies moving towards an orderly transition to net zero).

In general, fund applications in this area often do not contain sufficient, clear information explaining their chosen strategy and how this relates to the assets selected for the fund. We would expect applications to contain this level of information at the outset.

What we are doing

We continue to challenge firms at the authorisation gateway to help ensure that new (or repurposed) funds submitted for authorisation meet our regulatory requirements. We want firms to communicate clearly and avoid making misleading claims, both at the time of application and on an ongoing basis.

We continue to discuss with firms their assessments of the value provided by their funds. Where firms are providing an ESG service as part of a fund's offering, we expect them to be able to explain to us how they have considered the quality of this service in the context of the fees they are charging.

There are clear requirements on firms that they should be meeting in respect of the funds they provide. Nevertheless, we have received feedback which suggests some firms would find it helpful if we provided further clarity on how these requirements apply in the context of ESG investments. So, to reinforce our expectations – pre and post authorisation - and to support firms in the application of the existing legal requirements, we have developed the guiding principles in the annex for the design, delivery and disclosure of responsible and sustainable investment funds.

The aim of the guiding principles

The aim of the guiding principles is to help AFMs comply with existing requirements by ensuring that fund disclosures accurately reflect the nature of the fund's responsible or sustainable investment strategy in both the pre-contractual documentation (for example, the prospectus) and on an ongoing basis. We also want to see AFMs deliver on their funds' stated objectives and strategy and to provide sufficient information to enable consumers to monitor whether their expectations are being met.

If consumers understand the basis on which sustainability claims are being made by AFMs, and can monitor whether those claims are being met, this should improve the functioning of the market. It will reduce the risk that they buy products that do not meet their needs and create greater trust in ESG products.

Related initiatives

There are links between the guiding principles and other regulatory initiatives, such as the EU's Sustainable Finance Disclosure Regulation (SFDR). We acknowledge that, while SFDR has not been onshored in the UK, some UK authorised firms may also be complying in relation to their cross-border business in the EU. The intent of these guiding principles is to be complementary to obligations under SFDR.

Our broader work on climate- and sustainability-related matters is reflected in our 2021-22 Business Plan and is consistent with expectations in our 'remit' letter from the Chancellor, received in March, specifying that we should consider the Government's net-zero commitments when we work to advance our objectives and perform our functions as a regulator.

So, the guiding principles are not the end point of setting out our expectations in this space, and they have been developed with the aim of being compatible with prospective future disclosure rules for responsible and sustainable investment fund products. These include the plans announced in the Chancellor's Mansion House speech to introduce economy-wide Sustainability Disclosure Requirements and sustainable investment labels that allow consumers to compare the impacts and sustainability of their investments. We will be working closely with HM Treasury on these new policies. Furthermore, we are currently consulting on the implementation of TCFD-aligned disclosure rules for asset managers, which include certain entity and product-level disclosure requirements.

Our Business Plan also highlights a range of other outcomes we want to achieve, consistent with our remit letter, including promoting active investor stewardship that supports a market-led transition to a more sustainable future, and encouraging the development of innovative technological tools to help overcome industry and regulatory challenges.

What you should do next

When submitting fund applications, and in managing funds on an ongoing basis, we consider that the guiding principles will help you get it right. Where your funds make ESG or sustainable related claims, you should consider how you clearly and accurately disclose and reflect the nature of the fund in line with those claims to enable consumers to make an informed judgement about the merits of investing in a fund. If you have any questions about anything in this letter, including the guiding principles themselves, please contact your normal supervisory contact.

Yours faithfully,

Nick Miller,

Head of Department, Asset Management Supervision

Annex: Guiding principles

When are the guiding principles relevant?

The guiding principles are relevant where an FCA authorised investment fund pursues a responsible or sustainable investment strategy and claims to pursue ESG/sustainability characteristics, themes or outcomes. These principles are targeted at funds that make specific ESG-related claims, not those that integrate ESG considerations into mainstream investment processes.

The guiding principles have been developed with reference to existing statutory requirements, and existing Handbook rules and guidance. They set out how these rules apply in the context of the design, delivery and disclosure of responsible and sustainable investment funds. These provisions are important to protecting consumers.

Among the key existing legal requirements that apply to AFMs and to the authorised funds that they manage are:

(i) PRIN 2.1: Principle 7, COBS 4.2.1R –clear, fair and not misleading communications

(ii) Reg. 15(9) of the OEIC Regulations, s.243(8) and s.261D(10) of FSMA (see also COLL 6.9.6G) - Undesirable or misleading names

(iii) COLL 4.2.5R(3)(a) and (b); COLL 8.3.4R(3) – Contents of the prospectus of an Authorised Fund - Investment objectives and policy

(iv) COLL 6.6.3R(3)(a); COLL 8.5.2R(3)(a) - Functions of the authorised fund manager

(v) COLL 4.5.9R; COLL 8.3.5CR - Authorised fund manager's report

(vi) COLL 6.6A.6R - Strategies for the exercise of voting rights

(vii) SYSC 4.1.2CR, AIFMD level 2 regulation art 37 – resources for management companies and AIFMs

The guiding principles comprise an overarching principle and three supporting principles that focus, respectively, on 'design', 'delivery' and 'disclosure'. Each principle is accompanied by a set of 'key considerations', which add clarity.

Overarching principle: Consistency

A fund's ESG/sustainability focus should be reflected consistently in its design, delivery and disclosure. A fund's focus on ESG/sustainability should be reflected consistently in its name, stated objectives, its documented investment policy and strategy, and its holdings.

We expect authorised investment funds pursuing a responsible or sustainable investment strategy and that claim to pursue ESG/sustainability characteristics, themes or outcomes to consider the overarching principle, supporting principles and key considerations.

Principle 1. The design of responsible or sustainable investment funds and disclosure of key design elements in fund documentation

References to ESG (or related terms) in a fund's name, financial promotions or fund documentation should fairly reflect the materiality of ESG/sustainability considerations to the objectives and/or investment policy and strategy of the fund.

Key considerations

a. *Fund name*. Fund names are subject to restrictions[1] and they must not be misleading. Where a fund uses 'ESG', 'green', 'sustainable,' 'responsible,' 'ethical', 'impact', or related terms in its name, this could be misleading unless the fund pursues ESG/sustainability characteristics, themes or outcomes in a way that is substantive and material to the fund's objectives, investment policy and strategy.

b. *Investment objectives and policy*. The prospectus of a fund must include its objectives and policy[2]. A fund must be managed consistently with these[3]. The annual report of a fund must include the policy and strategy pursued for achieving its objectives and a review of the investment activities during the period[4]. Irrespective of whether its name contains a term in (a) above, where a fund claims to pursue ESG/sustainability characteristics, themes or outcomes, these should be appropriately reflected in the fund's objectives and/or policy.

c. *Investment strategy:* An AFM is required to disclose information about a fund in its prospectus which investors would reasonably require for the purpose of making an informed judgement about investing in the fund[5]. Where a fund claims to pursue ESG/sustainability characteristics, themes or outcomes, we expect that this information should include key elements of strategy. For example:
   - the investible universe, including investment limits and thresholds
   - any screening criteria (positive or negative) that it applies
   - specific E, S or G characteristics/themes or 'real world' (non-financial) impacts that it pursues
   - the application of benchmarks/indices, including any tilts to mainstream benchmarks, and expected/typical tracking error relative to the benchmark
   - the stewardship approach of the fund

d. *Stewardship approach*. An AFM must develop adequate and effective strategies for exercising voting rights to the exclusive benefit of the fund, ensuring that the exercise of voting rights is in accordance with the investment objectives of the fund.[6] AFMs are also subject to the requirements in COBS 2.2B either to develop an engagement policy covering certain areas, or to explain why they have not done so. Where investor stewardship forms part of a fund's responsible or sustainable investment strategy, we consider that the AFM should develop an engagement policy that complies with COBS 2.2B.6R and clarify how stewardship contributes to meeting the fund's intended ESG/sustainability characteristics, themes or outcomes.

Interpretation/application examples

a. *Fund name*:
   - Where a fund uses ESG or related terms[7] in its name, the FCA expects that the ESG/sustainability approach will be disclosed in the investment objectives of the fund.

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[1] Reg. 15(9) of the OEIC Regulations, s.243(8) and s.261D(10) of FSMA (see also COLL 6.9.6G)
[2] COLL 4.2.5R(3)(a) and (b), COLL 8.3.4R(3)
[3] COLL 6.6.3R(3)(a), COLL 6.6A.4R(3) / AIFMD level 2 regulation art 18(3), COLL 8.5.2R(3)(a)
[4] COLL 4.5.9R; COLL 8.3.5CR
[5] COLL 4.2.5R (27)(a), COLL 8.3.4R(19)
[6] COLL 6.6A.6R, AIFMD level 2 regulation art 37
[7] For example, 'ethical', 'sustainable', 'green', 'responsible'.

The FCA would not expect to authorise a fund that contains one of these terms in its name, if its investment objectives do not reflect the fund name.

- Where a fund uses one of these terms in its name, the FCA considers that this would be misleading unless the investment strategy leads to a material difference in how the fund is managed compared to a fund that did not take such considerations into account. For example, an index-tracking fund that excludes a small number of securities, or where the holdings are not materially different from a similar non-ESG index should not use these terms in its name.

- The term 'impact' or 'impact investing' has specific connotations. The FCA considers that a fund that uses the word 'impact' in its name in the context of ESG/sustainability outcomes should only do so if it is seeking a non-financial (real world) impact, and if that impact is being measured and monitored.

b. *Investment objectives and policy*: Where it is claimed that a fund pursues ESG characteristics, themes or outcomes, these should be appropriately reflected in the fund's objectives and/or policy.

   i. For example, a fund that claims to promote positive social change should:
      - be specific about what this means
      - describe how it aims to achieve this objective through its investment policy and strategy
      - set out how it will monitor and evaluate whether it has done so.

   ii. Where a fund is designed to generate a measurable, beneficial ESG/sustainability impact alongside a financial return, the firm should clearly state the intended 'real-world' outcome.

   iii. Where an AFM relies exclusively or largely on ESG data provided by a third-party, including ESG data that determine which securities qualify to be included (or that determine the weights of securities) in an index that a fund is tracking (or uses as a benchmark in accordance with COLL 4.2.5R(3)(c-b)), to make judgements about ESG matters, it should disclose this as part of the additional information required to be included in the prospectus.

   iv. Where a fund might hold securities, potentially at a reduced weighting, that an investor might not expect, given the ESG/sustainability focus of the fund, this should be made clear in the prospectus, including the circumstances when such securities might be held and the purposes for which they would be held.

c. *Investment strategy*:

   i. Where a fund integrates ESG considerations into mainstream investment processes (with no material ESG orientation in the fund design/strategy), we do not expect to see prominent ESG claims in the fund's name or documentation, or ESG positioned as a key part of that fund's offering.

   ii. The description of a fund's strategy should provide sufficient information for a consumer to be able to distinguish between offerings that pursue ESG/sustainability characteristics, themes or outcomes in different ways. For example, consumers should be given sufficient information to be able to distinguish between funds with the following (non-exhaustive) characteristics:

      - avoiding exposure to investments with certain characteristics – eg, by applying a negative screen to exclude companies that fail to meet internationally recognised standards, such as the UN Declaration of Human Rights; or by avoiding exposure to certain sectors, such as oil and gas companies

- applying a positive screen to promote particular sustainability characteristics or themes – eg, apply a tilt to the benchmark in an index strategy to overweight companies with particular characteristics (such as emissions-based thresholds); or invest predominantly in companies engaged in certain activities (such as water and waste management)
- pursuing a positive impact
    - through direct investment in new sustainable projects (eg, project financing of clean energy initiatives)
    - by influencing change through active investor stewardship (eg, encouraging companies to sign up to net-zero commitments/move towards greener investments).

d. *Stewardship approach:* Where stewardship is part of an active investment strategy, it should be clear how monitoring, engagement and voting activity in respect of ESG/sustainability matters are integrated with investment decisions, and how escalation and divestment decisions are made.

Principle 2. The delivery of ESG investment funds and ongoing monitoring of holdings

The resources (including skills, experience, technology, research, data and analytical tools) that a firm applies in pursuit of a fund's stated ESG objectives should be appropriate. The way that a fund's ESG investment strategy is implemented, and the profile of its holdings, should be consistent with its disclosed objectives on an ongoing basis.

Key considerations

a. *Resources to support delivery:* A fund can only be authorised by the FCA if its aims are reasonably capable of being achieved.[8] This would include any ESG aims or purposes. An AFM must have and employ effectively resources to achieve the proper performance of its business activities.[9] We expect a firm managing a fund that pursues ESG/sustainability characteristics, themes or outcomes to apply appropriate resources to do so.

b. *Data, research and analytical tools:* Where a firm uses ESG/sustainability research, data and analytical tools to support its fund delivery process, it should employ appropriate resources to oversee this. It should also consider due diligence on any data, research and analytical resources it relies upon (including when third-party ESG ratings, data and research providers are used) to be confident that it can validate the ESG/sustainability claims that it makes.

c. *Holdings*. Where a fund pursues ESG/sustainability characteristics, themes or outcomes, the AFM should take into account whether a reasonable investor would consider that the fund's holdings reflect any ESG/sustainability characteristics, themes or outcomes that have been disclosed or claims that have been made.

[8] Reg. 15(10) of the OEIC Regulations, s.243(9) and s.261D(11) of FSMA
[9] SYSC 4.1.2CR cf also SYSC 4.1.2DR, SYSC 4.1.4R, SYSC 5.1.1R, AIFMD level 2 regulation art 22

Interpretation/application examples

a. *Resources to support delivery:* Appropriate resources to support delivery can include investment professionals with appropriate skills and experience, technological inputs and ESG/sustainability-specific research, data and analytical tools.

b. *Data, research and analytical tools:* A firm should take appropriate steps to:
   - monitor the research, data and analytical tools used
   - assure the quality of inputs by conducting appropriate due diligence, model validation and data governance
   - understand how data and research inputs are sourced and derived (including relevant methodologies) and consider carefully how any gaps and limitations in such inputs may hinder achievement of the fund's stated objectives.

c. *Holdings:* Where a fund states that it will invest in companies contributing to 'positive environmental change', a consumer might reasonably expect fund disclosures to demonstrate how the profile of the fund's holdings and other elements of its strategy, such as the exercise of investor stewardship, contribute to outcomes related to matters such as biodiversity and the climate transition. Where holdings might appear contradictory to an ESG investment strategy, the AFM should consider explaining this apparent inconsistency to end investors.

Principle 3. Pre-contractual and ongoing periodic disclosures on responsible or sustainable investment funds should be easily available to consumers and contain information that helps them make investment decisions

ESG/sustainability-related information in a key investor information document should be easily available and clear, succinct and comprehensible, avoiding the use of jargon and technical terms when everyday words can be used instead.[10] Funds should disclose information to enable consumers to make an informed judgement about the merits of investing in a fund.[11] Periodic fund disclosures should include evaluation against stated ESG/sustainability characteristics, themes or outcomes, as well as evidence of actions taken in pursuit of the fund's stated aims.[12]

Key considerations

a. *Easy availability*. A firm should take appropriate steps to enable consumers to access relevant ESG/sustainability-related information to support their investment decisions and monitor outcomes – including, to the extent possible, where a fund is marketed via a distribution platform[13].

b. *Pre-contractual disclosures*. We expect information on a fund's ESG/sustainability focus to be made available to consumers in relevant regulatory documents[14] and be reflected in any

[10] UCITS KII regulation art 5(1)(b) and NURS-KII rules at COLL Appendix 2 art 5(1)(b), cf also PRIIPs regulation art 6(4)(c)
[11] COLL 4.2.5R(27)
[12] COLL 4.5.9R(6)/(7)
[13] PRIN2.1
[14] the prospectus and key investor information document or key information document, see COLL 4.2 and COLL 4.7, and the information required by FUND 3.2.2R (where relevant)

accompanying marketing materials in a clear, fair and not misleading way. The information should be presented in an *accessible* way that is clear, succinct and comprehensible, and that forms a sufficient basis to support consumers in making informed investment decisions.

c. *Ongoing performance reporting*. A firm should take appropriate steps to make information on how well a fund is meeting its stated objectives (i.e. intended ESG/sustainability characteristics, themes or outcomes) available to consumers on an ongoing basis (for example in annual and half-yearly reports). Such information should enable consumers to monitor whether their expectations are being met.

Interpretation/application examples

a. *Easy availability*: Where a firm relies on third-party data and analytical tools to support its fund disclosures, it should provide (subject to intellectual property considerations) interpretative information, describing relevant methodologies used and highlighting any material data considerations/limitations.

b. *Pre-contractual disclosures*: We expect the firm to take appropriate steps to include relevant and accurate information on the fund's ESG/sustainability focus in pre-contractual fund documentation (eg, prospectus / K(I)ID), and any accompanying marketing materials), presenting its disclosures in a way that can readily be interpreted by consumers. For example, if a fund aims to create 'positive sustainability impact', we expect its disclosures to include clear examples of the real-world impact that it is pursuing, how it proposes to achieve the target impact (eg, its screening criteria exclude investments in fossil-fuel companies), and how performance against this stated objective will be evaluated on an ongoing basis (eg, metrics, criteria).

c. *Ongoing performance reporting*:
- *Key Performance Indicators (KPIs)*. Where a fund applies quantifiable targets, reporting should include relevant KPIs, along with sufficient supporting information to enable end investors to interpret performance data, in a way that is not misleading. For example, a fund that invests in companies with 'green' characteristics in their targets (eg, carbon emissions, green revenues) should include KPIs on these characteristics in its ongoing performance reporting.
- *Non-financial (real world) outcomes*. Where a fund pursues non-financial outcomes, performance against such outcomes should, as far as reasonably feasible, be reported in a measurable and quantifiable way, using relevant standards/frameworks and methodologies, as appropriate. Where a fund pursues less measurable non-financial aims, performance against these should be evidenced and evaluated, with examples of actions taken in pursuit of these aims. For example, where relevant, we expect evidence of a fund's 'positive sustainability impact' to be provided on an ongoing basis to investors.
- *Stewardship:* Where stewardship forms an integral part of a fund's delivery strategy, the firm should articulate clearly, on an ongoing basis, how the execution of its stewardship strategy has supported the achievement of its stated objectives.