Financial Conduct Authority Review of ESG and Sustainable Funds:

On Thursday (16/11), the Financial Conduct Authority (FCA) published a report on how Authorised Fund Managers (AFMs) comply with existing regulatory requirements and expectations on the design, delivery and disclosure of Environmental, Social and Governance (ESG) and sustainable investment funds.

The review is a follow-up to the Dear Chair letter sent to AFMs in July 2021, which gave guidance on the FCA's existing requirements through a set of guiding principles. The Financial Conduct Authority mapped their findings against their Guiding Principles outlined in their Dear Chair letter:

Principle 1: Design
Inconsistencies in approach were evident with some AFMs setting ESG investment policies and strategies despite not having ESG or sustainability objectives within their objectives or even fund names. The Financial Conduct Authority reiterated that AFMs should comply with COLL 4.2.5(3)(a)E regarding their ESG and sustainable funds, and with COBS 4.2.1R with any financial promotions or communications so that these are not misleading.

Principle 2: Delivery
There were instances of funds with net zero emission targets that had no Scope 3 emission targets or acknowledgement/explanation in fund literature, and holdings in oil, gas, mining and manufacturing sectors. The Financial Conduct Authority explained the importance of financial promotions and communications being clear and having supportive explanations where necessary to ensure compliance with COBS 4.2.1R. Ensuring consistency across fund strategies, objectives, and communications is necessary for this.

Principle 3: Disclosure
Various disclosures reviewed by the Financial Conduct Authority failed to explain vital ESG and sustainability-related features of funds, such as the decision to exclude Scope 3 emissions or explanations regarding changes to ongoing reporting metrices, such as carbon emissions. The Financial Conduct Authority acknowledged the challenges in accessing some of this data, particularly Scope 3 emissions, but remind AFMs of the importance in describing such limitations and explaining these where possible.

Governance
Alongside the three Guiding Principles, the review showed deficiencies in oversight and controls across AFMs. This resulted in complications and challenges when evidencing key decisions and their rationale. By enhancing these areas, risk management for harmful practices conflicting with the Guiding Principles will be easier and more effective. The Financial Conduct Authority recommend making adjustments where necessary here so that there is appropriate oversight and control frameworks for identifying and addressing such risks.

Consumer Duty
Finally, the Financial Conduct Authority explained the relevance of this review and its findings to the Consumer Duty, particularly the Consumer Understanding outcome. AFMs which ensure that they are

adhering to the Guiding Principles and expectations will be better positioned for meeting the requirements of this outcome and evidencing this to the regulator if requested. AFMs should evaluate how their design, delivery, and disclosures for ESG and sustainable investment funds interact with the Consumer Duty outcomes on an ongoing basis to ensure they do not become misaligned.

Next Steps

Going forward, the FCA will continue their work alongside AFMs that were included in their review to help with addressing their findings and improve upon these areas. The FCA highlight how enhancements to these areas will help AFMs in their preparation for the proposed SDR and investment labels regime, as well as supporting Consumer Duty outcomes and requirements.

Table 1: FCA Findings and Good Practice Table

Area	Findings	Good Practice (FCA)
Principle 1: Design	• Inconsistencies in approach to setting ESG and sustainable investment objectives at the product design stage. • Some funds had ESG or sustainable investment related names but no ESG or sustainable investment objectives within them. • Inconsistencies in the level of detail included in ESG and sustainable investment approaches and aims. • Difficulties in identifying stewardship approaches from AFMs and stewardship engagement activities in fund literature.	1. Developing and/or using appropriate ESG and sustainability scoring systems or using benchmarks that are suited to the AFM's funds, with firms also demonstrating an understanding of their underlying methodologies and limitations, including of relevant third-party methodologies. 2. AFMs that demonstrated more effective stewardship approaches embedded their stewardship activity within investment teams, providing investment managers with ownership of engagement activity with the support of a central stewardship resource. 3. AFMs have active engagement policies and initiatives with investee companies to further their ESG and sustainability approach. Firms use voting as a means of influencing investee companies to pursue ESG and sustainability objectives. 4. AFMs make efforts to measure and record the outcomes of their stewardship activity with investee companies and how this furthers the ESG and sustainability objectives of their fund range.
Principle 2: Delivery	• Funds including holdings which are inconsistent with the fund's ESG or sustainability objectives. • AFMs not explaining missing information relevant to the ESG or sustainability objectives or profile of the fund.	1. A strong focus on investment research and due diligence for asset selection that is embedded in the AFM's investment processes. 2. Due diligence is carried out on third party data providers whose inputs are used to inform the AFM's external disclosures and reporting around delivery, focussed on gaining a clear understanding of the underlying methodologies, inputs and limitations of the data. 3. On an ongoing basis, we expect AFMs to maintain appropriate systems and controls to ensure data accuracy and compliance with underlying methodologies, as well as identifying and addressing any errors by third party data providers and assessing the ongoing appropriateness of ESG data for the delivery of the fund.

Principle 3: Disclosure	• Some AFMs did not explain information regarding key ESG or sustainability-related features of their funds. • Ongoing reporting of funds not explaining changes in ESG or sustainable investment metrices (e.g., Carbon emission). • Insufficient detail on ESG and sustainable investment policy goals within fund prospectuses with investors directed to firm-level policies that detailed this. • Non-disclosure of the contribution from individual funds to ESG and sustainable investment goals at a firm-wide level. • Poor presentation of ESG and sustainability information across fund documentation.	1. AFMs provide disclosures that are clear about the ESG and sustainability features of a fund, what it is designed to offer and how they measure performance on an ongoing basis. 2. AFMs, in explaining their use of benchmarks in the fund's prospectus and other consumer-facing communications, should ensure that the methodology, limitations and ESG data, including for ESG benchmarks, are made clear so that consumers can make informed and effective decisions. 3. AFMs test how information about the fund's ESG and sustainability features are understood by investors. They also gather data about investors' use of ESG and sustainability information on their website and use it to inform ongoing disclosures. 4. Links are used effectively in regulatory documents and factsheets to direct investors towards additional explanatory material around the AFM's sustainability approach and its impact.
Governance	• Insufficient oversight across funds, particularly for older funds. • Insufficient Management Information (MI) and governance records for funds.	1. A strong product governance structure is in place around the AFM's ESG and sustainable investment fund range. Risks relating to ESG are identified, monitored and reported through the governance structure. 2. Firms monitor ongoing adherence to the fund investment objective and policy, with exceptions reported to the relevant committee and overseen by the Board. 3. Management information relating to ESG and sustainability objectives and aims are monitored in the product governance structure. 4. Embedded investment policies and processes exist for ESG and sustainable investment funds, with relevant staff aware of them and involved in their delivery.