Testing how Authorised Fund Managers are embedding the Guiding Principles in ESG and sustainable investment funds

Multi-firm reviews
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We set out findings from our supervisory work that looked at 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.

This is a follow-up to the Dear Chair letter we sent to the chairs of AFMs in July 2021. That letter gave guidance on our existing requirements through a set of guiding principles that explained our expectations in this area.

Who this review applies to

The findings from this review are relevant to AFMs, their governing bodies, and portfolio managers of investment funds that market themselves as having ESG or sustainable characteristics. They may also be of interest to other stakeholders, including asset owners, trade bodies and investors.

Why we conducted this review

Asset managers have a role to play in offering a range of investment products to consumers, including products that aim to deliver ESG and sustainable investment goals in addition to a financial return. To maintain trust, investors need to be able to distinguish between the different claims AFMs make about their ESG and sustainable products and to be able to rely on the integrity of the disclosures marketed to them.

We previously wrote to AFM Chairs setting out our concerns about the quality and clarity of applications received for the authorisation of investment funds with ESG or sustainability features. Our letter included a set of 'Guiding Principles'. These gave more detail on our expectations of how AFMs should clearly and accurately design and deliver the ESG and sustainability objectives of a fund, while providing disclosures that align with these ESG and sustainability claims. These Principles are a tool to help AFMs comply with existing requirements.

Our Asset Management Portfolio Letter of 3 February 2023 highlighted the increase in the prominence of products which have ESG and sustainable investment characteristics within Asset Managers' business strategies. We explained the risk that some claims about ESG and sustainable investing could be misleading or inaccurate and this may have an impact on consumer confidence and market integrity. We also said that we would publish our review of AFMs' ESG and sustainability oversight practices, following on from our 'Guiding Principles' letter.

This review assessed how AFMs have implemented the Guiding Principles. We set out our findings to assist AFMs in identifying where further improvements may be needed to their approach. Under our rules (COLL 6.6.3R), AFMs are responsible for the overall management of authorised funds, including managing the investment made for and on behalf of the fund. AFMs are required to act in the best interests of the funds they manage and those who invest in those funds, under rules in COBS, COLL and our Principles for Businesses.

These findings will also support the Consumer Duty, which came into effect on 31 July 2023. The Consumer Principle (Principle 12) requires a firm to deliver good outcomes for retail customers, irrespective of whether they have a direct client relationship with those customers. Consistent with this rule, AFMs should ensure their practices are consistent with delivering good consumer outcomes. AFMs should have regard to the expectations that investors are likely to form from their ESG and sustainability products based on the way they are designed and delivered, the information disclosed about them and consider whether they are in line with the Consumer Duty.

The 'consumer understanding' outcome is particularly relevant for AFMs who provide ESG and sustainability products. These rules build on Principle 7 - requirements for firms to communicate information in a way which is clear, fair and not misleading. It emphasises that firms throughout the distribution chain should support the consumer understanding outcome. This includes by ensuring that their communications meet the information needs of retail customers and that firms should test this. Firms complying with the Consumer Duty should be supporting consumer understanding by giving investors the information they need at the right time and presented in a way they can understand to enable them to pursue their financial and non-financial objectives.

The proposed Sustainability Disclosure Requirements (SDR) and Investment Labels rules (CP22/20) will be of relevance to AFMs. This package of measures proposes an anti-greenwashing rule for all authorised firms, which reinforces the importance of sustainability claims being fair, clear and not misleading and consistent with the sustainability profile of the product or service. For investment products specifically, the proposals include investment labels for products seeking positive sustainability outcomes (underpinned by qualifying criteria); naming and marketing requirements; consumer-facing and detailed product-level information; and disclosures on how the firm is managing sustainability risks and opportunities. This package of measures seeks to embed transparency through the regime to help consumers navigate the market for ESG and sustainable investment products.

AFMs should consider the potential impact of the proposed SDR and investment labels regime on their firm and investment products and take necessary action to comply once new rules come into force. By releasing our findings now, we want to reinforce good practices and highlight poorer practices that should be addressed by AFMs. The Policy Statement and final rules will be published shortly and will set higher standards and help firms address some of the findings in this review.

Embedding the Guiding Principles and the good practice we have identified in our review will aid firms in complying with any new requirements that may come into force alongside their overarching Consumer Duty obligations.

What we did

Our review focused on both active and passive authorised retail funds that included a reference to ESG and/or sustainability-related terms in their name, such as 'responsible', 'ethical', 'climate' or 'social'. We included 12 AFMs of varying sizes in the review and asked them to provide an overview of their ESG and sustainability approaches.

We reviewed fund disclosures available to consumers and visited AFMs to discuss their ESG and sustainable investment approaches. We did not look at AFMs' marketing material. We evaluated firms against requirements and guidance in the FCA Handbook and expectations from our July 2021 Guiding Principles letter.

What we found

The AFMs in our review typically showed good intent to embed the Guiding Principles and had considered the design, delivery and disclosure of their ESG and sustainable funds through the lens of the Guiding Principles. We found evidence of some good practice in the design and delivery of ESG and sustainable investments.

However, in some cases we found the disclosure principle had not been fully embedded. This meant that key information about ESG and sustainable investment funds was difficult to identify, and some disclosures did not contain some important information that would more easily enable investors to make fully informed choices about the products they invest in.

We found that AFMs' governance arrangements over ESG and sustainable investment funds had generally evolved over time and were adapting to maturing market practice and expectations. AFMs encountered specific challenges in their oversight of older funds. This included those that had been adjusted to incorporate ESG and sustainability objectives and policies post-launch, where we found more limited records of key governance decisions and discussions.

We found:

- Despite some products having a reference to ESG or sustainability in their name, some did not have an explicit ESG or sustainability objective (although ESG and sustainability outcomes were typically reflected in the investment policy and/or strategy).
- The design of AFMs' stewardship approaches generally did not meet our expectations. It was often difficult to identify the nature of stewardship activities from fund literature alone and identify clear examples of progress from engagement.
- In some instances, fund holdings appeared inconsistent with a fund's ESG or sustainability objectives. Some AFMs were not able to explain how these holdings were consistent with the ESG or sustainability characteristics of the fund.
- Key ESG and sustainability information was often not explained or put into context in disclosures. In some instances, relevant ESG and sustainability information was not included in disclosures.
- Firm-level disclosures were not easily reconcilable with fund-level disclosures. We often found the contribution of an individual fund to firm-wide ESG and sustainability goals was not disclosed.
- In a number of cases, key ESG and sustainability information was not clearly presented and made accessible.

We expect AFMs to review their ESG and sustainable fund ranges and assess whether their disclosure material meets the requirements of our rules and the expectations set out in our Guiding Principles letter.

AFMs should review their oversight and controls frameworks to ensure that they manage the risks of misleading or inaccurate information and that our Guiding Principles and expectations are appropriately embedded in their processes.

Our detailed findings

Principle 1: Design

Principle 1 of our Guiding Principles publication referred to the design of ESG and sustainable funds and the need for clear disclosure of key design elements in fund documentation.

> Some funds did not have an explicit ESG or sustainability objective – or were inconsistently aligned with a stated ESG or sustainability objective and/or the ESG and sustainability approach stated in the investment policy.

There were inconsistent approaches by AFMs to setting specific ESG and sustainable investment objectives at the product design stage across the funds we reviewed. However, AFMs did set out their ESG and sustainability approach in varying degrees of detail in the investment policy.

While we noted that AFMs were setting ESG investment policies and strategies, some did not set any specific ESG or sustainability objectives for funds with ESG or sustainability-related terms in their names, in addition to the financial objectives. In most cases, the financial objectives were supplemented by additional ESG and/or sustainability information and policies that were disclosed in the investment prospectus and wider firm-level documentation. Some AFMs explicitly set a wide range of ESG and sustainable outcomes in fund documentation, such as the fund prospectus, but only committed to achieving at least one of those outcomes.

However, we also saw examples of AFMs including more explicit and detailed ESG and sustainability approaches within the prospectus for their funds. These approaches sought to achieve specific and defined investment aims, such as delivering a particular environmental or social impact or measurable improvement in the ESG and/or sustainability characteristics of a defined portfolio of investments.

On their ESG and sustainable funds, AFMs should comply with COLL 4.2.5(3)(a)R which requires investment objectives, the policy for achieving those objectives and any limitations on the policy, to be set out in the prospectus. The Guiding Principles also state that where a fund claims to pursue ESG and/or sustainability characteristics, themes or outcomes, such as in its name or marketing material, these should be appropriately reflected in the fund's objectives and/or policy.

AFMs should comply with the requirements in COBS 4.2.1R to ensure communications and financial promotions are fair, clear and not misleading, as well as considering the implications of the consumer understanding rule under the Consumer Duty, where relevant.

> The design of AFMs' stewardship approaches did not meet our expectations.

Our review identified that AFMs can do more in their fund and firm-level disclosures to explain their stewardship approach. This includes how their approach enables them to deliver on a fund's objectives, how they measure delivery of stewardship outcomes and any associated challenges.

Among the AFMs we reviewed, many said they used stewardship as a tool to further their funds' ESG and sustainable investment objectives. Our review identified that measuring impact on the operations of investee companies from stewardship activities may be an ongoing challenge for firms. Some AFMs were able to demonstrate longstanding, developed and transparent programmes of engagement with investee companies. However, it was often difficult to identify clear examples of progress resulting from this engagement. As a result, some firms appeared to rely heavily on stewardship activities without being able to demonstrate how they set, assessed and monitored outcomes, and how these linked to the investment objectives of funds.

In many cases, it was difficult to identify the AFM's stewardship approach and engagement activities from fund literature alone. Firm-level documents were also sometimes not accessible from, or cross-referenced to, fund-level documents. There were challenges in identifying how firm-wide stewardship activities related to fund-level objectives during our meetings and in disclosures to investors.

Our Guiding Principles emphasise that AFMs should develop an engagement policy that complies with COBS 2.2B.6R and clarify how stewardship contributes to meeting the fund's intended ESG and sustainability aims. We remind AFMs to review their disclosures on stewardship and consider if they are sufficiently clear on how this activity contributes to achieving their funds' ESG or sustainability objectives. This includes consistently linking these disclosures to relevant firm and fund documentation.

Good practice: Design

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

Principle 2 of our Guiding Principles referred to the delivery of ESG and sustainable investment funds and ongoing monitoring of holdings. The way a fund's investment strategy is implemented, and the profile of its holdings, should be consistent with its disclosed objectives on an ongoing basis.

> Fund holdings that appeared inconsistent with a fund's ESG or sustainability objectives.

We reviewed funds that included holdings in the oil, gas, mining and manufacturing sectors. The documentation explained these holdings were included because the underlying companies were on a path to achieving net zero emissions. However, in some instances we found that, while the companies had set an ambition to achieve net zero emissions by 2050, they had not set any targets for Scope 3 emissions. The AFM did not explain the absence of a Scope 3 emissions target in the fund literature and the treatment of these holdings in the firm's ESG and sustainable investment framework was not clear.

Our Guiding Principles state that where holdings might appear contradictory to a fund's ESG or sustainability investment strategy, the AFM should consider explaining this to investors.

We remind AFMs to consider how their fund communications and financial promotions comply with the requirement in COBS 4.2.1R to be fair, clear and not misleading, given that without a supporting explanation it may not be clear how some holdings align with the fund's disclosed ESG and sustainability objectives and/or policies. AFMs should have a credible, defined and documented approach to the treatment of these holdings in their investment frameworks. Where applicable, AFMs should also consider the customer understanding outcome within the Consumer Duty and how their disclosures align with this.

Good practice: Delivery

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

Principle 3 of our Guiding Principles stated that pre-contractual and ongoing periodic disclosures on ESG or sustainable investment funds should be easily available to investors and help them to make investment decisions.

> Key ESG and sustainability information was often not explained or put into context in disclosures.

We found that some AFMs failed to explain information about the key ESG and sustainability-related features of their funds. For example, some AFMs often chose to disclose carbon footprint data and carbon emissions metrics but omitted to explain that they excluded Scope 3 emissions, even though these are often the majority of a fund's carbon footprint. We also saw examples of ongoing reporting on carbon emissions metrics that showed the emissions of ESG and sustainable investment funds were higher than non-ESG or sustainable funds, without any explanation given.

We know there may be difficulties in getting reliable data on Scope 3 emissions and that it is not currently mandatory for companies to disclose these emissions. However, we remind AFMs that they should explain any material data considerations or limitations in fund disclosures and include the necessary contextual information about the use of third-party ESG and sustainability methodologies.

Some AFMs also explained that their funds continue to invest in carbon-intensive sectors with a view to promoting the transition to net zero emissions. However, investors may not expect an ESG or sustainable fund to have greater emissions than a non-ESG or non-sustainable fund. The AFM's approach should therefore be explained in disclosures, also with reference to any of the AFM's relevant engagement activity, to ensure these are fair, clear and not misleading, in line with COBS 4.2.1R.

> Firm-level disclosures are not easily reconcilable with fund-level disclosures.

It was common for the fund prospectus to have little detail on ESG and sustainability policy goals and instead investors were referred to firm-level policies that gave greater detail. We saw this particularly among AFMs who ran several funds with different ESG and sustainable investment characteristics, investment strategies and asset types.

We often found the contribution of an individual fund to firm-wide ESG and sustainability goals was not disclosed and, therefore, the nature and extent of ESG and sustainability outcomes a fund aimed to deliver was unclear. Individual funds often varied in their alignment to the firm-wide ESG or sustainability policy, even though the firm policy was described as a minimum standard.

AFMs should review and consider how they can improve and reconcile fund and firm-level disclosures in line with COBS 4.2.1R to ensure they are appropriately aligned and provide a clear indication of the ESG and sustainability goals the product aims to achieve. AFMs should consider the impact of the Consumer Duty on their funds, as relevant. We also remind AFMs that our climate-related disclosure rules include requirements to disclose material differences between fund and firm-level approaches, where relevant.

> Key ESG and sustainability information was often not presented coherently and accessibly.

Documents, and cross-references in documents, were often not linked together in a clear and coherent way. This may make it challenging for investors to understand key features of the fund and its ESG or sustainability-related performance.

Fund factsheets were the most common medium used by AFMs for ongoing reporting on the ESG and sustainability characteristics of their funds and were usually displayed on the AFM and third-party websites, including platform providers. However, some AFMs included further ESG and sustainability-related information in supplementary reports that were not displayed as prominently as the factsheet. In some cases, we found it difficult to navigate documents as key information was not where we would expect it to be and/or it was necessary to cross-refer between several documents to find it. We also identified some cases where the cross-references within the fund disclosures were out of date or no longer available. In some instances, AFMs did not provide any ongoing non-financial reporting or way of tracking the sustainability performance of their funds.

AFMs should review the quality and accuracy of cross-references in their disclosures and consider whether they are accessible for investors and presented in a clear, succinct and comprehensible way, in line with the Guiding Principles. We also remind AFMs to consider the impact of the Consumer Duty on their disclosures, where relevant.

Good practice: Disclosure

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

Overall, we found that AFMs need to refine their existing oversight and controls. We observed that AFMs’ governance arrangements had generally evolved over time and were adapting to maturing ESG and sustainability regulation. We saw AFMs encounter specific challenges in their oversight for older funds, including those that had been adjusted to incorporate ESG and sustainable objectives and policies post-launch. Governance records and management information were often lacking, which made evidencing key decisions, the rationale for those decisions and challenge required by our principles and rules, more difficult.

Effective oversight should mean that firms identify and appropriately manage risks of harm from practices that are inconsistent with existing regulatory requirements and the Guiding Principles. This is particularly important in light of the Consumer Duty.

Firms must act to deliver good outcomes for retail customers who hold, or are looking to invest in, ESG and sustainable funds. AFMs have a key role to play in this and should ensure that their strategies and intent are matched with appropriate oversight and control frameworks that are able to identify, monitor and manage the risk of poor outcomes, particularly from unclear ESG and sustainability disclosures.

Good practice: Governance

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.

Next steps

We expect AFMs to assess how they are meeting our rules and guidance in relation to their ESG and sustainable investment funds. This will also be a useful exercise to prepare for the proposed SDR and investment labels regime. AFMs should identify and address any shortcomings in the design, delivery and disclosure of their funds, and ensure they are not conducting their operations in a way that causes harm to consumers. Harm may occur if products are not designed, delivered and disclosed in a way which is consistent with the Guiding Principles.

We will continue to work with the AFMs included in our review to address our findings. We will also continue to monitor the market in line with our usual supervisory approaches, including challenging firms at our fund authorisation gateway where we find applications which are inconsistent with our rules and expectations or risk confusing or misleading investors.

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