Independent
Investment Management
Initiative

New UK ESG Regime:
Backed By IIMI Members

December 2021

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Introduction

Investor appetite for ESG (environment, social, governance)-focussed funds is reaching new heights, fuelled by a combination of the asset class' perceived performance benefits; regulatory intervention; and growing fears about stranded asset risk. According to Morningstar data, ESG funds accumulated $139.2 billion in net inflows during the second quarter of 2021, bringing total AuM (assets under management) to $2.3 trillion.[1] Following COP26, 220 asset managers, representing $57 trillion in AuM, signed up to the Net Zero Asset Managers Initiative, in further evidence of the industry's commitment to ESG.

Amid the ESG asset class' strong growth, regulators – particularly in the UK - are keen to ensure standards remain high following growing concerns about potential greenwashing. Greenwashing is a problem which the IIMI (Independent Investment Management Initiative) - together with its members - is looking to counter. IIMI recently polled its membership, which is comprised of leading independent asset management firms from the UK and Continental Europe, to gather their views on the recent steps taken by the UK's Financial Conduct Authority (FCA) around ESG.

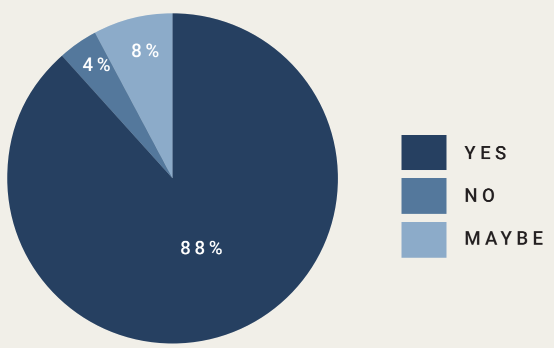
1 Reuters (July 27, 2021) Global sustainable fund assets hit record $2.3 trillion in Q2, says Morningstar

Improving clarity around ESG funds

In a letter to AFMs – published in July 2021 – the FCA noted that it had seen a notable increase in ESG/sustainable funds applying for authorisation, before adding that a number of these applications "have been poorly drafted and have fallen below our [FCA] expectations." In its letter, the FCA continued that many of the ESG claims in these applications do not bear scrutiny, and stressed they should have been addressed during the fund product design process. Among some of the more egregious examples of product mislabelling cited by the FCA were a proposed passive fund with an ESG-related name that was looking to track an index that was not ESG-focused. In another case, the FCA criticised a sustainable investment fund for having two high carbon-emitting energy companies in its portfolio holdings without "providing obvious context or rationale behind it – e.g. a stewardship approach that supports companies moving towards an orderly transition to net zero."

Such behaviour risks undermining consumer confidence in ESG funds. Alongside the FCA, asset managers have also expressed concerns about the prevalence of greenwashing, with the IIMI survey finding that 88% of members believe it is a problem.

DO YOU THINK THAT THE FUND MANAGEMENT INDUSTRY HAS A PROBLEM WITH GREENWASHING?



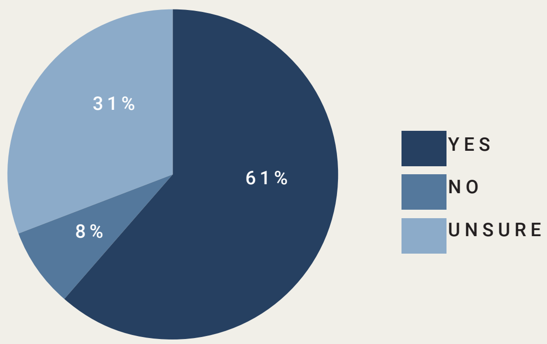
SOURCE: IIMI MEMBER SURVEY

In response, the FCA has outlined a set of guiding principles on the design, delivery and disclosure of ESG and sustainable funds. These requirements are entirely sensible and proportionate and have not elicited criticism from the IIMI or its diverse membership. For example, the FCA urges that references to ESG in a fund's name, financial promotions or any other documentation should reflect the materiality of ESG/sustainability considerations to the objectives and/or investment policy and strategy of the fund. The FCA also highlights that managers should not use terms such as 'ESG', 'ethical' or 'green' in their fund name unless they are directly adopting such strategies. The second principle states that the resources used by a firm to pursue its ESG objectives be appropriate, and the manner in which an investment strategy is implemented be consistent with its disclosed objectives. And finally, the third principle advises that pre-contractual and ongoing periodic disclosures by sustainable investment funds be available to consumers and must contain information to help them make investment decisions. The latter requirement will be vital in ensuring trust among retail clients.

As a mechanism to root out nefarious greenwashing practices, the guiding principles are likely to be quite effective. In addition, the UK government's recently published policy paper – "Greening Finance: A Roadmap to Sustainable Investing" – pledged that it would root out greenwashing in marketing by obliging financial firms to substantiate any claims they make about sustainability. Neil Robson, a partner at Katten, believes green mis-selling of funds will result in managers incurring penalties and sanctions moving forward, just as if they were selling inappropriate products to investors under the existing Markets in Financial Instruments Directive II (MIFID II) rules.

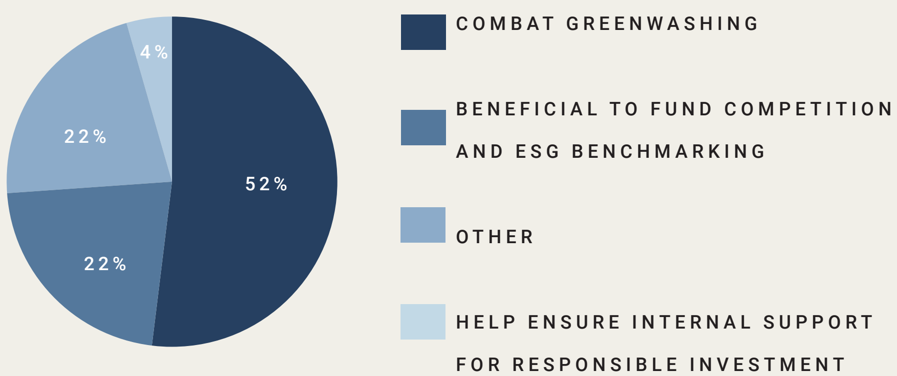
Overall, 61% of IIMI members said the FCA's guiding principles were a positive development for the industry. As to why this was the case, 52% of IIMI members said the principles would help combat greenwashing, while 22% argued they will be beneficial to fund competition and ESG benchmarking.

DO YOU SUPPORT THE FCA'S GUIDING PRINCIPLES ON THE DESIGN, DELIVERY AND DISCLOSURE OF ESG AND SUSTAINABLE FUNDS?



SOURCE: IIMI MEMBER SURVEY

IF YES TO THE CORRESPONDING PRIOR QUESTION, WHY DO YOU SUPPORT THE FCA'S GUIDING PRINCIPLES ON THE DESIGN, DELIVERY AND DISCLOSURE OF ESG AND SUSTAINABLE FUNDS?



SOURCE: IIMI MEMBER SURVEY

Enhancing ESG reporting in the UK

Having announced in November 2020 that it would introduce climate-related disclosure obligations for asset managers, life insurers and pension providers, the FCA has since published a consultation – CP21/17 – outlining its requirements. Under the FCA's proposals, in-scope investment firms (i.e. UK AIFMs; UK UCITS) will need to produce disclosures that are based on the Financial Stability Board's (FSB) recommendations in the Task Force on Climate-related Financial Disclosures (TCFD). The FCA has said the new reporting requirements will take effect from January 1, 2022, for the largest investment managers, namely firms with more than £50 billion of AUM. As of January 1, 2023, the rules will apply to all other fund managers running at least £5 billion in AuM. Although the proposals only cover UK managers, an article by international law firm Sidley Austin warns that non-UK managers could also be indirectly impacted. "The FCA's proposals could result in in-scope UK asset managers and asset owners requesting that a non-UK asset manager provide certain product-level information - in order to discharge the in-scope UK asset managers'/asset owners' own disclosure obligations," it continues.[2]

In terms of the specific reporting obligations, the FCA has instructed asset managers to report information at both an entity and product/portfolio level. In the case of entity-level disclosures, "these would be made with reference to activities over the previous 12 months using the most up to date information available. We [the FCA] are proposing to give firms the flexibility to select the 12-month reporting period for their first entity level TCFD report provided that the period begins no earlier than January 1, 2022, and that the first disclosures are published on their website by June 30, 2023," it said[3].

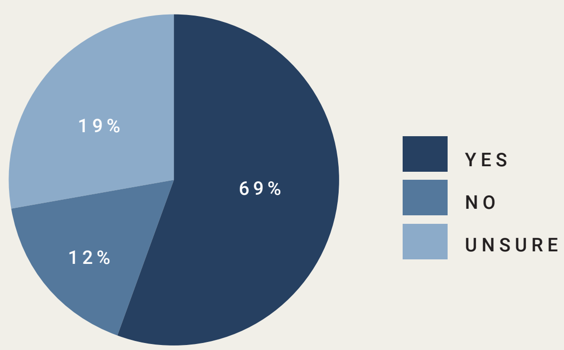
On product and portfolio level disclosures, the FCA highlighted "firms required to make public disclosures would be required to publish them on their websites by June 30 of each calendar year. These disclosures would be made using the most up-to-date data available at the time of reporting. The data must be calculated within the 12 month reporting period covered by the TCFD entity report. Firms would be required to publish disclosures on their website by June 30. This includes the website disclosures in the appropriate client communication which follows most closely after the reporting deadline. In the case of on-demand disclosures to institutional clients, firms must provide the requested information from July 1, 2023," according to the FCA. The FCA's proposals have received a positive response from the industry, with a number

2 Sidley Austin
3 FCA

of market participants describing them as being proportionate and sensible. Again, a majority (69%) of IIMI members have welcomed the FCA's proposals on TCFD reporting.

Moving forward, the recently published Greening Finance policy paper also included some added sustainability reporting requirements for investment firms – the Sustainable Disclosure Regulation. The disclosure obligations will likely oblige assets managers running more than £1 billion to report details about their sustainability approaches under a newly established UK taxonomy. The UK taxonomy will leverage the EU's version extensively, something the UK helped design when it was a member state. It is widely expected this new UK regime will seek to streamline existing disclosure requirements, including the compulsory TCFD reporting provisions.

DO YOU SUPPORT THE FCA'S PROPOSALS TO REQUIRE FUND MANAGERS TO PROVIDE DISCLOSURES BASED ON THE TCFD?

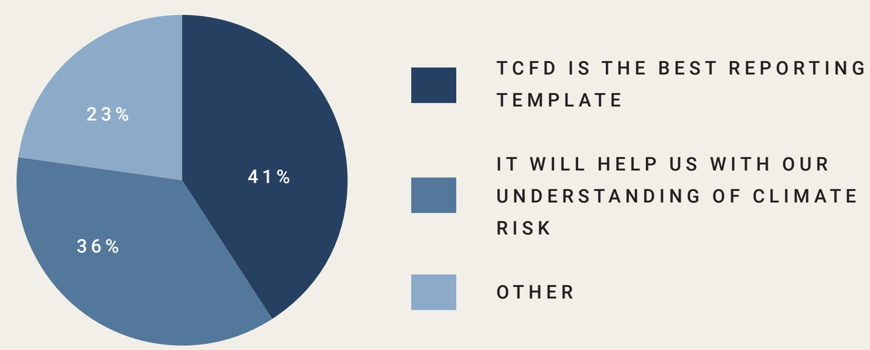


SOURCE: IIMI MEMBER SURVEY

Leonard Ng, a partner at Sidley Austin, says the minimum AuM thresholds for reporting are broadly fair, adding that regulators are focusing mostly on large to mid-sized asset managers as opposed to smaller independent boutiques. "In contrast to the EU – which designed a regulatory framework and ESG standards more or less from scratch and which apply to all managers – the FCA is using the TCFD, which is a template being used more internationally and applying that only to large managers. It appears the new UK Sustainable Disclosure Regulation will build on those TCFD-based disclosures and again apply them only to large managers, but we will have to see the proposal in the consultation paper soon to be published. Separately, there are a lot of arguments currently happening about what assets will be in scope for the EU's Taxonomy Regulation, which is adding to the confusion. It will be interesting to see if the UK's Taxonomy can overcome some of those difficulties seen on the EU side," says Ng.

IIMI members largely concur – especially as it relates to TCFD reporting. One asset manager member notes that in contrast to the SFDR and EU taxonomy - which are EU-centric in nature - the TCFD is a global framework and one that is already well understood. This sentiment is echoed in the IIMI survey, with 40% saying the TCFD is the best ESG reporting template available. Despite all of the recent focus on TCFD reporting, no IIMI members appear to be providing the TCFD template to their investors yet.

WHY DO YOU SUPPORT THE FCA'S PROPOSALS TO REQUIRE FUND MANAGERS TO PROVIDE DISCLOSURES BASED ON THE TCFD?



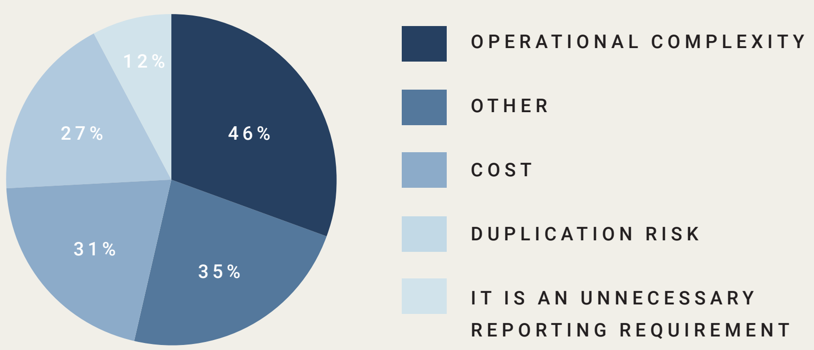
SOURCE: IIMI MEMBER SURVEY

ESG reporting could pose challenges

In isolation, the UK's climate reporting regime appears sensible, not least because it adopts a widely used international standard (TCFD) as its template. Nonetheless, the UK's approach does create its own problems, especially for firms who are caught out by other ESG regimes. With more regulators across the globe now contemplating their own bespoke ESG reporting regimes (i.e. the EU, the US and certain APAC markets), there is a risk that the entire process could become increasingly complicated and expensive.

An IIMI member also warns that large asset owners caught out by the rules are also likely to insist boutique fund managers fill out the TCFD template from 2022 despite the latter not being required to do so until 2023. This comes at a time when boutique investment managers are already grappling with rising regulatory costs and operational overheads – the latter a direct consequence of the pandemic. 46% of IIMI members said the FCA's rules risked creating further complexity, while 31% were worried about costs and 27% expressed concern about the possibility of duplication.

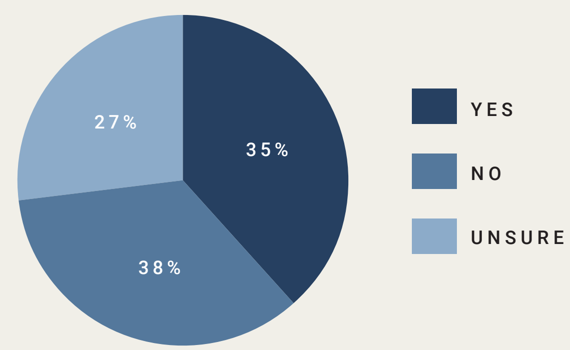
WHAT ARE THE BIGGEST CHALLENGES OF THE FCA'S PROPOSALS ON CLIMATE-RELATED DISCLOSURES?



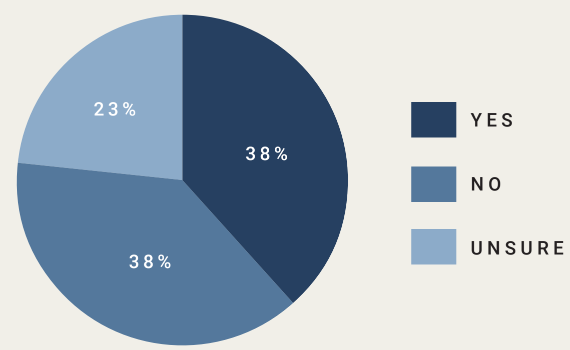
SOURCE: IIMI MEMBER SURVEY

Robson argues boutique firms may need to strengthen their ESG compliance teams as a result of these new rules. It is also possible that asset managers' ESG teams could rival regulatory compliance teams in terms of size and number of employees moving forward. IIMI members are fairly split about whether they intend to grow their ESG teams. 38% told the survey they had no plans to expand their ESG teams in the next 12 months, while 34% said they will increase headcount. IIMI members are also equally unsure as to whether their ESG teams will rival their regulatory compliance teams in terms of numbers/ size in the next two years.

DO YOU PLAN TO EXPAND YOUR ESG TEAM OVER THE NEXT 12 MONTHS?



DO YOU ANTICIPATE THAT YOUR ESG TEAM COULD RIVAL YOUR REGULATORY COMPLIANCE TEAM IN TERMS OF SIZE/NUMBERS WITHIN THE NEXT TWO YEARS?



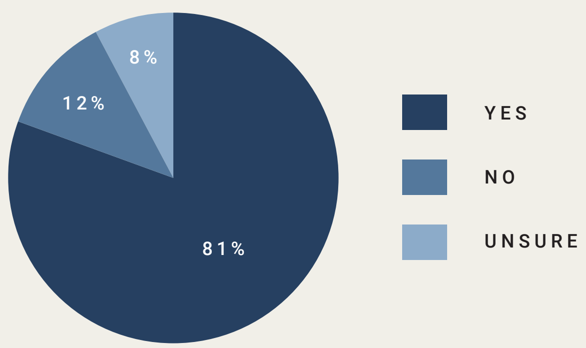
SOURCE: IIMI MEMBER SURVEY

While the IIMI fully supports a comprehensive and meaningful ESG reporting regime, it has growing concerns that too many regulators are introducing their own rules in silos, which is leading to duplication and arbitrage. Moreover, the multitude of different reporting templates and approaches that are likely to emerge is going to be confusing for investors, particularly retail. In order to mitigate this risk, it is vital that regulators engage and collaborate when developing their ESG reporting regimes so that there is a degree of standardisation and consistency.

This is echoed by IIMI members, with 81% saying they wanted to see more standardisation of ESG reporting globally. "Where obligations differ, the industry may appreciate clarity as to the rationale and nature of differences, and scope for cross-referencing in the case of any overlap. Consideration might also be given to "reasonable steps" to meet the more challenging or costly aspects of the requirements, especially where robust methodologies are lacking – for instance regarding climate scenario analysis. Finally, guidance on presenting these complex disclosures to investors in a digestible format, while of course avoiding greenwashing, would be welcome," says the IIMI member.

Others are unconvinced that standardisation of ESG metrics will happen. Ng says that while the attainment of harmonised, global regulatory standards around ESG is desirable, the likelihood of the authorities agreeing on them seem very slim at this point.

DO YOU BELIEVE THERE NEEDS TO BE MORE STANDARDISATION IN TERMS OF ESG REPORTING GLOBALLY?



SOURCE: IIMI MEMBER SURVEY

Key Points

- IIMI and the majority of its membership support the FCA's guiding principles and proposals to make TCFD reporting mandatory as it believes this will root out greenwashing.

- The UK must carefully consider the unintended consequences of potential overlap and divergence with other ESG regimes.

- With more markets increasingly adopting ESG legislation, an element of standardisation is required, otherwise, it could create further confusion. This is something that IIMI is willing to engage with regulators about.

About IIMI

The Independent Investment Management Initiative is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010 as New City Initiative and relaunched as IIMI in 2021, the IIMI counts amongst its members some of the leading independent asset management firms in the City and the continent. The IIMI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

Charles Gubert is a consultant to IIMI and Head of Regulation. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

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3RD FLOOR, PRINCES COURT
7 PRINCES STREET
LONDON
EC2R 8AQ

WWW.THEIIMI.ORG
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