ESG sourcebook obligations for the managers of limited partnerships, venture capital trusts investment trusts and EIS funds - grey washing?

Sustainability disclosure requirements within the FCA ESG sourcebook will be phased in over the next two years beginning with the anti-greenwashing rule. The new rules are not an easy or an enjoyable read and they will apply to the managers of all UK unauthorised alternative investment funds ("AIFs"), amongst others.

Anti-greenwashing rule	31st May 2024
Introduction of labels	31st July 2024
Naming and marketing rules come into force with accompanying disclosures	2nd December 2024
Ongoing product-level and entity level disclosures for firms with AUM > £50bn	2nd December 2025
Entity-level disclosures extended to firms with AUM > £5bn	31st July 2026

Anti-greenwashing – in force from 31st May 2024

From 31st May 2024 any reference to the sustainability characteristics of a product or service must be consistent with the *[actual*] sustainability characteristics of the product or service; and be fair, clear and not misleading.

The term 'sustainability characteristics' is defined by the FCA as 'environmental or social characteristics.

There is no FCA definition of 'sustainability'.

Sustainability labels – in force from 31st July 2024

From 31st July 2024, the managers of UK AIFs will be allowed to use one of four sustainability labels in the name of their funds and also in their financial promotions. These labels must not be used beforehand.

Use of a label is only allowed if the fund has an explicit goal that aligns with one of the labels; if at least 70% of the gross value of fund assets are invested in accordance with this goal and if they are selected with reference to a robust, evidence based standard that is an absolute measure of environmental and/or social sustainability. Selection must be applied in a systematic way and may be based on or determined by an authoritative body, industry practice or a proprietary methodology.

All labels must have robust and evidence based KPIs that can demonstrate the products' progress towards its goals as well as an escalation plan setting out the actions and timescales that the manager will take if the assets do not demonstrate sufficient progress against the goal or the KPIs.
Reference should be made to the standards produced by the SASB to determine the topics that a retail client would reasonably associate with sustainability characteristics.

There are four labels:

1. **Sustainability focus**
   Descriptor': 'invests mainly in assets that focus on sustainability for people or the planet'.

2. **Sustainability improvers**
   Descriptor**:** 'invests mainly in assets that may not be sustainable now, with an aim to improve their sustainability for people or the planet over time'. This label may only be used if short and medium term targets time are identified by which the product is expected to achieve its goal.

3. **Sustainability impact**
   Descriptor**:** "invests mainly in solutions to sustainability problems, with an aim to achieve a positive impact for people or the planet'. This label may only be used if the basis for its selection specifies a theory of change describing how the impact will be achieved. None of the other labels may use the word 'impact' in the name of the fund.

4. **Sustainability mixed goals**
   Descriptor**:** 'invests mainly in a mix of assets that either focus on sustainability, aim to improve their sustainability over time, or aim to achieve a positive impact for people or the planet'. As is implicit, this label may only be used where there are two or more sustainability goals.

If the manager displays one of these labels on its website, it must use the relevant graphic [*to be*] prescribed by the FCA and also in a consumer-facing disclosure, a pre-contractual disclosure and Part B of a public product-level sustainability report.

A manager may only use a label if it has the wherewithal commensurate with the achievement of the goal, a high standard of diligence in its selection and monitoring and an investor stewardship strategy.

Sustainability-related terms - in force from 2nd December 2024

The following are defined as sustainability-related terms: 'ESG' (or 'environmental, social and governance'); 'environment', 'environmental' or 'environmentally'; 'social' or 'socially'; 'climate'; 'sustainable' or 'sustainability'; 'green'; 'transition'; 'net zero'; 'impact'; 'responsible'; 'sustainable development goals' or 'SDG(s)'; 'Paris-aligned'; and any other term which implies that a sustainability product has sustainability characteristics.

A manager who uses a sustainability term in the name of his fund, regardless of whether or not he also uses a label in the name, or in a financial promotion, must prepare: a consumer-facing disclosure for retail clients; and a pre-contractual disclosure in a prospectus or, if there is no prospectus, in Part A of a public product-level sustainability report; and if a label is used then also Part B of a public product-level sustainability report.

A manager who uses a sustainability term in the name of its fund but not a label is restricted from using the terms 'sustainable', 'sustainability' or 'impact' and must publish on its website an explanation as to the purpose of labels, a statement that no label is used and a brief explanation as to why not. Additionally, the name must accurately reflect the environmental or social characteristics of the fund, for example that at least 70% of its assets should have environmental or social characteristics.

The ESG sourcebook is a minefield of ambiguous and dense regulation. FCA regulated firms will need to consider their ESG obligations very carefully indeed.

It is more than possible that, as presently written, the ESG sourcebook will deter as many worthy fund managers as it will prevent the less worthy from greenwashing.

The rule that a manager who uses a sustainability related term but not a label must sit on the naughty step and explain why it isn't using a label, a forgivable decision given the obligations attached to using a label, will prejudice the capital raising endeavours of the worthy managers who want to launch new funds to develop assets which offer society environmental and social benefits but who are understandably cautious as regards their compliance with these new rules. This is a shame. There is a better balance to be struck. At the moment, the FCA ESG sourcebook reads as though it has been written by a climate change denier bent on squashing any and all new green funds with the deadweight of excessive FCA regulation – 'grey washing'.

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28 March 2024