THE
INVESTMENT
ASSOCIATION

FCA CP21/18: Enhancing Climate-Related Disclosures by Standard Listed Companies and Seeking Views on ESG Topics in Capital Markets

Response from the Investment Association

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary

The IA welcomes this opportunity to input into the FCA's consultation on enhancing climate-related disclosures by standard listed companies.

The risks presented by climate change to business, society and the environment are clear. The need for companies, investors and regulators to act with urgency to address them is undeniable. Climate change, and efforts to mitigate its impact, could result in a significant loss of value in investee companies. This will ultimately impact on ordinary savers, whose pensions and savings are invested in these companies. TCFD-aligned disclosures are a crucial step forward to managing the impact of climate change; supporting companies to focus on the effects of climate change on their business and to communicate how these are being managed to their investors and other stakeholders. As such, the investment management industry welcomed the Government's published roadmap on making TCFD reporting mandatory across the economy by 2025 and the FCA's policy statement 20/17 requiring all commercial companies with a UK premium listing to report in line with TCFD. This complements the IA's own expectations, set out in 2020, that all listed companies should report in line with TCFD.

Managing assets for both retail and institutional asset owners, the IA's members are major investors in UK listed companies. They rely on quality disclosures on climate risk to effectively integrate these risks into the investment process. Quality disclosures contribute to accurate asset valuations, which in turn supports financial stability. Enhancing climate-related disclosures enables investment managers to provide the necessary support and challenge through their stewardship role to their investee company's transition to more sustainable business models. This will be crucial in contributing to the UK's goal to achieve net zero carbon emissions by 2050.

Enhancing TCFD disclosures by all listed companies is also essential to enable investment managers to make their own disclosures on the climate risks their portfolios are exposed to. Following regulations requiring occupational pension schemes to report on climate change-related matters, pension funds will need to obtain climate-related information from their managers and investment managers will shortly be required under FCA rules to make their own TCFD disclosures subject to the FCA's CP21/17.

We are pleased to see that the FCA is proposing to extend the scope of its existing requirements to issuers of standard listed equity shares. Our members are clear there is a pressing need for an increase in the quantity and quality of climate-related disclosures from investee companies. We are particularly pleased to see proposals to extend the scope of the Listing Rule to apply to non-equity issuers of securities. Issuers of debt securities and the activities they finance will play a prominent role in the transition to a net zero carbon economy.

The extension of scope to the standard listing and to fixed-income asset classes will also be a key development in helping asset managers to meet their own reporting obligations. In addition, we welcome the proposals to encourage issuers to consider using SASB's sector specific metrics in making TCFD disclosures and would encourage the FCA to make a clear statement to this effect, mirroring the statement made by the FRC earlier this year.

However, we believe there is an opportunity for the FCA to go further in their approach to enhancing TCFD disclosures from listed issuers.

- The FCA needs to establish a timeline on when the rules will apply on a mandatory basis. The urgency of the need for all market participants to tackle climate change, starkly reinforced in the IPCC's recent report, calls for mandatory disclosures sooner rather than later. Investment managers and pension schemes rely on quality underlying data from issuers to make their own TCFD disclosures which will shortly be required on a mandatory basis. To support these disclosures the IA's members would expect to see the disclosure requirements progress to being mandatory by 2025 if not earlier. Whilst we support the process being undertaken by the IFRS Foundation to develop a International Sustainability Standards Board (ISSB), there is little clarity or certainty on the timing of deliverables of the ISSB. Consequently, we do not believe that the FCA should defer the progression of the TCFD Listing Rules to a mandatory basis until such a time as the UK implements the ISSB Standard.

- As climate related factors increasingly drive investment decisions, it is essential that investors can rely on the robustness and accuracy of investee company disclosures. Our members therefore, recommend that the FCA follows the lead of other jurisdictions such as the EU who will require companies in scope of the Corporate Sustainability Reporting Directive (CRSD) to "seek limited assurance for reported sustainability information, while including an option to move towards a reasonable assurance requirement at a later stage". The FCA should work closely with BEIS to align this recommendation with the work they are doing on Audit and Corporate Governance reform. Recognising that the consistency of disclosures and the capability of auditors is not yet sufficient to facilitate a full audit, the FCA should in the meantime require that the disclosures are subject to limited assurance.

Corporate reporting is foundationally important in facilitating greater quality of climate related disclosures along the investment chain. It is therefore paramount that the

requirements on issuers and companies are consistent with the requirements that are placed upon investment managers and their clients. To this affect we ask that the FCA and DWP works with and encourages BEIS to revise its proposals on climate related disclosures and take an approach that is consistent with the more comprehensive requirements of the FCA and DWP. A lack of regulatory alignment on this issue jeopardises the intended aims of regulators to promote coherent economy wide reporting.

Finally, we welcome greater clarity on how the FCA will continue to adapt its rules in response to developments in the TCFD framework in the future. It is important that the Financial Stability Board (FSB) has an open and transparent governance process for evolving the TCFD recommendations, following developments in market practice, with significant input from investors as the key users of financial reporting. There also needs to be clarity from the FSB on how the TCFD framework will interact with the standards developed by the IFRS Foundation's ISSB.

Discussion paper on ESG issues in Capital Markets

In relation to the creation of a UK green bond standard, we do not believe that the FCA should be pursuing this approach. There are already a number of different bond standards in existence which has led to fragmentation and a lack of consistency in green bond issuances. The FCA should not contribute an additional standard to this landscape, further reducing the consistency of bond issuances, instead it should be encouraging alignment with existing international standards.

With regards to the ESG data and ratings market we recognise that the industry plays an increasingly important role in the sustainability and responsible investment market. We agree with the concerns raised by the FCA in the consultation document, regarding this industry and the lack of transparency on how the providers operate. Though there is some tension between bringing the market into the FCA's regulatory perimeter and affording the market the flexibility it needs to continue to innovate and meet the demands of investors, we recommend that the FCA apply regulatory scrutiny to the market to ensure appropriate governance, adequate transparency and management of the inherent conflicts of interest within their business models.

Greater disclosure on governance procedures provides end users of the services with confidence that there is appropriate oversight of the providers' outputs, and that errors and omissions are corrected where necessary.

Our members similarly value transparency around methodologies and how they are applied as this is imperative for investors in understanding and interpreting ESG data and ratings. A clearer insight into the providers use of estimations and their approach to them is important when incorporating the data and/or ratings into the investment process.

Questions

1. **Do you agree with our proposal to extend the application of our existing TCFD-aligned disclosure requirement (set out in LR 9.8.6R(8)) to issuers of standard listed equity shares, excluding standard listed investment entities and shell companies? If not, what alternative scope would you consider to be appropriate, and why?**

Yes. The Investment Association and our members have, since 2020, set our own expectations that all listed companies should be reporting in line with TCFD. In addition, in our response to the FCA's CP20/3 we recommended that the FCA expand the scope of LR 9.8 to include all commercial companies with a standard listing.

Ensuring that there are high quality disclosures across all listed commercial companies is a crucial step towards managing the impact of climate change. Investors are currently not receiving clear and consistent disclosures from companies across the listed sector. Meaningful and comparable TCFD reporting will allow investors to factor this material issue into their investment process, contributing to more efficient asset valuations and targeted engagements with investee companies.

The majority of investors do not invest solely in UK premium listed equities and so they do not have access to TCFD reporting from the entirety of the issuers that make up their portfolios. In light of this, enhancing TCFD disclosures by standard listed issuers is also an important precursor to comprehensive TCFD reporting further along the investment chain; including enabling asset managers to comply with the proposals set out in the FCA's CP21/17, and DWP's Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021.

2. **Do you consider that issuers of standard listed GDRs and standard listed issuers of shares other than equity shares should also be subject to our TCFD-aligned disclosure requirements? If not, what alternative approach would you consider to be appropriate, and why?**

The IA recommends that the TCFD aligned disclosure requirements apply to all issuers of listed securities including, equity, debt (and debt-like) securities, and GDRs. Ensuring that there is TCFD reporting across as wide a range of securities as possible will be instrumental in enabling investment managers to play their role: allocating capital in a way that is consistent with and supports the transition to Net Zero carbon emissions.

See below for our position on including debt and debt-like security issuers in scope.

3. **We welcome views from market participants on whether to apply TCFD-aligned disclosure rules to issuers of standard listed debt (and debt-like) securities, and how best to do this.**

The IA recommends that the TCFD-aligned disclosure requirements apply to issuers of debt and debt-like securities.

Issuers of these types of securities will make a significant contribution to efforts to transition to a net zero carbon economy and there are no distinctions between the impacts that climate

change will have on a company based on the types of security it issues. Ensuring that issuers of listed debt securities make TCFD aligned disclosures will support investors to monitor and assess the climate change impact of their portfolios and allow for more accurate pricing of assets.

In addition, ensuring that issuers of listed debt make TCFD-aligned disclosures will be a vital step in facilitating more comprehensive climate-related disclosures along the investment chain. Without such disclosures from debt issuers, investment managers will face significant coverage gaps in the disclosure and data available to them when they seek to comply with the proposals within FCA CP21/17, especially the proposals regarding portfolio level TCFD reports, data provision, and core metrics.

3. **In particular, we seek input on the following:**

a. **What climate-related information from issuers of these securities would market participants find decision useful and how far would these information needs be met by TCFD aligned disclosures?**

As mentioned, we believe that the TCFD aligned disclosure rules should apply to all commercial issuers of debt and debt-like securities, and that they should make disclosures consistent with all 11 TCFD recommendations.

We do however note that, of particular importance and value for investors in debt securities will be those disclosures under the metrics and targets pillar of the TCFD's recommendations, in particular disclosures of Scope 1, 2, and 3 greenhouse gas emissions data. Such disclosures will enable investment managers to accurately assess the climate risk associated with the securities they are invested in and allow them to meet their own risk management requirements.

b. **Do market participants' information needs differ according to the different types of issuer in LR 17?**

The information needs of market participants regarding climate-related disclosures will not differ significantly according to the different types of debt issuers. All of these issuers are exposed to the impacts of climate-change related risks or opportunities. Investors in these types of issuers would expect that these issuers are responding in some way to the adverse impact that climate change may have on the value of the bond and the likelihood of the investors' capital being returned.

c. **If you consider that we should apply TCFD-aligned disclosures rules to issuers of standard listed debt (and debt-like) securities, should some issuer types be excluded from the rule to deliver an effective and proportionate approach? If so, which types of issuers should be included/excluded and how can the scope best be defined?**

Investment managers will have portfolios that include securities from issuers of various types, and in order for them to meet the requirements as proposed in CP21/17, they will need disclosures from all the issuers and asset classes in their portfolio.

However, we recognise that many of these issuers, including Special Purpose Vehicles, Commercial or Residential Mortgage-Backed Securities and other 'ring-fenced' issuers of debt where there is security over asset, will struggle to meet the requirements. Climate-related information on the underlying securitised products may be difficult for the issuer to attain, in some cases e.g. Collateralised Loan Obligations, the providers of the underlying loans are not required to provide climate related information, or as is the case for legacy asset backed securities it is not practically possible to gather data as there is no corporate entity to provide this information.

If the FCA intend on implementing the product level scope as proposed in CP21/17 it will have to require TCFD-aligned disclosures for all issuers of standard listed debt and debt-like securities. We believe that a more proportionate response is to declare these types of issuers out of scope for the reporting of metric requirements outlined in CP21/17 - For further information please see our response to CP21/17.

This will allow the FCA take a far more proportionate response in the requirements it places on the various issuers of standard-listed debt.

d. Are there any other matters we should take into consideration – e.g., competitiveness, complexity of the application of the rule, burden on issuers in LR 17, or the feasibility to comply with any potential rules

The FCA will have to give consideration to the mobility of the bond market, with issuers able to issue debt securities in differing currencies and list their debt securities of different markets, when implementing the proposals and strike the correct balance between the reporting burden of issuers and the disclosures investors need for accurate asset valuations and their own reporting requirements. The FCA should also work with regulators in other jurisdictions to ensure a consistent approach for debt issuers globally to report against TCFD to avoid such disclosure arbitrage.

We also recognise that there are legitimate concerns about the capacity of some issuers to comply immediately with the disclosure requirements, especially more technical elements such as scenario analysis and scope 3 emissions. However, there is already a large degree of proportionality written into the listing rules through allowing a comply or explain basis and the option to explain what steps are being taken to be able to comply.

4. Do you agree with our proposal to mirror the structure and wording of LR 9.8.6R(8) and LR 9.8.6BG to LR 9.8.6EG for companies with a UK premium listing? If not, what alternative approach would you consider to be appropriate, and why?

Yes, we believe this is the most appropriate approach. The IA does not believe there is a need to create separate requirements based on a Company's listing segment.

Standard-listed companies benefit from access to public capital in much the same ways as those on the premium segment. Similarly, climate change-based risks and opportunities will have a material impact on the long-term value of issuers across both listing segments, and issuers across both listing segments will have an important role to play in the transition to Net Zero. As such standard listed companies should be required to meet investor and wider

stakeholder expectations regarding their response to climate change and make TCFD aligned disclosures consistent with this.

We would like to stress the importance that all listed companies are required to make disclosures in line with all 11 of the TCFD recommendations. TCFD's 11 recommendations are essential disclosures that evidence how well companies are responding to climate change. There should be enough specific information and detail in the disclosures so that they are comparable. Disclosures at the four-pillar level are too broad and do not always allow for intra-sectoral comparisons of company reporting and so reduce the decision-useful nature of the disclosures for investors and other stakeholders.

We also stress the importance that the FCA and BEIS work closely together to ensure that the proposals outlined in this paper and those set out within the BEIS consultation on Requiring Mandatory Climate-related Financial Disclosures by Publicly Quoted Companies, Large Private Companies and Limited Liability Partnerships, are complimentary. This is also paramount to reduce the complexities that in-scope issuers will face in seeking to comply with both requirements. We note that the CP states that the FCA has been working closely with BEIS to deliver coherent disclosure requirements for companies within the scope of both regimes.

However, there are a number of differences in the reporting requirements. For example, BEIS' proposals do not require entities to make disclosures with the 11 recommendations but only at the general 4-pillar level, nor does it require a disclosure of scenario analysis or scope 3 disclosures. The two reporting requirements are therefore not consistent with each other.

In our response to BEIS' consultation we noted significant concerns with the following elements of the proposed approach:

- To only require disclosures at the very general 4-pillar level;
- Lack of scenario analysis; and
- Lack of mandatory Scope 3 greenhouse gas emissions disclosure.

We believe that BEIS should seek to strengthen its proposals across these areas and bring its requirements in line with those of other regulators such as the FCA's proposals and the DWP. Doing so will ensure that corporate reporting enables quality and consistent disclosure along the investment chain.

We strongly encourage the FCA, BEIS, and other regulators to continue to work closely together to ensure that there is greater regulatory alignment - and specifically, that BEIS should take an approach that is consistent with the more comprehensive requirements of other regulators such as the FCA and DWP.

5. Do you agree that, subject to the TCFD's final guidance materials being broadly consistent with those proposed, we should incorporate them into our existing and proposed handbook guidance provisions as described (including both the existing guidance relating to LR 9.8.6R(8) and our proposed new guidance relating to LR 14.3.27R):

a. the TCFD's proposed updates to the TCFD Final Report and TCFD Annex

b. the TCFD's proposed standalone guidance document on metrics, targets and transition planning

c. the TCFD's technical supplement on measuring portfolio alignment. If not, what alternative approach would you prefer?

The IA agrees that the proposed updates relating to the proposed standalone guidance on metrics, targets, and transition planning should be referenced in the Handbook.

The IA's members welcomed the review of the FSB's guidance on Climate-related Metrics, Targets, and Transition. Climate-related reporting has evolved significantly since 2017, and it is time for some of the guidance to reflect those changes. The IA agrees that there is a need for greater standardisation of metrics and the introduction of core, cross-industry climate-related metrics that link to real financial impacts. These developments will boost the comparability of company disclosures, enabling greater incorporation of metrics and targets into the investment process. Consequently, we are supportive, in principle, of the FCA incorporating into its handbook guidance the proposed updates to the TCFD Final Report and Annex and the standalone guidance on metrics and targets. However, we are concerned that issuers may not have sufficient lead time to comply with any new provisions in the finalised TCFD guidance. Please see our response to the FSB Consultations for further information.

We are less certain about the need for the FCA rules for listing issuers to refer to the technical supplement for portfolio alignment. The TCFD's proposed technical note for portfolio alignment is explicitly designed to facilitate greater use of forward-looking metrics to measure the alignment of the portfolios of financial institutions with climate goals. For this reason, we welcomed proposals within the FCA's CP21/17 for climate-related disclosures from asset managers, life insurers and FCA-regulated pension providers to refer to the technical supplement. However, the technical supplement has less relevance for in-scope entities in their capacity as listed issuers of securities making disclosures to their shareholders.

If the FCA incorporates references to the technical supplement into their handbook guidance for listed companies then several asset managers will be captured under the proposals within both CP21/17 and CP21/18. This will result in duplicative requirements for a number of asset managers.

If the FCA were to incorporate the various proposed documents into its handbook we are concerned about the time that issuers will have to adapt to these changes. The FSB has not confirmed when they will release the final version of the proposals, and with the Listing Rule taking affect for accounting periods from 1 January 2022, it is likely that several issuers will not have sufficient 'lead time' to comply.

Finally, we welcome greater clarity on how the FCA will continue to adapt its rules in response to developments in the TCFD framework in the future. It is important that the FSB has an open and transparent governance process for evolving the TCFD recommendations, following developments in market practice, with significant input from investors as the key users of financial reporting. There also needs to be clarity from the FSB on how the TCFD framework will interact with the standards developed by the IFRS Foundation's ISSB.

6. Do you agree that we should update the Technical Note 801.1 to reflect the proposed new rule and associated guidance in this CP?

See response to Q5.

7. Do you agree with our encouraging listed companies to consider the SASB metrics for their sector when making their disclosures against the TCFD's recommended disclosures, as appropriate? If not, please explain.

Yes.

The IA and its members believe there is a clear and urgent need for internationally agreed sustainability reporting standards. We therefore welcome the IFRS' establishment of the ISSB. The IA strongly urges the FCA to work with the ISSB in establishing clear timelines for the release of a global standard. To ensure the future alignment of UK standards with those to be produced by the ISSB, the ISSB should commit to developing these standards before 2025.

Given the complex international coordination and governance required to reach consensus and publish a standard, and a lack of clarity on timings, we are concerned that an international reporting standard will not be adopted in the UK for some time. In the interim, IA members consider it essential that progress is made towards more comparable and consistent disclosure from investee companies. To this effect the IA encourages companies to make use of SASB's sector specific metrics. SASB's sector specific guidance helps companies to determine what information is decision-useful for their investors, and brings consistency to reporting amongst peers in the same sector, facilitating more effective comparison of the long-term value of companies within sectors. To reinforce this expectation, we recommended in our 2021 Shareholder Priorities that listed companies consider adoption of the SASB standards to complement their TCFD disclosures

In response to the FCA CP20/3, the IA recommended that the FCA should, together with the FRC, signal their support for greater adoption of SASB. We also draw attention to recommendation 9 of the AMTF Report: Investing with Purpose – placing stewardship at the heart of sustainable growth which states *"The UK asset management industry supports the early adoption of TCFD by investee companies and the use of other reporting standards, such as SASB, as a stepping stone until an international reporting standard is developed."*

SASB's framework supports greater comparability on key climate related metrics through a sector-based materiality lens. Sustainability issues differ by sector, and even where there are similar sustainability concerns these can manifest differently in different sectors. We therefore, agree that the FCA should encourage listed companies to consider the SASB metrics when making TCFD disclosures.

8. Do you agree with our approach to maintain a 'comply or explain' compliance basis until such time as a common international reporting standard has been published and adopted in the UK? If not, what alternative approach would you prefer, and why?

No. The IA and our members believe that all listed companies should be making disclosures consistent with the recommendations of the TCFD on a mandatory basis by 2025.

The IA is supportive of the IFRS' ISSB but there is no clarity on the timescale it will operate to or when a common international reporting standard will be adopted in the UK. The FCA should commit to make TCFD aligned reporting mandatory for all listed companies by 2025.

This approach balances the urgent need for enhanced climate-related disclosures for investors while giving issuers sufficient time and clarity as to when they need to have developed systems and capabilities for fully complying with the Listing Rule and reporting against all 11 recommendations of the TCFD. We also note that a commitment to make TCFD reporting mandatory across listed companies is consistent with the timelines outlined in the UK's Joint Government-Regulator TCFD Roadmap.

The 2020 TCFD Status Report, the FRCs Climate Thematic Review, and the IAs own research demonstrates that there are significant 'information gaps' and a lack of comparability and consistency in corporate TCFD reporting. The current state of TCFD reporting undermines the quality, comparability, and therefore the value of climate disclosures and reduces the degree to which they can be integrated into the investment process. In response to this, the FCA needs to send a clear signal to companies that the TCFD disclosure requirements will soon progress to a mandatory basis.

Applying the TCFD disclosure rule on a comply or explain basis is also inconsistent with the approach taken by other regulators such as DWP's Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021, and the FCA's own proposed rules for regulated firms, as outlined in CP21/17. Both these requirements apply on a mandatory basis and compliance with both relies on asset managers having access to comprehensive TCFD reports from underlying investee companies.

9. **Do you agree with our approach not to require third-party audit and assurance for issuers' climate-related disclosures at this time? If not, what additional requirements would you consider to be appropriate?**

No. TCFD aligned disclosures should be subject to mandatory limited assurance from a third party.

In recent years, the disclosure of significant environmental and social issues has become increasingly important to investors as they integrate these factors into the investment process. Climate risks can have a material impact on the long-term value of the company. However, companies' climate related disclosures are often not verified. It is imperative that investors have confidence in the robustness and accuracy of these disclosures, considering they increasingly inform investment decisions.

Ideally, the best way to create this level of confidence would be through auditing the disclosures, and in the long run the IA believes that a key goal of the ISSB should be to create standards that are designed to allow for the audit of sustainability information.

In response to BEIS' consultation on audit and corporate governance reform, the IA recommended that ESG disclosures, in particular TCFD reporting, should be subject to mandatory assurance. The common framework provided by TCFD, through facilitating more consistent corporate disclosures, allows for assure-able disclosures. Where a company's statutory auditor may not have the necessary capabilities to provide assurance on climate-related disclosures the company may commission the services of specialist providers.

We therefore encourage the UK Government and regulators, such as the FCA, to position the UK in line with other world leading jurisdictions such as the EU whose proposed Corporate Sustainability Reporting Directive (CSRD) will require "all companies within the scope to seek limited assurance for reported sustainability information, while including an option to move

towards a reasonable assurance requirement at a later stage". Requiring assurance will increase the credibility of the disclosures not only for investors but other stakeholders and providing end-users with the confidence to integrate the disclosed information into the decision making processes.

As set out in our Shareholder Priorities 2021, IA members expect companies to reflect climate-related matters in their annual report and accounts and ensure that the financial disclosures and assumptions relevant to climate change are consistent with their narrative reporting against TCFD. We encourage companies to consider using the framework and educational guidance provided by the IASB and the Investor Expectations for Paris-aligned Accounts published by the Institutional Investors Group on Climate Change (IIGCC).

Under existing accounting and audit requirements, auditors are required to assess whether there is any inconsistency between the narrative disclosures and the company's accounts. We call on the FCA to work with BEIS and the FRC to consider how it may encourage wider adoption of these practices.

10. Do you agree that our new rule should take affect for accounting periods beginning on or after 1 January 2022? If you consider that we should set a different timeframe, please explain why.

Yes - the IA agree that the rule should take affect for accounting periods beginning on or after 1 January 2022.

11. Do you agree with the conclusions and analysis set out in our cost benefit analysis (Annex 2)?

12. If future changes were considered in relation to the UK prospectus regime, we would welcome views on also taking the opportunity to introduce specific requirements in relation to UoP bond frameworks and their sustainability characteristics?

The IA is supportive of the principle of introducing specific requirements on the sustainability characteristics of UoP bond frameworks.

Our members have expressed concern regarding a lack of transparency as to the plans for and actual allocation of proceeds gathered from UoP instruments. The terminology, 'Use of Proceeds,' despite being well established in fixed income markets, has been applied in very general terms in the green bond market, and so is subject to misinterpretation. For example, the IA's members have noted instances where the stated goal of a UoP bond is to fund a set of green projects, but the actual proceeds were used in the interim to finance other corporate objectives. Consequently, and as the FCA is rightly concerned, green 'Use of Proceeds' bonds do not necessarily finance the nominated assets.

Stricter requirements that would require prospectuses to include some information on the issuer's use of key terminology and how it intends the proceeds will be linked to the nominated projects would aid transparency, help avoid 'greenwashing', and so improve the integrity of the market.

13. Should the FCA explore supporting the UoP bond market by recognising existing standards (eg, ICMA Principles), potentially through our recognition of industry codes criteria and process?

The IA's members would welcome the formal endorsement of the existing ICMA principles by the FCA. ICMA's recommendations and guidelines provide a globally recognised framework for Use of Proceeds bonds, and so formal recognition from the FCA will help further promote the use of the ICMA principles as a common global standard.

14. We would also welcome views on more ambitious measures the FCA could consider, for example to require that the central elements of UoP bonds be reflected in contractual agreements and set out in the prospectus.

The IA is supportive of the FCA requiring that the central elements of UoP bonds are reflected in the contractual terms and set out in the prospectus.

The integrity of the green bond market relies on issuers being held to the delivery on the use of the proceeds that are defined for the issuance, and bond holders having the confidence about the final use of the capital. The inclusion of the central terms in contractual agreements or the prospectus, with its increased liability standards, would provide investors such levels of confidence.

We do recognise that there are some concerns that setting these requirements may have adverse impacts on issuers. Issuers do not always have certainty on the final project evaluation, or allocation of proceeds when preparing the contractual terms and so requiring issuers to narrowly define these central elements in the prospectus will reduce the flexibility available to them.

However, improving transparency and rigor in the issuance process will be vital in securing long-term confidence in the market.

15. We would welcome views on the potential harm set out above and what, if any, actions the FCA or the Treasury should consider.

The IA also shares concerns regarding the potential harms identified by the FCA. While investors value third-party verification there have been concerns raised in the past about the conflicts of interest created by an "issuer pays" model, whether verifiers have sufficient information to allow them to reach informed conclusions, and ultimately whether investors can sufficiently rely on the conclusions reached by those verifiers.

16. Should the FCA, alongside the Treasury, consider the development and creation of a UK bond standard, starting with green bonds?

No. A number of bond standard frameworks, including green bond frameworks, already exist, and the IA is concerned that a proliferation of such standards across multiple jurisdictions will lead to fragmentation and, ultimately, a lowering of standards. Instead, the FCA and Treasury should look to encourage alignment with existing bond frameworks, such as the EU's Green Bond Standard (GBS), and principles such as ICMA's Green Bond Principles.

We do recognise, however, that the EU GBS references the EU Green taxonomy, and that the UK is currently developing its own taxonomy which may differ somewhat from the EU taxonomy. However, the issuance processes and frameworks for the ongoing management of the bond, will not be affected by the taxonomy. Further transparency and consistency across jurisdictions is required and we do not believe that the creation of the UK's own bond standard is an appropriate response where greater harmonisation is what investors need.

17. Do you agree with how we have characterised the challenges and potential harms arising from the role played by ESG data and rating providers? If not, please explain what other challenges or harms might arise?

ESG data and ratings are one of a number of analytical tools that investment managers use in assessing the sustainability related risks and opportunities of a potential investment.

Through the introduction of sustainability reporting requirements for investment managers in recent years, financial market participants have been required to report on the sustainability profile of their funds, before issuers are required to do so. For example, the SFDR is being implemented in the EU before the Taxonomy and CSRD are finalised. Without accurate underlying data from corporates, investment managers and asset owners are required to provide disclosures that are subject to substantial data gaps. This can result in a reliance on third party data providers to meet their reporting requirements. However, as characterised in this discussion paper, there are significant concerns relating to governance and the lack of transparency of methodologies in data management and quality.

As highlighted in a recent report by UNPRI (Do ESG Information Providers Meet the Needs of Fixed Income Investors?) the challenges are further exacerbated for fixed income as ESG data and rating providers do not sufficiently cover these types of issuers e.g. sovereign debt, company ownership (listed or private), company funding structures (focus on loans is limited), location (emerging or developed markets). And ESG ratings for issuers of both equity and debt issuers are determined using equity characteristics and identifiers.

Furthermore, we would like to highlight the following challenges:

- Costs to investors;
- Issuer reporting requirements;
- Low correlations;
- UK small cap companies;
- Quality and reliability of ESG data; and
- Data governance and oversight.

Costs to investors - The FCA has not remarked on the issue that arises when an asset owner successfully requests that a mandate names a specific ESG data and ratings provider, for example as a benchmark by which they assess the investment manager's performance. This requires the investment manager to subscribe to a particular provider and can lead to predatory pricing practices by the provider. These costs are ultimately borne by the end – investor.

Issuer reporting requirements - The ESG rating industry is oligopolistic in nature. Consolidation through a series of acquisitions by financial service incumbents buying smaller ESG ratings providers has resulted in a market which, while still retains several smaller providers, is dominated by larger issuers. As such issuers who are inundated with requests to complete surveys and questionnaires are more likely to send responses to the large

established firms that they know are used widely by their shareholder or debt-holder base. This serves as an effective barrier to entry for smaller, innovative service providers, and the possibility for disruption is, therefore, limited.

Regulators could address this by ensuring issuer reporting is more comprehensive, creating standardised terminology and reporting, thus reducing the reliance of investors on ESG data providers. More comprehensive reporting supports investors to supplement the input from data providers with their own analysis. Our members are supportive of the work being undertaken by the IFRS Foundation's to develop an International Sustainability Standards Board which will create a globally harmonised framework for sustainability reporting standards. In the interim, we have called in a letter to G7 economies, for national regulators to commit to implementing mandatory economy wide reporting on international TCFD reporting agreed by national regulators and have also encouraged them to signal their support for companies to start reporting in line with the Sustainability Accounting Standards Board (SASB) standards.

Low correlations – Low correlations of ratings are not generally a concern, after all, stock recommendations using similar information are often different, however the analysis, methodology and assessment used by the ESG rating analyst to make the final ESG rating is important. In certain instances, low correlations of ESG data points are not acceptable for example there should be limited subjectivity in relation to a company's CO_2 emissions.

UK small cap companies - The capacity of larger issuers to engage with ESG data and ratings agencies, and those agencies willingness to engage more with the larger issuers means that larger issuers are able to engage more frequently with the ESG ratings and data providers. For example, larger issuers will be able to correct errors, provide up to date information and have a better understanding how they can improve their ESG ratings. Correspondingly, smaller companies who are not able to respond to the ratings agencies or are not covered, may be inappropriately penalised. As such, funds that invest a large portion of assets in smaller companies, may not be able to ascertain the overall ESG credentials of their fund.

The overall effect of these issues may be to constrain further investment into UK smaller companies. Such smaller companies provide significant benefit to the UK economy and will also be significant contributors to the transition to Net Zero.

Quality and reliability of ESG data - As noted in the IA Response to the EU Renewed Sustainable Finance Strategy Consultation other concerns aside from the lack of transparency in methodologies, our members have around ESG data includes:

- Lack of internal consistency of methodology applied to companies in the same sectors, and across historical data for particular companies.
- An overreliance on publicly available data such as news articles, or historic litigation cases, which may be misleading, not been subject to appropriate controls, or out of date. These may often not take into account the impact of remediation efforts undertaken by the company.
- Infrequent review cycles can result in out-of-date data.
- A lack of willingness to engage with the issuer, to better understand and assess publicly available data. Where engagement does take place, it is often done over a protracted period, meaning that the rating of the issuer may be inaccurate for a long-time while the engagement is taking place. There is also relatively poor coverage in emerging markets and private companies.

Data governance and oversight - It is not clear whether ESG data and ratings providers have appropriate data governance and oversight processes in place in their assessments of the quality of data they receive from corporates. ESG data and ratings providers do not appear to have systematic approaches to challenging the data they collect via questionnaires etc. Whilst investment managers use ESG ratings and data as only part of their assessment in their investment decision process, the significant gaps in issuer data mean that clarity on each individual data provider's approach and is important to asset managers in their assessment of which ESG data and ratings providers' product is the most accurate and useful and reflects their own sustainable investment objectives.

18. **Would further guidance for firms on their use of ESG ratings – and potentially other third-party ESG data be useful, potentially clarifying expectations on outsourcing arrangements, due diligence, disclosure and the use of ratings in benchmarks and indices? Are there other aspects such guidance should include?**

Members welcome the FCA's recent 'Guiding Principles on Design, Delivery and Disclosure of ESG and Sustainable Investment Funds'. We note in particular the need to disclose the reliance on third-party ESG rating or data providers in a fund's investment decision process (principle 1), the consideration of due diligence when using third-party ESG data in the fund delivery process (principle 2) and describing relevant methodologies used and highlighting any material data considerations/limitations when using third party ESG data to support fund disclosures (principle 3).

Further guidance on the use of ESG ratings and data could be helpful but we recommend that this is done in consultation with the investment management industry and corporates, in addition to the service providers, to ensure the guidance addresses key issues and challenges for all those in the ESG data and ratings supply chain.

19. **We would welcome views on whether there is a case either to encourage ESG data and rating providers to adopt a voluntary Best Practice Code, or for the FCA to engage with the Treasury to encourage bringing ESG data and rating providers' activities inside the FCA's regulatory perimeter.**

We recognise the growing prominence of the ratings and/or data services provided plays in the investment process for many managers. The accuracy and transparency of methodology around the output of ESG data and rating providers have a material effect on capital allocation decisions both with regards to the investment process and fund flows. For example, publicly facing ESG scores by providers (e.g. Morningstar Sustainability Rating Globes) directly affect Fund flows as investors base decisions on the perceived ESG commitment of a fund.

Similarly, funds will be using the products of ESG data providers in order to fulfil their regulatory obligations such as SFDR disclosure requirements and assisting advisors in assessing investor's suitability preferences, and importantly the requirements proposed in the FCA's CP21/17. Due to the current state of issuer reporting with its many data and coverage gaps, managers will need to utilise ESG data and ratings providers to comply with these reporting requirements.

The ESG data and ratings provider market therefore plays an important part in the efficient operation of capital markets. The FCA should focus on ensuring that they have appropriate governance, adequate transparency and management of conflicts of interests.

The IA also encourage the FCA to work with regulators in other jurisdictions to develop consistent standards and frameworks for the regulation and supervision of ESG data and ratings providers. This is in the interest of all parties – it will help drive more alignment and consistency between data products and ESG ratings products globally; reduce the barriers to entry faced by new data product and ESG ratings providers, which should in turn lead to more competitive pricing of the products produced by this sector. It will also support those providers that operate cross border/in multiple jurisdictions by providing consistency in regulatory expectations and requirements.

There are some concerns about how bringing the ESG data and ratings providers into scope for regulation may affect the potential for innovation and growth within the industry. The market is still nascent and there is a demand for their services which should not be impeded by unnecessarily burdensome regulatory requirements. It is important that the market is afforded some degree of flexibility to be able to continue to innovate and meet the demands of market participants. We believe that the FCA will have to be cognisant of concerns about how any regulatory requirements may impact on the ability of the market to innovate and develop.

Our members would like to reiterate the point raised in the Asset Management Taskforce Stewardship Report, that some of the issues and concerns around the use of and reliance on third-party ESG data and rating product providers could be addressed by global regulators working together to harmonise corporate reporting standards for sustainability.

Data gaps arise due to a lack of consistent and comparable corporate reporting on sustainability issues, and therefore investment managers are forced to use third party providers to ‘fill the gaps’. A focus on obligatory and improved corporate reporting standards of sustainability issues from issuers would resolve a lot of issues that this discussion chapter highlights.

We also draw attention to recommendation 19 of that report that states that all service providers in the stewardship investment chain, including data providers should demonstrate how they support effective stewardship, and encourages them to do so through becoming signatories to the UK Stewardship Code.

We would also like to draw the FCA’s attention to our response to the IOSCO consultation on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, in which we provide further detail on our members’ views on the potential regulation of this market.

20. If there is a case for closer regulatory oversight of ESG data and rating providers, we welcome views on:

a. Whether transparency, governance and management of conflicts of interest are the right aspects of ESG data and rating providers’ operations and activities to prioritise in regulatory oversight, and if not, what other aspects should be considered

The IA supports the focus on transparency, governance and conflicts of interest. Of particular note should be a focus on ESG data and rating providers' data governance, model governance and governance of the whole process. In addition, systems and processes around data hygiene, data storage, data management, quality and usage should be identifiably robust. As noted above, regulators should be mindful of ESG data and rating product providers' involvement in creation of regulation where they are then able to sell a regulatory solution.

b. Whether and how regulatory priorities should differ between ESG rating providers and other ESG data providers

We believe there is a commonality in regulatory priorities. Transparency of methodology on how data is used, or data gaps are filled, is just as important as to the methodologies of how a ratings provider has assessed a corporate or a securitised debt product. Similarly conflicts of interest will arise in both scenarios through other business lines they operate such as credit ratings or consultancy services. Governance and oversight are clearly imperative to every organisation.

Ratings Providers - With regard to ESG rating provider we highlight that transparency of methodologies is particularly important in relation to funds and securitised debt. Our members need to understand how ESG rating providers map issues with regard to the underlying assets in these products and how they then use this to create an overall rating. Within securitised debt, ESG rating providers need to ensure that the ratings 'roll up' to the right issuer, where the investor holds the parent or subsidiary, or correspond with the holding investors have through securitised debt.

Given the pivotal position of ESG ratings agencies, members are agreed on the need for some form of regulatory intervention to ensure ESG rating providers are meeting the needs of the market. In line with the preference for transparency over consistency of ratings, regulation focused on transparent methodologies whilst having due regard to providers' intellectual property could be an effective way could be an effective way forward.

For instance, the FCA may create a framework of disclosures that captures the different components ESG rating providers use to make their assessments and provide consistent transparency. We believe, that for such a framework to have the most impact it should be aligned with other such frameworks internationally, and so we encourage the FCA through its participation in the IOSCO workstream on ESG data and rating providers to advocate for a globally harmonised framework.

Data Providers - Specifically, for ESG data providers the focus should be on data governance, model governance and effective systems and processes around data hygiene and data storage. Processes and policies relating to data management, quality and usage should be identifiably robust. Data providers should publicly disclose methodologies in every instance, not just when providing averages and estimations (when actual data is not available). For example, quant scores for ESG data and rating product providers are generally done at a peer group comparison level; how this is scored should be disclosed as there are a range of variables such as company size.

c. The similarities and differences between the policy issues that arise for ESG rating providers and those that arise for CRAs, and how far these similarities and differences might inform the appropriate policy response

In terms of appropriate policy response – our members support the focus on transparency, governance and management of conflicts which is important for both CRA and ESG rating providers.

At the entity level there are some similarities between credit rating and ESG ratings – both are making an assessment of the long-term viability of a corporate's business model. The former based on projected cash-flows ensuring the business can continue to be a going concern whilst the latter is assessing the implications of a corporate's strategy on ESG factors and ESG factors impact on the viability of a corporate's strategy.

At the product level however credit ratings are assessing downside risk – they are making an assessment of the creditworthiness of a borrower with respect to a particular debt or financial obligation with a finite duration whereas ESG ratings look for both upside opportunities and downside risks.

21. **What other ESG topics do you consider that we should be prioritising to support our strategic objective? Please explain**.