25 January 2023

SDR and labels policy
Financial Conduct Authority
12 Endeavour Square
London, E20 1JN

Via electronic mail to: cp22-20@fca.org.uk

Re: The Financial Conduct Authority's Consultation Paper "Sustainability Disclosure Requirements (SDR) and investment labels"

To whom it may concern,

Carbon Tracker Initiative (Carbon Tracker) and Planet Tracker would like to thank the Financial Conduct Authority (FCA) for the opportunity to provide comments on its Consultation Paper CP22/20: *Sustainability Disclosure Requirements (SDR) and investment labels (October 2022)*.

Carbon Tracker is an independent, London-based financial think tank that carries out in-depth analyses to help investors understand the financial impacts of the energy transition on capital markets and investments in high-cost, carbon-intensive fossil fuels. Planet Tracker is an award-winning non-profit financial think tank aligning capital markets with planetary boundaries, with a particular focus on achieving transformation in the food and materials systems. Both Carbon Tracker and Planet Tracker are initiatives of Tracker Group Limited. In this response, references to "we" refer to both Carbon Tracker and Planet Tracker.

We welcome the FCA's initiative to introduce requirements for entities to report on their material sustainability risks and opportunities. The structure and overarching content that the FCA has adopted for the proposed requirements will assist in adoption, particularly due to alignment with extant sustainability reporting regulation and standards, including, but not limited to, the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and the International Sustainability Standards Board's (ISSB's) Exposure Drafts IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1), and IFRS S2 *Climate-related Disclosures* (IFRS S2). As the FCA adds disclosure requirements for future topics, it may also want to consider alignment with the recommendations of the Task Force on Nature-related Financial Disclosures (TNFD).[1]

However, we believe that the FCA can take further steps to support the provision of useful information to the market and to align more closely with key regulations and standards - namely by providing additional implementation guidance and requiring that sustainability-related disclosures that impact financial reporting are provided, at a minimum, in annual financial reports.

[1] The final version is expected to be released later this year.

We also broadly believe that reliable sustainable product labelling will promote market integrity and provide more consistent and comparable information. An increased trust in the information provided will increase demand for (and, as noted by the FCA, capital flows to) lower-carbon investment products (as well as those with a biodiversity focus), and in turn pressure investee companies to decarbonise. Although we believe that both sets of information will greatly increase society's ability to decarbonise and address biodiversity loss, and so meet global temperature and emissions-related targets and reduce nature depletion, our work primarily focuses on entity-level reporting. Accordingly, we have limited our responses to the questions that address proposed sustainability reporting at an entity-level.

Please do not hesitate to contact me directly (bdavidson@carbontracker.org), Peter Elwin, Director of Fixed Income, Head of Food & Land Use Programme at Planet Tracker (peter@planet-tracker.org), or David Astley, Associate Analyst, Accounting, Audit and Disclosure at Carbon Tracker (dastley@carbontracker.org) if you have any questions. We remain at your disposal for further discussions on this important subject.

Barbara Davidson

Barbara Davidson
Head of Accounting, Audit and Disclosure, Carbon Tracker Initiative

Q12: Do you agree with our proposal to build from our TCFD-aligned disclosure rules in the first instance, evolving the disclosure requirements over time in line with the development of future ISSB standards?

We broadly agree that the FCA should build on its existing TCFD-aligned disclosure rules. The fact that the TCFD recommendations have been in existence for over five years, and that other regulators have also started to require TCFD-related disclosures,[2] means that many entities are familiar with and/or have already started to gather the data that is needed to provide this information.[3] This also means that investors and other users will be more familiar with analysing these types of disclosures. We further agree that the TCFD's four focus areas - governance, strategy, risk management, and metrics and targets - provide a reasonable foundation for the disclosure regime. However, as we note in our response to Question 18, the FCA's proposed requirements could be further improved to help ensure that entity-level reporting is useful.

We approve of the proposal to develop additional disclosure requirements in line with developments of future ISSB standards and their adoption in the UK; alignment with these future standards will promote global transparency, comparability and interoperability. However, while we understand that the ISSB plans to issue the final IFRS S1 and S2 in Q2 2023, the timelines for subsequent standards have not yet been defined.[4] As the immediate need for more transparency over other material environmental, social and governance (ESG) matters is evident across the market, it may be useful for the FCA to consider providing some preliminary reporting guidance for these additional topics (see our response to Question 18). We also encourage the FCA to take a similar approach with recommended TNFD-aligned disclosures, when released, remaining mindful that the TNFD framework is being built on the shoulders of the TCFD framework.

Q18: Do you agree with our proposals for sustainability entity report disclosures? If not, what alternatives do you suggest and why? In your response, please comment on our proposed scope, location, format, content, frequency of disclosures and updates.

We agree with the FCA's ambition to require the entities within the scope of these requirements to report on their ESG risks and opportunities, and their management and governance thereof. Aside from encouraging the FCA to extend these reporting requirements to pension providers, as discussed in response to Question 28, we do not provide further comment on the proposed scope of these proposals.

However, as we note above, we do believe that the FCA could further enhance the proposed requirements by providing additional guidance to better meet the needs of users of material sustainability information. Here, we have sought to be as succinct as possible - but we are

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[2] For example, the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021 in New Zealand, the Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022 in the UK, and Directive (EU) 2022/2464 of the European Parliament and the Council of 14 December 2022 in the European Union.

[3] See also Carbon Tracker's and Planet Tracker's combined response to the International Sustainability Standards Board's Exposure Drafts IFRS S1 and S2 at: https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/exposure-draft-comment-letters/c/carbon-tracker-and-planet-tracker-ad721355-8e89-4aa7-a832-a3ec235d6f11/cti-pt-combined-issb-cl-s1-s2-2022.pdf.

[4] See https://www.ifrs.org/projects/work-plan/issb-consultation-on-agenda-priorities/#current-stage.

happy to further discuss our response with the FCA. We would also direct the FCA to the comment letters that we submitted in response to the ISSB's Exposure Drafts - IFRS S1 and S2.[5]

Location and format

The draft Handbook text proposes that entities report on "the actual and potential impacts of any material sustainability-related risks and opportunities," as well as the governance, management and targets relating to these risks and opportunities. To be of most use to investors and other users, we strongly believe that any such sustainability-related information (including TCFD-aligned disclosures) that can impact the assumptions and estimates that an entity uses to prepare its financial statements (such as, but not limited to, the timing of, or costs related to, emission reduction targets, and/or the impacts of regulations on demand for underlying investee company products) should be included in general purpose financial reporting (e.g., in the entity's annual report) and not in separate, standalone reports.

Such information should be provided alongside and appropriately cross-referenced to the other material financial information that entities provide in their annual reports – including the associated financial statements. This would allow users to connect relevant information more easily and provide context to an entity's sustainability information. Providing these disclosures in the annual report would also mean that the reported sustainability risks and opportunities would be within the scope of an auditor's consistency check for material inconsistencies (and so potential material misstatements).[6] Understanding that auditors have read and considered this information for any material differences to the financial statements may provide investors and other users additional comfort regarding the quality and reliability of such data.

In our reviews of corporate reporting, we have often observed considerable time lags between the publication of sustainability versus annual reports. The use of multiple reports (and so locations) also increases the informational burden on users and the chance of seemingly inconsistent information being provided to the market, and within a different timeframe than the relevant financial information. This can lead to confusion over which reporting periods are covered by the sustainability or related reports. Separate reports could also imply separate oversight and controls over this data. For further information, see our response to the ISSB's consultation on the Exposure Draft for IFRS S1, Question 10.

We also believe that location of information is one of the keys to tackling greenwashing, a core regulatory priority for the FCA. A standalone report may result in sustainability information being prepared and assessed separately from the information disclosed in the annual report, potentially leaving it open to greater error and so risk of misstatement. The effectiveness of the information could also be reduced, particularly if users are not able to find it.

Lastly, in line with the reporting location, we believe that the entity offering sustainability reporting should be coterminous with the group covered by financial reporting (with the possible exception of reporting Scope 3 emissions and other specific areas such as

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[5] See https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/exposure-draft-comment-letters/c/carbon-tracker-and-planet-tracker-ad721355-8e89-4aa7-a832-a3ec235d6f11/cti-pt-combined-issb-cl-s1-s2-2022.pdf.

[6] See International Standard on Auditing (ISA) 720 (Revised) – *The Auditor's Responsibilities Relating to Other Information*, and Public Company Accounting Oversight Board (PCAOB) Auditing Standard 2710 – *Other Information in Documents Containing Audited Financial Statements*. In both cases, auditors are required to consider other information contained in the annual report or filing for material inconsistencies.

biodiversity and labour practices). This is also the position we took in our response to the ISSB's consultation on the Exposure Draft on IFRS S1, Question 5. Where an entity's/ group's sustainability reporting boundary does not align with its financials, this should be clearly identified and explained to users.

Content

As stated above, we broadly agree with starting with the TCFD focus areas for these disclosure requirements. We also appreciate that the FCA wishes to avoid being overly prescriptive. However, to ensure that the proposed disclosures are decision-useful and comparable, we believe that it would benefit both entities and users if the FCA provided more detailed guidance on what would be required to comply with these proposals. Below we have provided some examples of the type of guidance that we believe is needed.

- **Further guidance on "sustainability."** Despite the variety of sustainability-related standard-setters, there is currently no commonly accepted definition of sustainability. And as we have indicated to the ISSB in our response to the IFRS S1 Exposure Draft, the word "sustainability" can be interpreted (and indeed used) in diverse ways. Accordingly, and in the light of ensuring a more consistent, comparable definition of sustainability across the various market players, we believe that the FCA should work with other standard setters and regulators over time to develop a common definition. In the interim, the FCA could provide additional guidance on what it means by "sustainability." For example, we note that the draft Handbook defines "sustainability characteristics" as "environmental, social or governance characteristics."[7] The FCA could further add to this definition by drawing **relevant** parts from the draft IFRS S1 BC30 as excerpted below (which also includes references to environmental, social and governance):

  > *Information that gives insight into environmental, social and governance-related risks and opportunities that affect enterprise value, providing a sufficient basis for users of general purpose financial reporting to assess the resources and relationships on which an entity's business model and strategy for maintaining, adapting and/or developing that model depend.*

- **Guidance on sustainability risks and opportunities**. As it stands, other than references to the ISSB's proposals (and Sustainability Accounting Standards Board, or SASB, standards), there is little guidance as to what constitutes potential sustainability risks and opportunities beyond that they may be categorised as environmental, social and/or governance related (as noted above). By providing an example set of risks and opportunities for E, S and G (or the noted sustainability topics) that are relevant to the sectors covered by the requirements, the FCA would help companies identify and assess their own risks and opportunities (both existing and future). We note that, in our response to the ISSB's Exposure Draft on IFRS S1, we recommended that the ISSB consider providing additional guidance on sustainability-related risks and opportunities.[8] In order to support comparability across jurisdictions and reduce the

[7] See p. 4 of the draft Handbook text.
[8] For example, see paragraph BC40 in the draft IFRS S1 Basis for Conclusions: "Significant risks are those that an entity prioritises for management responses. They include risks and events that in the short, medium or long term could disrupt the entity's business model or its strategy for sustaining and developing the business model that

burden on entities of complying with several different regulations, the FCA should continue to target a level of consistency with IFRS S1.

- **The importance of quantitative information, including time horizons.** Investors and other users need both quantitative and qualitative information to understand the scale, scope and possibility of the potential impacts of different material sustainability risks and opportunities. This enables them to compare the entity's sustainability information to its relevant financial information and so make a fuller assessment of the integrity of the entity's sustainability and financial reporting, as well as its governance and management over such matters. Reporting the anticipated effects over short-, medium- and long-term time horizons (and defining such horizons), would provide users with a clearer guide on how these may develop. Where entities identify potential impacts that could reasonably be quantified, they should be quantified, explained, and clearly connected to the relevant areas of financial reporting.

- **Concentration of risks and opportunities.** Setting out how identified material risks and opportunities are concentrated in areas of its business or in relation to specific assets would be valuable. Similarly, users of this information need to understand the potential relationships between different sustainability risks and opportunities, and whether their interactions compound potential impacts. This is particularly relevant for asset managers that are signatories to the Net Zero Asset Managers initiative and so, along with other types of financial institutions, are part of the Glasgow Financial Alliance for Net Zero.

- **Identify impacts on financial reporting.** Where entities have identified and reported on material sustainability risks and opportunities, it is important for them to also set out the relevant areas of the financial statements that are or can be impacted. Explanation as to how these matters have or have not been considered when preparing the current year's financial statements would provide investors and other users with a better understanding of the financial impacts of such risks and opportunities on the entity's financial position and performance. We also note that the TCFD had originally highlighted the interaction between financial reporting and its recommended disclosures.[9]

- **Providing additional information on governance over these matters.** The draft Handbook proposes that entities include "the *firm's* approach to governance, with respect to managing sustainability risks and opportunities" in their entity-level sustainability reports.[10] However, in our reviews of corporate reporting we have seen little evidence of Board or management oversight (e.g., via discussions in audit committee reports, when applicable, or consideration in financial statements) over climate-related or other relevant sustainability matters. As noted in our response to Question 2 of the ISSB's Exposure Draft on IFRS S2, including a general description of the roles and responsibilities of management and/or Board committees is no longer sufficient; there is increasing pressure from investors to ensure that management/Board

could affect the resources or relationships on which the entity depends or that threaten the viability of, or creates opportunities for, the entity."

[9] *Task Force on Climate-related Financial Disclosures (June 2017), Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*, p 8.

[10] See *ESG* 4.6.1R (1) (a).

committees have also followed these processes. Accordingly, we have excerpted below the list of disclosures that the ISSB (and so the FCA) could further require entities to provide to address this concern (amended as appropriate):

- *provide an explanation of whether and how they ensured that the impacts of material climate-related risks were included in current period financial statements;*
- *indicate how they scrutinised and considered the impacts of the company's transition or emissions reduction strategy on current period financial reporting;*
- *indicate how they determined that the company provided consistent climate-related information across its general purpose financial reporting;*
- *indicate whether they discussed the treatment of material climate-related issues with its external auditors and how they scrutinised the auditor's work to ensure that they also considered the impact of material climate matters in their audit of the financial statements;*
- *explain how they engaged with investors to ensure that the audit remains fit for their purpose; and*
- *the results of these actions.*[11]

As noted, the above is a non-exhaustive list of potential further requirements and guidance that the FCA could provide for reporting on material sustainability risks and opportunities. We believe that it would be beneficial to both entities and users if the FCA incorporated these types of examples into its proposed requirements. Similarly, the FCA should consider providing more specific requirements and guidance for the three other reporting areas currently set out in the draft Handbook, as and when possible.

Lastly, we believe that, when it publishes the final requirements and guidance on material sustainability matters, it is particularly important for the FCA to highlight the connection between sustainability reporting elements and an entity's financial statements. Further, the FCA may want to build on the proposed requirement ESG 4.6.1R (2)[12] to consider explicitly requiring entities to explain how the sustainability-related products that they are offering **align with** or further support their overall approach to governance, strategy, risk management or targets and metrics (such as, for example, how the product(s) will help the entity to achieve any relevant emissions targets). Being able to understand an entity's risks and opportunities in the full context of its relevant financial reporting is essential to the efficiency and effectiveness of capital allocation (and so of markets).[13]

Frequency of disclosures and updates

We agree that reporting entities should be required to update their disclosures annually. We further believe that the information that is proposed to be required by the FCA should be reported at the same time as the entity's financial statements and in the same reporting document, as set out above.

[11] See our response to *Question 2-Governance* in our comment letter on the IFRS S2 Exposure Draft.
[12] "A *firm* must explain, either in its *sustainability entity report* or in a cross-referenced *public product-level sustainability report*, where its approach to a particular *investment* strategy, asset class or product is materially different to its overall entity level approach to governance, strategy, risk management or targets and metrics. "
[13] See our response to *Question 6-Connected information* in our comment letter on the IFRS S1 Exposure Draft.

Q19: Do you agree with how our proposals reflect the ISSB's standards, including referencing UK-adopted IFRS S1 in our Handbook Guidance once finalised? If not, please explain why?

Yes, as noted, we generally agree with how the proposals reflect the ISSB's standards. Depending on the FCA's timelines, we also believe that it is appropriate for the FCA to direct entities towards the proposed IFRS S1 for some guidance on the content of sustainability disclosures, particularly as a means of providing greater detail to users and helping to develop consistency across reporting. Once IFRS S1 is formalised in the UK we would encourage the FCA to align its sustainability reporting requirements and guidance as closely as possible, where appropriate for the sectors in scope, with the contents of the final IFRS S1. We expect that in doing so, the FCA's requirements and guidance would come closer in line with the suggestions provided above in response to Question 18.

Looking forward, we believe that it would be appropriate for the FCA to include references to further sustainability topic-specific standards issued by ISSB and adopted by the UK as guidance for entities to make use of according to their identified risks and opportunities. Before then, and until such topics are covered by subsequent ISSB Sustainability Disclosure Standards, the FCA may want to assist entities seeking to address some of these areas of reporting today by highlighting or referencing existing relevant standards, frameworks and guidance, such as the CDSB's Framework and technical guidance on biodiversity and water,[14] in the final Handbook.

Q20: Do you agree with our proposed general 'anti-greenwashing' rule? If not, what alternative do you suggest and why?

Overall, we strongly support the proposed general anti-greenwashing rule. Carbon Tracker's review of 134 carbon-exposed companies' FY2021/22 financial statements found that they all appeared to treat climate-related matters differently between their financial reporting and their sustainability-related reporting.[15] We believe that such inconsistencies could be an indication of greenwashing. As noted above, we have also seen little evidence of Board oversight of these matters (e.g., via discussions in audit committee reports, when applicable).[16] Further, Planet Tracker recently published a note which highlights the growing sophistication of greenwashing.[17]

The growing market interest in products and funds that are advertised as having a positive focus or impact from an ESG perspective has resulted in a concurrent increase in scrutiny of said products and funds.[18] Improving regulations over the marketing and labelling of sustainability/ESG products and funds, as proposed by the FCA, should help build and maintain trust in the goals and results of such investments. As the FCA has noted, this goes a

[14] IFRS - Climate Disclosure Standards Board, see https://www.cdsb.net/sites/default/files/cdsb_framework_2022.pdf. See also CDSB's biodiversity and water guidance, respectively available from https://www.cdsb.net/biodiversity and https://www.cdsb.net/water.
[15] See https://carbontracker.org/reports/still-flying-blind-the-absence-of-climate-risk-in-financial-reporting/.
[16] See our comment letter response to the ISSB's Exposure Draft on IFRS S2, Question 2.
[17] See https://planet-tracker.org/wp-content/uploads/2023/01/Greenwashing-Hydra-3.pdf.
[18] See, for example, https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2022/04/esg-backlash/.

long way to improving market integrity, an essential part of mobilising the capital that is required to meet the goals of the Paris Agreement and other sustainability-related targets.

It is imperative, though, that the FCA is sufficiently resourced and empowered to be able to thoroughly and consistently monitor market participants to ensure that its anti-greenwashing stipulations are being followed, and to perform regular post-implementation reviews. In this light, it may be appropriate to require review-level or higher assurance of this information at a later date, once entities have begun to implement the new requirements.

Q28: To what extent would the disclosures outlined in Chapter 5 be appropriate for pension providers ie do you foresee any challenges or concerns in making consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports?

In general, we would agree with requiring consumer-facing disclosures, pre-contractual disclosures and building from the TCFD product and entity-level reports for pension providers and as such would encourage the FCA to introduce these requirements. As with asset managers, pension providers have the potential to contribute to global sustainability goals and are exposed to ESG risks and opportunities and therefore should also disclose the relevant material information. As explained in our above response, we also believe that this sustainability information and any other the TCFD entity-level information should be provided in the pension providers' annual reports (alongside the location of their financial reporting). Further, we believe that the FCA could better assist pension providers by providing further and more detailed implementation guidance to enhance the decision-usefulness of disclosures and their connection to financial information.