CFA Society
United Kingdom

10 September, 2021

Thorben Heidrich
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Submitted by e-mail to cp21-18@fca.org.uk

Dear Mr Heidrich,

CFA UK response to the FCA regarding CP21/18: Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets

The CFA Society of the UK (CFA UK)[1] is delighted to have the opportunity to continue to share its views on this topic with the FCA following on from our response letters to CP20/3 and PS21/17 last year and to BEIS in May 2021.[2] We are grateful for the constructive dialogue with you and your team and for your participation in our webinar on 25 August, which raised the profile of these matters among our membership.

Climate change, and society's response to it, is having an increasingly profound impact on the global economy and in turn the investment world in which our members work. Investment professionals need high-quality information to assess the risks and opportunities that climate change presents to the companies they invest in. We acknowledge that around the world there has been a step-change in the level of commitment to and activity levels in climate reporting, but note that the ability to assess how companies are affected by and contribute to climate change is difficult and that there is little time left to address these issues.

As reporting by investment firms, life assurers and pension schemes is to be mandated by the FCA[3] and the DWP[4] on portfolio exposure to the physical and transitional risks of climate change, all companies must necessarily make this data available in a comparable, consistent and understandable way.

These mandatory requirements require standardisation of the carbon-related disclosures made by issuers of securities. In that light, CFA UK backs and promotes the TCFD's guidance, above any other provider, as the leading global authority. It follows that CFA UK welcomes the central proposals of your paper, namely (i) the proposed extension of TCFD-reporting beyond premium

[1] CFA UK's mission is to help build a better investor profession for the ultimate benefit of society. We refer you to Appendix 1 for a brief overview of both CFA UK and our umbrella organisation, CFA Institute.
[2] These response letters can be viewed here on our Society's Professionalism webpages: (https://www.cfauk.org/professionalism/advocacy/responses#gsc.tab=0)
[3] CP21/17: 'Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers' (https://www.fca.org.uk/publications/consultation-papers/cp-21-17-climate-related-disclosures-asset-managers-life-insurers-regulated-pensions)
[4] DWP: 'Taking action on climate risk: (https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes)

listed companies and Public Interest Entities ('PIEs') to standard listed companies, and (ii) the consultation on the appropriate carbon-related disclosures for issuers of debt securities.

We are grateful to those working group listed at the foot of this letter for their assistance with our responses to your consultation questions, which are provided in Appendix IIA and IIB, and wish to highlight some of the members of the working group came with fixed income and green bond experience.

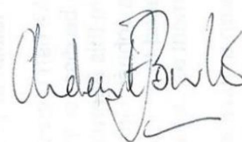
CFA UK is broadly supportive of your proposals but has three suggestions around their implementation, as follows:

- As stated in our response in CP20/3, we consider some of the eleven recommendations in the TCFD pillars to be fairly basic, largely descriptive, and straightforward for companies to adopt. While we have altered our view as to which of the recommendations should become mandatory as a result of TCFD's proposed changes to its guidance for the recommendations, we maintain that some should be mandatory rather than disclosed on a comply-or-explain basis.
- We concur strongly with your contention that Second Party Operators ('SPOs') play a critical role in many companies' measurement of their climate-related exposures. As an initial step we support your proposal that these companies adopt a code of practice which could in turn be recognised by regulators such as yourselves. As ARGA evolves out of the FRC to assume greater powers for a corporate auditor profession in the medium-term, we could see a strong case for these firms to fall under ARGA's regulatory oversight in the same way as other specialist assurance firms such as those for cybersecurity, environmental reports, certain valuations or data governance.
- We write as a UK-based society to a UK national regulator but on a subject which is unavoidably global. As stated in the third paragraph of this letter, we back TCFD rather than any other source for this very reason. By extension we recognise that the regulatory solution needs to be global also, and we encourage your efforts to reach alignment with other regulators. It is critical that regulations are aligned across all major listing venues for both debt and equity, but in particular for debt securities, where decisions on domicile and listing venue, on- or off- shore, arise on a regular basis.

CFA UK welcomes the FCA's consultation on this matter of great importance to the investment profession and broader society, and we appreciate this opportunity to share our views.

Should you have any questions or points of clarification regarding this letter or our responses to the questions, do not hesitate to contact us.

Yours sincerely,



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and the oversight of the Professionalism Steering Committee.

APPENDIX I
About CFA UK and CFA Institute

CFA UK serves nearly twelve thousand leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments, or as in-house employees responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.
- For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.
- It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.
- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.

Context to our responses to the questions

The CFA UK supports CFA Institute by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. This includes maintaining the public's trust in financial markets and in the investment profession.

One of the CFA Standards of Professional Conduct, germane to climate change disclosure, is:

'Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.'

We are therefore keen to see climate change disclosure being of practical use to investment professionals.

CFA Society members are present in many types of firms and in a variety of professional roles. Some examples will bring this to life:

Supporting fair valuation
Objective valuation of equity and debt instruments by investors is essential for robust capital markets. Valuation disciplines require the forecasting of cash flows, the determination of risk premia and discount rates, comparability across companies, etc., and material upside or downside due to climate change needs to be reflected in valuations. Research analysts and sell side brokers will be particularly interested in understanding the climate change risks and opportunities faced by the firms that they cover.

Disclosure and transparency
As the asset management industry gears up for greater transparency on ESG and climate change, the quality of information it provides will depend on what is reliably and consistently available from the underlying issuers of equity and debt into which its funds invest.

Incorporation in portfolio construction
Consistent data and metrics on climate change, and disclosure of the same, will feed into the portfolio construction process and allow better incorporation of climate-change-related risks and rewards into the process. As climate change is seen to be largely a non-diversifiable risk, it could have a material impact on risk expectations.

Fund design
A better understanding of climate change will assist the investment process of equity and debt funds while facilitating the construction of appropriate fund mandates reflecting, for example, any constraints on climate-change-related risks and impacts. ESG-oriented funds, needless to say, will benefit even more from meaningful disclosure.

Stewardship & engagement
Improved climate change disclosures will enable analysts and portfolio managers to raise climate change issues much more effectively with company boards where they are a matter of concern. This engagement could then also extend to the tabling and voting on well calibrated and focused climate change related resolutions at company AGMs.

Appendix IIA
Responses to questions on proposals

Q1. 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?

CFA UK supports the extension of the FCA's TCFD-aligned disclosure requirement to standard listed equity shares. The approach represents a logical extension of its prior efforts and is consistent with the government's Roadmap.[5]

CFA UK wishes to propose one important caveat, however, which we expand in answer to question 8.

Q2. 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?

As the staged rollout of the FCA's disclosure guidance and rules continues, market participants will call for and hopefully bear witness to the increased harmonisation of disclosures. This should apply equally to GDR issuers and issuers of non-equity shares.

We fully support the extension to both standard listed GDR issuers and standard listed issuers of shares other than equity, subject to potential exemption if a standard listed GDR issuer could prove this requirement conflicted with its home market regulation or legislation. Given that the Listing Rules refer the reporting entity back to the TCFD recommendations, this would seem to minimise the likelihood of such a conflict.

Q3. 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. 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?***

CFA UK believe debt investors would prefer to see, in addition to entity-level disclosures similar to those provided by listed entities, information provided at the security issuing level. This would allow debt investors to more precisely measure their exposure to climate risk as a direct result of investing in specific securities.

More precisely, we believe debt investors would value seeing the assets or businesses that are being financed with the proceeds. Is the debt being extended to a diversified energy group, for example, and do their loans or bonds support coal-generating activities or the renewable generation assets?

For asset-backed securities such as ABS, CLOs and RMBS, we believe debt investors would prefer to see disclosures at the specific asset or pool level (for securities like RMBS and CMBS this could mean the environmental rating of each asset) in addition to the corporate/entity-level

[5] HM Treasury's 'Roadmap towards mandatory climate-related disclosures' (Nov. 2020): (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf)

disclosures. Again, debt investors must be facilitated to accurately measure their exposure to climate risk as a direct result of investing in specific securities. It may also inform the asset backed security investor of how/whether the sponsor/arranger etc for the asset-backed securities are managing the exposures differently at the asset/pool level compared to the group entity level.

Entity and group-level disclosures remain important. Investors choose green bonds not only for their risk and return but for their positive externalities in terms of reducing carbon emissions. Where energy companies with significant hydrocarbon businesses wish to take advantage of capital market support for their renewable energy businesses while at the same time funding their hydrocarbon business from internal cashflows, investors have potential leverage to make their participation conditional upon broader change. Regulators have a role to require prominent, convenient disclosure of how a company's broader business activities and plans affect the fundamental objective of reducing carbon emissions.

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

CFA UK believe that the needs are similar, but as laid out in our response to point a**)** above, information at both the issuance level and, where relevant, the asset/pool level will be useful**.**

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?

While we believe that ultimately TCFD disclosures should be applied to all debt issuers irrespective of their size, we think that, as has been the case for equities, climate-related reporting for debt issuers should be proportionate and concentrate initially only on those companies which have (i) sizable operations which make their carbon footprint a matter of public interest, and (ii) the ability and resources to comply with the requirement. We suggest these issuers could be defined in the same way as Public Interest Entities ('PIEs') will be following BEIS' recent consultation on Restoring Trust in Audit and Corporate Governance.[6]

We suggest that short-term debt securities with a maturity below one year should be excluded from such requirements.

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?

Noting and agreeing with the feedback to TCFD's consultation, CFA UK supports standardisation. Therefore, we would urge that the FCA moves in co-ordination with other international regulators to prevent such obvious loopholes and poor incentives.

Equally, CFA UK does not wish to encourage avoidance strategies: issuing private debt instead of public debt, adopting alternative ownership structures, or switching the listing domicile**.**

[6] CFA UK Response letter to BEIS (June 2021): 'Restoring Trust in Audit and Corporate Governance (https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-beis---restoring-trust---final.pdf)

Q4. Do you agree with our proposal to mirror the structure and wording of LR 9.8.6R(8) and LR 9.8.6BG to LR9.8.6EG for companies with a UK Premium listing? If not, what alternative approach would you consider to be appropriate, and why?

Yes.

With regards to the structure and wording of LR 9.8.6R(8), this gives companies the flexibility to report their TCFD disclosures in the manner that suits them best – wholly or partially, within the annual report or otherwise. Importantly, for all variations it makes adequate provision to ensure that investors can easily locate these disclosures.

We watch with interest whether companies will take advantage of being allowed partial disclosure to cherry-pick what is disclosed in the annual report (the 'good stuff') and what is reported on outside (the 'bad stuff').

As for LR 9.8.6BG to LR9.8.6EG, we do not believe any wording needs to be adjusted for issuers of standard listed equity shares.

Q5. 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

Yes, in principle, if they are broadly consistent with those published. It is vital that carbon-related disclosures are made consistently across all markets, and TCFD is the acknowledged global leader of these developments.

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

We assess that the TCFD's proposed updated standalone guidance[7] on metrics, targets and transition planning is a significant advance on the original TCFD recommendations of 2017. On this basis, some of the recommendations, principally those in the Metrics & Targets pillar, will likely need to be implemented on a comply-or-explain basis for many companies for now. (See our response to question 8.)

c) the TCFD's technical supplement on measuring portfolio alignment.

We have no comment.

Q6. Do you agree that we should update the Technical Note 801.1 to reflect the proposed new rule and associated guidance in this CP?

Yes. Technical Note 801.1 should be updated to reflect these new rules, but we do consider any update would likely be relatively minor, and in principle the content will remain the same.

[7] TCFD Public consultation on proposed guidance on climate-related metrics, targets & transition plans (June-July 2021): (https://www.fsb-tcfd.org/publications/)

Q7. 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. To avoid standards shopping, SASB metrics should only augment TCFD disclosures and not be a substitute for them.

Encouraging issuers to consider the SASB metrics has merit so long as it is not given too much prominence and it is clear that this 'encouragement to consider' is of a significantly lower order of regulatory expectation than the TCFD's recommendations to 'describe and discuss'. This is important as SASB's metrics differ from the TCFD metrics in a number of significant respects. Neglecting to ascribe primacy to the TCFD metrics could be confusing and lead to non-standardised and non-comparable disclosures. Noting that SASB metrics appear limited to scope 1 emissions, we feel it is important to qualify this 'encouragement to consider' by emphasising that the TCFD's guidance asks for companies to disclose scope 2 and, if possible, scope 3 emissions.

Note that it has not been possible for us to review all of the SASB metrics. Our impression, however, is that many of the SASB metrics are significantly more detailed, specific and comprehensive than the TCFD recommendations and even the new proposed guidance on metrics and targets. 'Encouraging their consideration' allows companies the opportunity to identify and include detailed metrics which they find relevant and practical to implement.

For instance, SASB metrics include the measurement of risks associated with oil and gas reserves and resources. We believe users of accounts would find this to be important information which is not captured in the TCFD metrics, even for scope 3 emissions. We worry, however, that, oil and gas companies are probably unlikely to adopt these voluntarily.

Q8. 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.

As referenced in our response to question 1, CFA UK believe that some of the recommendations in the TCFD guidance are relatively basic and straightforward for companies to meet, and we are inclined to make mandatory some of the disclosures identified in LR 9.8.6E for the largest companies.

In both our response to CP20/3[8] (question 4) and our response to BEIS (question 6)[9], we opined that not all of the eleven recommendations should be implemented on a comply-or-explain basis, and we identified five that should be mandatory. Specifically, these were Governance a), Strategy a), Risk Management a) and b), and Metrics & Targets a).

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[8] CFA UK Response Letter to the FCA's CP20/3 (Oct. 2020): 'Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations'' (https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-final-letter-to-fca.pdf)

[9] CFA UK Response Letter to BEIS (May 2021): 'Requiring mandatory climate-related financial disclosures by publicly-quoted companies, large private companies and Limited Liability Partnerships ('LLPs')': (https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/beis-mandatory-tcfd.pdf)

However, as discussed in question 5 above, we have been asked to respond to this consultation on the basis of proposed new guidance for the TCFD's recommendations, and we note that the requirements have advanced significantly in the Metrics & targets section.

CFA UK maintains that companies should report on some of the recommendations – those which are largely descriptive – on a mandatory basis. On the basis of the TCFD's proposed changes, however, our view of precisely which of the eleven recommendations should be mandatory has also changed. This gave rise to significant discussion by our working group.

In conclusion, the majority of members in the working group supported that the Strategy b) and Governance b) recommendations should be mandatory and that Metrics a) should be disclosed on a comply-or-explain basis, at least for the standard listed companies that are the focus of this consultation.

Notwithstanding the discussion as to precisely which of the recommendations become mandatory, CFA UK believe all premium and standard listed companies should be able, as a minimum, to articulate the impact of climate change on their business and markets and how they are beginning to govern, form strategy and manage these risks.

We note the FCA's argument in paragraph 3.52 to delay making some of these disclosures mandatory until such time as a new accounting standard is developed by the IFRS, but we find it hard to conceive how this standard, once developed, would contradict or invalidate any of the disclosures that companies would have been mandated to make in the six TCFD descriptive recommendations under the Governance, Strategy and Risk Management pillars identified above.

Q9. 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?

Yes.

We cite the burden on issuers in initiating these climate-related disclosures, the formation of these disclosures being in the early stages, the significant advance that the proposed new Metrics & Targets guidance represents, and the scale of the reorganisation now taking place in the audit sector. Besides, formal audit is not yet possible, as there are as yet no agreed standards against which to audit.

As a first step, auditors could be required to review a company's approach and internal controls (including the calculations supporting any metrics) and assure their robustness.

The FCA could express an expectation or provide a provisional timeline for the development of more structured verification will be required in the future in order to incentivise service firms to prepare. Climate-related disclosure can only become assurable once there is a reporting framework and companies will need to build the systems to be able to report it first. These systems come with a cost and the benefits of having assurance may only be seen by investors once the information is there and known to be reliable.

CFA UK is of the view that in time these disclosures will need independent third-party assurance and verification, though perhaps not by audit firms but by carbon data specialist firms.

Q10. Do you agree that our new rule should take effect for accounting periods beginning on or after 1 January 2022? If you consider that we should set a different timeframe, please explain why.

A majority of this working group support the above proposed timeframe, with dissenting views falling either side both for greater urgency and for more time. Both public interest and the urgency of transitioning to a low-carbon economy are consistent with the implementation of the new rule as soon as is practicable.

The working group examined questions of proportionality, acknowledging that the standard list includes small companies and companies with relatively low emissions. In what ways could such companies be carved out from the 1 January 2022 deadline and given more time to prepare? It is very difficult to identify an appropriate threshold for size or climate-related exposure below which companies might be given more time.

On the basis that only the descriptive recommendations (see our response to question 8) are made mandatory and that the more advanced recommendations are introduced on a comply-or-explain basis, we are comfortable with 1 January 2022.

An important final point on behalf of membership, who are predominantly investors, is that as more companies are allowed exemptions from, or fall outside the scope of, the FCA's climate change reporting disclosure measures, the less it becomes possible and reasonable to expect asset management firms to be able to aggregate those corporate measures within their own firm and fund disclosures.

Q11. Do you agree with the conclusions and analysis set out in our cost benefit analysis (Annex 2)?

We agree with the central conclusion that while the benefits are difficult to quantify, we would expect them to exceed the costs.

Regarding the specific cost estimates, it may be that differing expectations on large and mid-size firms, as indicated by TCFD guidance, would result in greater differences in expenditure than the analysis estimates.

A member of our team with experience evaluating the ESG policies of large listed companies questioned the assumption that scenario analysis would be conducted internally, arguing that proper execution would require experienced third parties. The costs here could be significant.

We note that the size of team budgeted in Annex 2 seems to sit at the lower end of the TCFD Guidance on Scenario Analysis for Non-Financial Companies section B4 (p. 11), but perhaps this reflects the FCA's expectations for the differing requirements of standard-listed rather than premium-listed entities.

In contrast, another member of our group with experience at a standard listed entity with a market cap around £30 million believed that a small company would be unlikely to dedicate as large a proportion of staff time as estimated by the FCA in Annex 2. This also seems consistent with the TCFD Guidance on Scenario Analysis for Non-Financial Companies being targeted at large and mid-sized companies, with the lighter expectation that small companies may find information in it useful to 'help them with scenario analysis appropriate to their needs'.

Over time the costs may be partly driven by the extent to which the FCA choose to and are able to enforce their expectations. CFA UK forms the view that there might be greater gap between the costs for larger and smaller entities than suggested by the CBA, with a somewhat higher overall cost.

Appendix IIB

Responses to questions on discussion topics on ESG integration in UK capital markets

Q12. 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 Up bond frameworks and their sustainability characteristics?

CFA UK believe UoP bond terms should be made binding by their inclusion in the prospectus.

Issuers should be obliged to formulate them in a manner that recognises both any material uncertainties and how contingencies may be dealt with. If the UoP bond proceeds cannot be used for the intended purpose (e.g. the project falls through), we believe that there is a strong case that lenders/noteholders should have the option to put the bonds back to the issuer at par.

Alternatively, the bond prospectus could include an “alternative” use of the proceeds as long as that use aligns with the objective of the initial UoP.

Q13. Should the FCA explore supporting the UoP bond market by recognising existing standards (e.g. ICMA Principles), potentially through our recognition of industry codes criteria and process?

Yes.

CFA UK believe it would be beneficial, as market participants would prefer having fewer but widely accepted robust standards. The ICMA principles are well-written, and their recommendations can support the navigation of potential conflicts of interest and bondholders’ concerns with UoP issuance.

We note, however, that the ICMA principles stop short of rendering most of their recommendations as requirements. As such, we believe that recognition of the ICMA principles by the FCA under their code recognition process would support these standards being upheld.

The bond principles also stop short of recommending the inclusion of a put-at-par provision in the event that UoP bond proceeds are not used for their specified purpose (or an alternative equivalent). This should be a requisite feature of UoP bonds. CFA UK believes it undermines trust in this new market when an issuer raises proceeds for a declared purpose and then use them for a different purpose.

Q14. 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.

As stated in our responses to both question 12 and 13 above, CFA UK supports an approach requiring UoP terms of issuance to be binding. Issuers should be obliged to formulate issuance terms in a manner that recognises both any material uncertainties and how contingencies may be dealt with.

We encourage the FCA to consider whether scope 3 emissions disclosures could be made mandatory in relation to UoP issuance by companies involved in the energy sector or other high-intensity sectors such as real estate and infrastructure.

Where green or sustainability bonds include embedded call options, we have also considered the risk that credibility in this sector as a whole might be undermined if there are too many instances of issuers exercising these options before the disincentives for failure to meet

sustainability standards take effect, such as before first sustainability test is carried out, or where coupon rachets only affect coupons very late in the life of the bond. Some of our members believed that call premia and reputational risk to individual issuers should provide sufficient disincentives without the need for regulatory intervention, but others believed that recent experiences indicated that standard setting was appropriate for products premised upon achieving a public good. We draw attention to this as a topic for future consideration.

Q15. We would welcome views on the potential harm set out above and what, if any, actions the FCA or the Treasury should consider.

In our response to BEIS on Audit and corporate governance reform[10] and specifically question 37 relating to the scope of ARGA's new powers as a regulator, CFA UK agreed that ARGA should be given regulatory oversight responsibilities – not just for financial audit firms but also for all third-party firms that provide assurance for a company's business, such as climate change and data security checks.

Paragraphs 4.16 to 4.26 of this consultation clearly set out the importance of the role that Second Party Opinion ('SPO') providers have in assuring that Sustainability Linked Bonds ('SLBs') meet the sustainability criteria that they were issued under. While ARGA is new and has many initiatives to undertake, CFA UK believes that in the fullness of time SPOs should fall under its regulatory oversight. The Treasury and the FCA can facilitate this process by consulting on whether ARGA should be expressly vested with these responsibilities and powers.

We can hope this will ensure that SPO services are fit for purpose and that the SLB market enjoys sufficient integrity to become mainstream.

Q16. Should the FCA, alongside the Treasury, consider the development and creation of a UK bond standard, starting with green bonds?

While we could see some benefits and improved market efficiency, CFA UK believe it may be better to have fewer standards and more standardisation across global markets to reduce standards shopping between different standard setters (ICMA, EU GBS, the Climate Bond Initiative, etc.). We refer to our response to question 13 regarding the ICMA principles and to question 3 d) regarding the proposals for introducing climate reporting for debt issuers. We encourage the FCA and the Treasury to use their influence to ensure that existing green bond standards are fit for purpose and that they keep pace with new developments.

Q17. 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?

Yes.

CFA UK agrees with the characterisation of the challenges, especially the multi-dimensional nature and the issue of data gaps identified in paragraph 4.44.

We identify additional challenges and areas of potential harm below.

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[10] CFA UK Response to BEIS on 'Restoring Trust in Audit and corporate governance'' (June 2021): (https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-beis---restoring-trust---final.pdf)

Key challenges:

1. This is still a very new field, and the needs of the market are still developing. Any regulation needs to avoid stifling innovation.
2. It is not only the multi-dimensional nature of ESG performance that is an issue but also the fact that it combines both discrete measures (i.e. in or out) and linear/graduated measures.
3. Conflicts of interest appear diminished by the 'firm pays' model (as opposed to 'issuer pays'), but this does not necessarily prevent rating-hunting (as seen in corporate default ratings), and this creates a governance challenge.

Potential harms:

1. Investment firms may rely on ratings without fully understanding them. The widespread application of technology can quickly reduce this area to a numbers game void of any understanding or interrogation of the qualitative factors and interpretations behind a given rating.
2. ESG can create a barrier to entry for large firms against smaller ones. It can create a 'busy fools' outcome, which is inefficient – more so for smaller firms as the overhead is a greater percent of total costs.
3. ESG scandals can harm the reputation of all involved, including the UK as a listing venue.
4. The costs of meeting rating agency data requests can be onerous, especially to smaller issuers, and issuers face the risks of revealing competitive information. Rating agencies possibly have a bit of a 'no regret' attitude to data requests and probably need to do more work themselves.

Q18. 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?

Yes, in line with the first of the potential harms we listed in question 17, it is important that firms are guided to use ESG ratings appropriately.

Given the need for innovation, guidance need not be too prescriptive, but investors in particular need to be aware of the limitations of ratings. Benefits may arise from rating agencies being clear and open about their methodologies, and guidance to firms should stress the need to seek out and understand the methodologies.

Finally, firms should be guided to understand that they can outsource ESG rating tasks but not the responsibility. As outlined in our response to question 16, we agree that the FCA and the Treasury should give consideration to and consult on bringing SPOs inside the regulatory perimeter at a later point in time.

Q19. 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 think there is a case for this. The FCA could apply its Code Recognition process.

Transparency could be improved in these areas:

- better disclosure about how data gaps are filled in
- disclosing the frequency of interactions the ESG rating agencies have with the corporates
- disclosure of any data or conclusion that is contested by the company in question
- informing users how frequently ESG scores are updated, and
- insight into the process by which companies can contest any data or conclusion.

As for the regulatory perimeter, we refer you to our responses to questions 16 and 18.

The FCA may consider waiting for further market consolidation (which we will undoubtedly see) and innovation before considering which activities are brought inside the perimeter. An apt time may well be when climate stress tests become mandatory and the reliance on third-party tests increases. Furthermore, waiting for sustainability accounting standards may be sensible. And if ARGA is going to be involved, they may need some space to attend to a number of reform proposals coming out of the reorganisation of the corporate auditor profession.

One possible guide to best practice is the Australian Joint Ore Reserves Committee Code (JORC Code) used in the mining industry. This is an industry response but works well in its own context.

Q20: 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?***

We agree that these are the sensible aspects to prioritise. The key here is transparency, particularly as it regards to the infilling of data and the use of assumptions where the original data has not been provided by the issuer in question. Insight into the calculation methodology can be crucial.

There is a case to be made for stock market coverage as there are significant data gaps related to companies with smaller market caps, which disadvantages investors in a more dynamic part of the market. Better efforts by the rating agencies to provide home market relevant context taking into account the cultural differences between markets, for instance in global governance expectations.

> ***b) Whether and how regulatory priorities should differ between ESG rating providers and other ESG data providers?***

We believe the focus should be on ratings providers over data providers. ESG ratings providers likely have a much greater impact on capital flows to both funds and issuers, and openness and transparency around how ratings are determined requires scrutiny.

> ***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?***

We do not believe the ESG rating providers and CRAs should necessarily be categorised together. Taking the issues raised in turn:

> **Unreliable ratings.** We agree with the lack of transparency in rating methodologies and how ESG rating providers deal with incomplete and unreliable data inputs. We should avoid making too close a comparison as the key difference here is the degree of subjectivity within a rating. By design ESG ratings will contain a higher level of

subjectivity (about, for instance, which attributes are seen as positive and as negative) than a credit rating score. What should be encouraged is making it easier for issuers to engage in the process and update information, and greater transparency around the calculation methodology for ratings.

Bias in ratings. We agree with the conclusions in Table 1. However, we do not judge that conflicts of interest for ESG ratings providers are as potentially damaging as with CRAs. One thing the FCA could consider, in tandem with CP21/17, is the required minimum and consistent level of disclosure from portfolios of ESG metrics, alongside some contextual comments. Disclosure requirements around the use of third-party scores should be introduced, in the same way the FCA requires them around historic performance figures. We recognise this is a balancing act, however, and there is potential harm from over-regulating at a time of significant innovation.

Cliff-edge effects, over-reliance and adverse incentives. As the industry likely continues to consolidate around a few large providers, greater transparency should be encouraged from the ESG ratings agencies in order to facilitate comparisons with their ratings. Given the increased level of subjectivity in an ESG rating vis-à-vis those of a CRA, it is not surprising that there is greater divergence in ratings in the ESG ratings provider group.

Q21. What other ESG topics do you consider that we should be prioritising to support our strategic objective? Please explain.

CFA UK believes, with reference to the FCA letter 'Authorised ESG & Sustainable Investment Funds: improving quality and clarity', that the priority for the FCA is to:

- promote effective competition in the interests of consumers by improving transparency and understanding of disclosures in relation to ESG, and
- ensure an appropriate degree of protection for consumers by focusing on the methodologies around the labelling of funds as 'green' or 'sustainable'; either implicitly or explicitly
- provide the investment industry with forward guidance around the proposed regulatory glide path for any SFDR-like regulation.

CFA UK highlights the gap in the market understanding in relation to metrics such as Weighted Average Carbon Intensity ('WACI') of a portfolio, in particular how WACI should be reported for long–short portfolios. We note the suggested metrics in CP21/17 include portfolio WACI. The whole area of climate reporting in relation to derivatives requires urgent attention.

Where company financial statements include a note providing segmental analysis by sector (such as under IFRS 8), it is important that these segments clearly allow users to differentiate those that may be affected (either positively or negatively) by transition risk. Categories such as transportation, automotives, mining and energy are opaque.

In relation to derivatives, CFA UK's Pension Expert panel held exploratory discussions following the release of the DWP's final guidance in June and is considering to write a position paper on the subject. CFA UK would be pleased to engage with the FCA (and the DWP) further on this topic.

CFA UK draws attention to the response to question 20 b), highlighting the impact ESG rating providers are likely to have on both capital flows to funds and issuers. The use of 3rd party ESG data by index creators could have a material impact on capital flows. In relation to the FCA's operational objective of promoting and enhancing the integrity of the UK financial system, we believe this is an area the FCA should pay close attention to.

Appendix III
Recent CFA UK response letters on TCFD and ESG reporting by Firms and Corporates

Response to BEIS on audit and corporate governance reform [June 2021]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-beis---restoring-trust---final.pdf

Response to BEIS on requiring mandatory TCFD Disclosures by public companies, private companies and limited liability partnerships
[May 2021]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/beis-mandatory-tcfd.pdf

Second Response to the DWP on Taking Action on Climate Change
[March 2021]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/follow-up-letter-to-department-for-work-and-pensions.pdf

Response to the FCA Position Statement (PS20/17) on proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations
[February 2021]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-follow-up-letter-to-fca---february-2021.pdf

Response to the FRC's Discussion Paper on the Future of Financial Reporting
[February 2021]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/future-of-corporate-reporting.pdf

Response to the DWP on Taking Action on Climate Change: improving governance and reporting by occupational pension schemes
[October 2020]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/dwp-cc-full-letter-october-2020.pdf

Response to CFA Institute's Consultation Paper on the development of CFA Institute's ESG Disclosure Standards for investment products
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-form-consultation-paper-on-esg-disclosure-standards.pdf

Response to the FCA (CP20/3) on proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations
[October 2020]
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-final-letter-to-fca.pdf

Response to the BSI (PAS7341) 'Responsible and Sustainable Investment'
(February 2020)
https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-letter-to-bsi-on-pas-7341-28-february-2020.pdf