Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York

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Via electronic mail: cp21-17@fca.org.uk

Louisa Chender
Financial Conduct Authority
12 Endeavour Square
London E20 1JN

Managed Funds Association Response to CP21/17

Dear Ms Chender,

Managed Funds Association ("MFA")[1] welcomes the opportunity to respond to the Financial Conduct Authority's ("FCA") Consultation Paper 21/17, "Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers"[2] (the "Consultation"). We have set out below detailed responses to a number of the questions posed in the Consultation.

I. INTRODUCTION

MFA members use a wide spectrum of investment strategies to serve a diverse and representative class of institutional investors. Globally, institutional investors – such as pensions, nonprofits, foundations and endowments, and colleges and universities – invest more than $1.7 trillion in hedge fund and alternative investment firms to help support retirement security, higher education, and the important work done by foundations and charities across communities.

Alternative investment managers consider a broad array of risk factors when making investment decisions, including climate risk. Many of our member firms manage assets on behalf of investors who are increasingly attentive to climate risk and to environmental, social, and governance ("ESG") risks more broadly. Consequently, MFA members are acutely aware of the need for accurate, consistent, decision-useful climate-related disclosures that will facilitate their ability to make informed and financially responsible investment decisions on behalf of the investors they serve.

MFA therefore supports the efforts of the FCA to facilitate accurate, reliable, and comparable investor disclosures on the topic of climate risk, while maintaining a proportionate approach that acknowledges the diversity of investment strategies, investors and clients to which the proposed disclosure framework will apply. Our main points discussed throughout the letter are:

Importance of Disclosure Regime Consistency Among the U.S. and U.K markets

MFA notes that the United States is the largest jurisdiction for the management of alternative assets and the United Kingdom is the second largest. Accordingly, alternative asset managers anticipate that the

[1] MFA represents the global alternative investment industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 140 member firms collectively manage nearly $1.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, London, Brussels, and Asia.

[2] See https://www.fca.org.uk/publication/consultation/cp21-17.pdf.

U.S Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) will develop, in close consultation with the FCA, the standards and norms that will eventually govern ESG disclosures for alternative managers. As such, we strongly encourage the FCA to work closely with U.S. regulators so that the UK's disclosure regime and the rules that the SEC and CFTC are expected to develop are interoperable.

Diversity of Investment Strategies

MFA urges the FCA to consider the broad array of investment strategies utilized by asset managers and to avoid imposing a "one-size-fits-all" disclosure regime that may not be workable for strategies that invest in assets outside of listed equities. The FCA should also consider the differences between certain types of investment positions. For instance, when setting reporting requirements for climate risk exposure the difference between short and long positions must be taken into account. MFA also requests that the FCA consider the organisational structure of asset managers in sub-advisory relationships in formulating climate-related disclosures, bearing in mind that the parent entity – if it is in the United States – will be subject to the SEC and/or CFTC rule set.

Needs of Professional vs Retail Investors

MFA believes the FCA should not implement a one-size-fits-all approach to disclosure across retail and professional investment products as investment managers should have the flexibility to provide more or less granular data depending on the nature of their target investor base. Professional investors may wish to receive more detailed and granular data on underlying investment portfolios as they often have unique targets related to climate risk or exposure, whereas retail investors may wish to receive more standardised disclosures that are simple and easy to digest.

Sequencing of Disclosure Requirements

We urge the FCA to underpin its proposed disclosure framework for asset managers with an effective and comprehensive issuer disclosure framework, which should take precedence over asset management-focused disclosure in terms of timing. Therefore, we suggest that the FCA adjust implementation of reporting standards for asset managers to allow sufficient time for the UK's new corporate disclosure regime to take effect as well as the U.S. corporate disclosure regime to be developed.

FCA Should Focus on UK-Based Managers

We support the FCA's decision not to extend the proposed disclosure regime to third country managers marketing funds through the UK national private placement regime. This will avoid the issue of managers being required to comply with UK standards that overlap or conflict with their domestic regulator's climate disclosure standards as there is an ever-increasing number of jurisdictions implementing their own sustainability disclosure frameworks.

II. COMMENTS

Q1: Do you agree with our proposed scope of firms, including the £5 billion threshold for asset managers and asset owners? If not, please explain any practical concerns you may have and what scope and threshold would you prefer.

<u>Calculation of £5 billion threshold</u>

We agree with the FCA's proposed threshold of £5 billion assets under management ("AUM"). This threshold will help to ensure that the new regime is applied in a proportionate manner and will capture climate data relating to a large portion of the assets being managed in the UK. In addition, the application of the threshold will not prevent managers from complying with the new disclosure regime on a voluntary basis, or as a result of data demands from asset owners that are themselves within scope of the new framework.

We would, however, welcome further clarity from the FCA on the intended scope of the £5 billion AUM calculation, particularly as it applies to portfolio management firms. In our view, the calculation should make a clear distinction between assets that a firm may invest on a discretionary basis and assets in respect of which it solely provides advisory services.

We note in this regard that, for the first phase of implementation, the FCA has suggested importing the AUM calculation that applies under the existing SMCR regime (based on FSA038 (Volumes and Type of Business)). Although this guidance has not explicitly been extended to Phase 2 managers, it seems reasonable to assume that the same method of calculating AUM is intended to apply in Phase 2. FSA038 makes the following points in particular:

- AUM should include the value of those parts of the managed portfolios in respect of which responsibility for discretionary management has been formally delegated to the firm (including delegations from non-UK firms); and
- Firms should include any AUM relating to all investment management clients whether managed under a discretionary *or* an advisory arrangement.

Although the guidance does not make clear exactly which type of agreements are intended to be included under the advisory category, the FCA should make clear that, where a firm provides the regulated service of investment advice alongside the regulated service of portfolio management, assets in respect of which the firm solely provides investment advice will not count towards the threshold. Requiring firms to include these assets in their calculation would unnecessarily increase the total AUM calculation. This is particularly the case from the perspective of UK sub-managers that provide separate portfolio management services and advisory services to a single client, that is, the parent entity in the US or another third country. Advisory relationships between investment managers and their UK sub-managers are not generally defined in a restrictive manner. As a result, extending the sub-manager's AUM calculation to the entire portfolio of assets it may potentially advise on, regardless of whether it has a role in managing those assets, would, at worst, have the unintended result of bringing the third country investment manager's AUM into the calculation. We therefore recommend that the FCA focuses the AUM calculation purely on assets in respect of which the UK firm is able to exercise discretionary investment decisions.

<u>Extension in scope regarding "private market activities"</u>

We note that the draft definition of portfolio management, which sets the scope of the new requirements, covers not only the FCA regulated activity of managing investments but also "private equity or other private market activities consisting of either advising on investments or managing investments on an ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities". It appears clear from the text of the Consultation that the policy underlying this language is to draw firms that are active in the private equity sector within scope of the rules. However, the reference to investment in unlisted securities could be interpreted to capture other activities outside of this category. We therefore recommend that the FCA makes the intended scope of this extension as clear as possible in the final draft text, which could be achieved by revising the definition to refer solely to "private equity activities consisting of managing investments on an ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities". This would clarify the intended scope of the provision and ensure that the text could not be read to extend to, for example, private market advice on unlisted securities occurring outside of the private equity sector.

Application of requirements to UK sub-managers

We support the FCA's decision to allow clients of portfolio management firms to request product-level TCFD data at their discretion, rather than mandating the production of data in circumstances where the client has not requested it.

We also note that in the context of a UK sub-manager providing portfolio management services to its "client" (a US or other third country investment manager), the client is unlikely to request a detailed, portfolio-level disclosure, given that the client would generally have the same level of access to data on, for example, the carbon footprint of the portfolio as its sub-manager.

In these circumstances, where portfolio level disclosures are unlikely to be requested or produced, it would appear disproportionate to apply entity-level reporting requirements to the sub-manager. Such data will be of limited value where the sub-manager's sole client is a third country investment manager. We therefore recommend that the FCA considers an exemption from the proposed entity-level disclosure requirements for UK sub-managers that provide portfolio management services exclusively to a single client – the US or other third country parent investment manager.

Application to third country managers

We support the FCA's decision not to extend the proposed disclosure regime to third country managers marketing funds through the UK national private placement regime. This will avoid the issue of managers being required to comply with UK standards that overlap or conflict with their domestic regulator's climate disclosure standards (bearing in mind that an ever-increasing number of jurisdictions are implementing their own sustainability disclosure frameworks).

Q2: Do you agree with our proposed scope of products? If not, what types of products should, or should not, be in scope and why?

If the FCA does go forward with applying the new requirements in a product-neutral manner across authorised funds, alternative investment funds and portfolio management services, we would recommend consideration of the following points:

a) the FCA should not implement a one-size-fits-all approach to disclosure across retail and professional investment products. Investment managers should have the flexibility to provide more or less granular data depending on the nature of their target investor base (e.g. given that professional investors may wish to receive more detailed and granular data on underlying investment portfolios);

b) the FCA should bear in mind the wealth of investment strategies that will be caught within the proposed universe of products, and allow for managers to apply the disclosure standards in a flexible way that takes account of their individual investment strategies. Any guidance should preferably acknowledge that while data gaps on carbon emissions and other relevant metrics exist throughout the industry, these gaps may be more or less extensive depending on a manager's investment strategy (e.g. obtaining high quality data on climate risk is likely to be a particular challenge where managers do not primarily invest in listed equities).

Q3: Do you agree with our phased implementation and timings? If not, what approach and timings would you suggest and why?

In our view, the proposed phase-in dates for asset managers within scope of the new requirements do not allow sufficient time for the publication and review of issuer data and we urge the FCA to delay implementation of the proposed reporting standards by at least twelve months, in order to give the UK's new corporate disclosure regime sufficient time to take effect.[3] We consider that an effective issuer disclosure framework should operate as the foundation upon which all other applications of climate related disclosures are built, including those that apply directly to asset managers. Such a foundation and framework will inform and facilitate capital investment and disclosures to end-investors, and will encourage the dissemination of high quality data throughout the value chain. For this reason, climate disclosure regulation aimed at corporate issuers must take precedence in terms of timing, prior to the phase-in of asset manager-focused measures. Disclosure cycles should also be phased such that investment managers have sufficient time to collate and consider relevant issuer disclosures prior to being required to publish their own climate risk disclosures.

There are a number of issues with the proposed timeline for implementation:

a) Phase 1 asset managers would be required to work on the basis of very limited UK corporate disclosure when preparing their initial TCFD report since mandatory climate-related disclosures are not required to be made by corporate issuers until June 2023;[4] and

b) Although Phase 2 asset managers may have more climate-related disclosures from issuers when they first become subject to the FCA's proposed requirements, they may still have difficulty in preparing their initial TCFD report due to the following:

   a. phase 2 managers will not have the benefit of corporate issuer reports throughout the entire initial reporting period since the first set of issuer reports will be published at various intervals during 2023 due to varying corporate accounting periods;

   b. the first set of reports published by corporate issuers is likely to be of variable quality because many issuers will be considering and reporting against the relevant standards for the first time;

   c. corporate issuers have the choice to comply with the proposed corporate disclosure requirements or explain why the disclosures are not in their reports. Therefore, there

[3] We believe such a delay is necessary due to the intended phase-in dates for TCFD disclosure requirements, which would operate as follows:

a) for asset managers in the first phase of implementation, the proposed requirements would become effective from 1 January 2022. Phase 2 managers would then come within scope from 1 January 2023. The same phase-in timeline would apply to asset owners, albeit with different thresholds for inclusion in Phase 1 and Phase 2; and

b) TCFD reporting requirements will apply for accounting periods beginning on or after 1 January 2021 for premium listed companies. However, we understand that the FCA is only seeking to broaden the scope of these requirements to cover standard listed issuers for accounting periods beginning on or after 1 January 2022. *See* https://www.fca.org.uk/publications/consultation-papers/cp21-18-enhancing-climate-related-disclosures-standard-listed-companies. This would mean that the first annual financial reports issued in compliance with the new TCFD requirements would be published in 2023 for the majority of UK listed companies.

[4] We also note that other asset managers falling outside scope of Phase 1 will encounter the same issue relating to lack of issuer disclosures where they provide services to Phase 1 asset allocators, which are likely to require their external managers to provide them with TCFD compliant data.

will likely be a higher number of corporates choosing to explain rather than comply during the first reporting period than in later reporting periods, as they digest TCFD requirements and enhance their internal data gathering and reporting procedures; and

d. although the FCA is considering whether to extend the disclosure requirements to issuers of standard listed debt securities, the current proposal has been limited to listed equity shares. This potential limitation, combined with the ability for corporates to explain rather than comply, means that the new issuer disclosure requirements will not cover a complete universe of listed issuers during the initial reporting period.

We therefore urge the FCA to delay implementation of the proposed reporting standards by at least twelve months, in order to give the UK's new corporate disclosure regime sufficient time to take effect and to closely coordinate with the U.S. regulators to allow for interoperability of asset managers across the UK and U.S. regimes. This includes the proposed standards on scope 3 emissions data reporting. The FCA should also retain flexibility to provide for further delays in implementation of certain aspects of the rules after it has had the opportunity to assess the quality and availability of the corporate data being disclosed.

Q4: Would there be significant challenges in using proxy data or assumptions to address data gaps? If so, please describe the key challenges and implications as well as any preferred alternative approach.

As a general matter, proxy data and assumptions can form useful inputs for firms seeking to quantify their exposure to climate risk. However, the extent to which proxy data is representative of an investment or subset of investments will vary, and reporting on its output may not always form meaningful data for investors. If firms are required to disclose that they used proxy data or assumptions as a result of data gaps, it should therefore be open to them to disclose to investors the circumstances in which they rely on proxy data. We therefore agree with the FCA's approach that where firms do use proxy data, contextual information and any perceived limitations of that data should be disclosed alongside it. However, we would suggest revising paragraph 2.1.10 of the ESG Sourcebook to make clear that where data gaps exist, there is no requirement to address those gaps by replacing them with proxy data or assumptions in circumstances where this would lead to a misleading or unreliable result. The FCA should also bear in mind that as the need for proxy data, assumptions and scenario analysis increases, so too will the need for asset managers to rely on the services of third-party data and software providers. This has a potentially significant cost attached to it, particularly given that not all service providers cover the same market sectors (so firms may need to rely on a number of external providers). The extent to which such third-party data providers are subject to their own professional standards and governance may therefore be worthy of consideration by the FCA, given the increasing importance of their output to the market.

Q5: Do you agree with our proposals for the provision of a TCFD entity report, including the flexibility to cross-refer to other reports? If not, what alternative approach would you prefer and why?

MFA supports the FCA's decision to allow firms the flexibility to cross-refer to disclosures made as part of a group report, or by another member of the firm's group. This is particularly helpful for asset managers that pursue a global investment strategy through a number of local sub-management firms. However, we recommend refining the scope of the entity reporting requirements in two key respects:

a) As noted above, we do not believe that entity-level reporting requirements should apply to UK sub-managers that provide portfolio management services exclusively to a single client – the non-UK parent investment manager. Such data will be of limited value in circumstances where the sub-manager's sole client is a third country investment manager.

b) We also do not believe it is necessary for the rules to provide specifically for an asset owner to cross-reference TCFD disclosures published by the asset owner's external asset managers. This disclosure approach could substantially and disproportionately increase the external manager's potential liability in connection with its disclosures (i.e. given that the asset owner's own stakeholders - a potentially very wide class of investors that the external manager has no oversight of - may themselves make investment decisions on the basis of the cross-referenced disclosures). A more proportionate approach would be to require the asset owner to effectively diligence its external managers' TCFD reports and simply summarise any relevant sections of those reports into its own disclosure, such that they form a cohesive part of the asset owner's disclosure report. Alternatively, the FCA could simply require the asset owner to focus on its manager selection procedures in its disclosure.

Q6: Do you agree with our proposed approach to governance, strategy and risk management, including scenario analysis? If not, what alternative approach would you prefer and why?

MFA urges any scenario analyses be voluntary in nature. Given the level of uncertainty regarding such data, the results of a scenario analysis exercise may simply not have much value to the investor community or may even serve to create confusion. MFA notes the following challenges firms may face in incorporating scenario analysis into their disclosures:

a) Generally, where firms are required to stress test their approach to quantifying and managing risk (e.g. in the case of capital requirements calculations), such tests will incorporate data deriving from historical periods of stress or volatility. There is no such historical data in respect of climate risk; as a result, methodologies for scenario analysis and other forms of climate-related stress testing are still being developed by the industry;

b) Scenario analysis may not be appropriate or meaningful for certain investment strategies, particularly those involving a high turnover of investments; and

c) The results of any such analysis may well vary significantly across different asset managers, given the lack of available data and accepted methodology[5]; thus, there may in practice be limited comparability between individual managers' scenario analysis.

This is not to say that scenario analysis should not have a place in managers' internal climate risk assessments; however, disclosure of the results of scenario analysis should be voluntary in nature (i.e. such that managers need only disclose the data where they are confident that it is reasonably accurate and helpful to investors).

Q10: Do you agree with our proposed requirements for product or portfolio-level disclosures, including the provision of data on underlying holdings and climate-related data to clients on demand? If not, what alternative approach would you prefer and why?

The FCA should allow scope for asset managers to disclose the impact of short selling strategies on climate risk management in a pragmatic and flexible manner.

[5] See, for example, the Bank of England's publication "Key elements of the 2021 Biennial Exploratory Scenario: Financial risks from climate change", which notes that "all climate scenarios are subject to significant uncertainty, both from estimating the precise extent of transition and physical risks resulting from the conditioning assumptions, and from estimating the impact of these risks on macroeconomic and financial variables".

Short selling strategies can, in particular, fulfil a number of valuable functions in relation to the management of carbon risk, not simply at a portfolio level, but also on a market-wide basis[6], as follows:

- short selling can mitigate carbon risk by acting as a hedge against long positions. We anticipate that the need for managers to manage both physical and transition risk attached to their portfolios will increase significantly in the near-term;

- at market level, short selling can be one way to express views on certain issuers or industries that are perceived as not doing enough to transition towards less carbon-intensive practices; and

- short selling can play a valuable price discovery role, *i.e.*, by exposing the improper pricing of carbon risks.

The FCA should not only, therefore, leave scope within its guidance for managers to adopt short selling strategies in managing climate risk, but should also ensure that managers have the ability to calculate and report on short selling in a pragmatic manner that provides their investors with a clear illustration of climate risk and impact attached to the portfolio. This may, for example, involve disclosing climate risk separately in the context of long and short portfolios or investment strategies where it makes sense to do so.

Q12: Do you agree that firms should calculate metrics marked with an asterisk according to both formulas set out in columns A and B of Appendix 3? If not, please explain why, including any challenges in reporting in accordance with either or both regimes.

In our view, the FCA should not require firms to disclose data according to both TCFD and SFDR methodologies, for the following reasons:

a) The U.S. regulators have not yet indicated what disclosure regime they might adopt, and we believe the UK should – as a matter of priority – adopt a system that operates seamlessly among UK and U.S. jurisdictions. This reflects that the majority of alternative investment assets are subject to U.S. rules and the second largest jurisdiction for alternative assets is the UK;

b) In addition, not all UK firms will be reporting under the SFDR as a matter of course;

c) presenting investors with two similar, but not identical, metrics risks confusion; and

d) the underlying data inputs are sufficiently similar across the two sets of metrics that data published by UK and EU managers will be comparable from the perspective of investors seeking climate risk data.

Q13: Do you agree that, subject to the final TCFD guidance being broadly consistent with that proposed in the current consultation, our proposed rules and guidance should refer to: a. The TCFD Final Report and TCFD Annex in their updated versions, once finalised b. The TCFD's proposed guidance on metrics, targets and transition plans and the proposed technical supplement on measuring portfolio alignment. If not, what other approach would you prefer and why?

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[6] The advantages of short selling have previously been recognised by the Principles for Responsible Investment in its Technical guide on ESG incorporation in hedge funds (May 2020).

As a threshold matter, MFA members would strongly prefer adherence to TCFD standards to remain voluntary on the part of the manager, rather than being mandated across the entire asset management sector. This is in part because we believe the UK rules for alternative asset managers should be integrated with U.S. rules, which are still being developed. However, if the FCA wishes to incorporate TCFD principles on a voluntary basis into the finalised text, the FCA should consolidate any relevant TCFD guidelines into the FCA Handbook rather than simply cross-referencing TCFD publications. MFA believes it is important that the power to apply, adjust and enforce compliance with climate disclosure guidelines remains within the full control of the FCA so that it can ensure flexibility to align with the U.S. and global markets. The FCA is considerably better placed and resourced to monitor the compliance of UK firms with any new climate disclosure and governance standards, and to adjust domestic reporting frameworks if that becomes necessary over time (e.g. as a result of changes in the global rule set.

Consolidating any relevant TCFD guidelines into the Handbook would have the advantage of:

(i) helping to ensure that the Handbook functions as a comprehensive reference source for supervised firms;

(ii) ensuring that the FCA is able to adjust the reporting rules at short notice and where necessary as a result of market developments or modifications in the TCFD framework; and

(iii) facilitating the ability of the FCA to provide high-level supplemental guidance where necessary (e.g. in connection with asset classes such as derivatives and commodities, which are not dealt with in a comprehensive manner under the TCFD framework).

Q17: Do you agree with our proposed approach that would require certain firms to provide product or portfolio-level information to clients on request? If not, what approach and what types of clients would you prefer and why?

As a general principle, MFA does not believe that public disclosure on climate risk is in the client's best interests in a single managed account relationship.

We support the FCA's view that portfolio-level disclosures should solely be required to be made available to clients upon request. This will avoid managers being required to produce reports in circumstances where they are unnecessary from the client's perspective.

We note that the draft Handbook text on this point currently provides that:

> "If a firm receives a request for on-demand information from a client who is entitled to make such request under ESG 2.3.5R, it must prepare and provide the on-demand information to the client within a reasonable period of time and in a format that is reasonably acceptable to the client."

While this approach is generally helpful, we suggest that the FCA revise its language to ensure that managers are able to adopt a common format for disclosure across their managed accounts (i.e. in circumstances where the manager has multiple different clients to whom it provides portfolio management services). This will assist managers in responding to multiple competing requests for data in different formats, and providing information to clients in a responsive and timely manner.

III. CONCLUSION

MFA supports the FCA in its efforts to facilitate reliable and comparable disclosures on the topic of climate risk, including but not limited to corporate issuer disclosures. The FCA should also consider the need for clear and complete data and guidance on climate risk across a range of asset classes and closely integrated with the approach that U.S. regulators are developing. We look forward to contributing the views of our members as the FCA refines its approach in the important area of climate risk. Please do not hesitate to contact Michael Pedroni, Executive Vice President for Global Markets or Jennifer W. Han, Chief Counsel & Head of Regulatory Affairs.

Respectfully Submitted,

/s/

Bryan Corbett
CEO and President
MFA