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Dear FCA colleagues,

**Sustainability Disclosure Requirements and investment labels**

We welcome the opportunity to respond to your consultation on Sustainability Disclosure Requirements (SDR) and investment labels.

The Quoted Companies Alliance (QCA) has examined the proposals and provided a response from the viewpoint of small and mid-sized quoted companies.

As the proposals contained in this paper predominantly apply to FCA-regulated firms, including asset managers and asset owners, the majority of the content within the consultation falls outside of the QCA's direct remit. However, we have a strong interest in the public market ecosystem as a whole, including with regard to the firms that support and advise small and mid-cap companies, and there is potential that the proposed new requirements will have a knock-on effect on these companies too. We have, therefore, produced a shorter, more limited response instead of answering each of the questions posed.

We highlight several issues below that we believe the FCA needs to address before taking forward the proposals.

Our primary concerns are threefold, and relate to:

1. **How the proposals could, over time, result in unintended consequences for smaller companies. Specifically, we are concerned that the proposals could adversely impact small-caps by driving funds away from these companies.**

It is inherently difficult for smaller companies, and especially those who are not required to report against the TCFD-aligned disclosures and who have a minimal environmental impact, to prove they are indeed sustainable and thus be included in a sustainability fund. We provide further detail on this issue under the heading *Reporting challenges for smaller companies* below.

As a result of this, it is unclear how smaller companies, where reporting is less detailed, could be included in one of the sustainability product categories proposed by the FCA. In particular, we highlight the following as concerns that the FCA needs to take into consideration:

- The extent of reporting required for smaller-quoted companies to be included in one of the sustainability product categories;
- Whether smaller companies would need to comply with the requirements of the Green Taxonomy;
- The size of companies and the level of resources required to make reporting viable.

Reporting challenges for smaller companies

Environmental data and reporting is particularly challenging for smaller quoted companies, and especially those that fall outside of scope of regulatory requirements such as the TCFD-aligned disclosure requirements. On the whole, the number of companies in this sphere producing emissions data is small, and, where there is data, there can often be issues with its accuracy and reliability.

Early stage or high growth businesses often have misleading figures in terms of environmental data. This is because data on carbon emissions per unit of revenue often seems inflated due to low production/output levels, which makes the data difficult to normalise. For instance, smaller, high-growth companies may be investing in the expansion of their business, such as in building new factories, offices etc., and may not yet have extensive product and/or service lines that boost revenue, so their emissions data seems particularly high when compared with revenue. For larger companies, which typically have enough capital to spend on achieving carbon neutrality, this is not an issue. However, for smaller companies, where budgets are typically tighter, this has to be directed to core business operations, making it more challenging for smaller companies to establish their sustainability credentials.

This can also be the case for "green investments" too, and there are examples of companies that are committed to developing solutions to climate change challenges that score poorly on emissions data as their emissions per unit of revenue are high due to their smaller nature. There are examples of companies who are building the products and services to fight climate change that score negatively in ratings when their entire business model is focussed on having a positive social/environmental impact. It then becomes difficult for these companies to grow, innovate, and provide solutions when funds are directed away from them.

The potential threat for smaller companies is that if they have been unable to invest sufficiently in their own sustainability reporting they may not attract fund flows. An additional strain is the limited overlap between "green" funds and those that invest in small-caps. This is already a poorly served market and extra reporting requirements have the potential to make it worse.

**2. The proposed sustainable investment label descriptions and objectives, and the removal of the "Responsible" product category.**

The refining of the descriptions of each product category and their intended functions is troubling due to the removal of the "Responsible" product category initially included. We understand that the sustainable investment label descriptions have been refined so that they are more accessible to consumers. However, this is concerning as there are funds that offer some sustainable investments (and are therefore not appropriate for the "No sustainable label") but do not qualify for one of the three "Sustainable" investment label descriptions.

This situation has occurred in the European Union where, as a result of the Sustainable Finance Disclosure Regulation (SFDR) and MiFID II, investment advisers are now required to ask their clients if they have any

sustainability preferences. The majority state that they favour investing sustainably. The result of this is that most funds are directed to sustainable assets, meaning that assets without specific sustainability objectives are often unable to attract and retain investment. This could be particularly detrimental to smaller quoted companies who, as described above, often have distinct challenges in reporting their credentials.

We appreciate that the FCA's proposals intend for a smaller proportion of the market to attain one of the sustainability labels compared with the proportion of UCITs that are currently Article 8 or Article 9 under the SFDR. However, the addition of the "Responsible" product category would help to mitigate this risk in the UK and avoid the situation currently occurring in Europe.

We therefore urge the FCA to reconsider the inclusion of this product category, or, at a minimum, ensure that the thresholds for attaining a sustainability label are set at a sufficient level to ensure they only cover those funds that are going over and above others in terms of their sustainability practices.

3. **Crowding investment into sustainability funds could result in driving down the cost of capital for these type of investments but could potentially lead to poor investor outcomes.**

A potential issue that does not seem to have been considered by the FCA is regarding the potential for the (under)performance of sustainability-related assets in the future. Over the last decade, sustainability-related assets have performed relatively strongly; however, this performance is not guaranteed in the future. Certain developments, along with the proposals in this consultation, that intend to increase investment in sustainability-related assets run the risk of pouring money into certain stocks that simply cannot sustain future expected returns. Cheaper finance for green companies in the short-term has the potential to produce the unintended consequence of equating to lower potential returns for green investors in the longer-term.

However, we note that the performance of sustainability funds has dropped off over the last few years, with investors recognising the risks that such assets pose. Nevertheless, we urge the FCA to consider the future performance of sustainability-related assets when taking the proposals forward.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

James Ashton
Chief Executive