

Greenwashing – key risks and issues in financial services



Speed read

As appetite in the market for “green” and ESG badged products grows and grows, so too grows the number of legislative and regulatory initiatives intended to prevent or mitigate the risk of greenwashing.¹ This briefing gives a snapshot on what greenwashing means, what you can do about it, and some key developments.

What is greenwashing?

According to the EU Taxonomy Regulation,¹ greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met.

However, the term can be used in a more generic sense to suggest that a product or service has or is provided by a firm that has certain ESG credentials, when it does not – the term “ESG” encompassing environmental (E), social (S) and potentially also governance (G) elements, not just the environment.

¹ Please see Recital (11) of the Taxonomy Regulation: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852>

Why are we talking about it in financial services?

This is topical for three reasons:

- First, the EU is attempting to steer private capital into initiatives to help “green” the EU and achieve its targets for reducing carbon emissions to help stop global warming. To hit those targets, many sectors of the economy, such as manufacturing, agriculture and energy, require an extra annual investment of between €180-290 billion, and even more to achieve zero emissions by 2050.

The risk of greenwashing is a significant concern in this context, because governmental bodies and regulators are conscious that investors must have confidence in what products say as regards their green credentials, for this nascent sector to continue to grow and flourish. If scandals emerge, where it turns out that investors have been sold something on the basis of green credentials that turned out to be false, confidence may be impacted.

So that is essentially the first reason why we hear so much about greenwashing at present. It is important to investor confidence in green or ESG badged products/services (and/or the firms that provide them), and in turn, is necessary to achieve the fundamental objective of funding a green transition.

- Secondly, but closely related, there is a point about market trends. There is a clear and growing demand for financial services products and services with green or ESG credentials, with a growing perception that “green sells”. The UK FCA has also recently observed that “*ESG and sustainable investment funds are currently the fastest growing segment of the European funds market, reflecting increasing investor appetite for these investments.*”²

And as night follows day, we have regulators expressing concerns about three overarching and interlinked regulatory points:

- market integrity – regulators want safe markets where firms behave properly and responsibly, in line with good standards;
- investor protection – a product must do what it says on the tin;
- firms must ensure their communications are fair, clear and not misleading.

Beyond firms wishing to remain in good standing with regulators and avoid supervisory scrutiny or enforcement proceedings, there is also the need to consider reputational risk.

- Thirdly, there is a concern about litigation risk – e.g. the risk that a firm is sued by a client or investor that claims to have been mis-sold, or possibly litigation by an activist group wishing to obtain press headlines through litigation against a large financial services firm or group.



Greenwashing initiatives

EU

SFDR³

- This deals with greenwashing risk by (among other things) requiring relevant firms to make detailed disclosures in relation to relevant products and services that have environmental or social characteristics, or a sustainable investment objective. The intention is to make clear what the product or service is actually promising and what it actually delivers.
- This regulation applies in a horizontal way across in scope products and services, such as funds, managed portfolios and fund linked insurance policies. It does not apply more broadly – e.g. structured products, derivatives, bank accounts and loans are out of scope.
- SFDR is coming into force in a phased way and initial requirements became applicable on 10 March 2021.

Taxonomy Regulation⁴

- The Taxonomy Regulation is a classification framework for assessing activities in order to determine whether they are environmentally sustainable – i.e. it is intended to provide a common language for deciding what is “green” and what is not.
- Among other things, the regulation will require disclosure in relation to a product or service that (in general terms) is in scope of SFDR and has either environmental characteristics, or a sustainable investment objective relating to the environment. In particular, it will be necessary to disclose how aligned the product or service actually is, with what is considered “green” under the taxonomy.
- The Taxonomy Regulation is coming into force in a phased way beginning on 1 January 2022.

European green bond or EuGB regulation

- A proposal for a Regulation on European green bonds was published on 6 July 2021⁵, although the timing from this point is unclear.
- Its goals are to make it easier for investors to identify and trust high quality green bonds and reduce the risk of greenwashing, PLUS to stimulate the issue of green bonds and therefore help redirect private capital flows towards more environmentally sustainable investments (i.e. similar themes to SFDR).
- If adopted *“this proposed Regulation will set a gold standard for how companies and public authorities can use green bonds to raise funds on capital markets to finance such ambitious large-scale investments, while meeting tough sustainability requirements and protecting investors”*⁶.
- The Commission’s draft
 - Introduces a set of rules that issuers of green bonds must follow in order to call a bond a ‘European green bond’ or ‘EuGB’
 - Proposes the establishment of a voluntary label
 - Requires issuers to ensure the bond proceeds are allocated to assets/expenditure in full compliance with the Taxonomy Regulation, to ensure the bond can be considered environmentally sustainable under that regime (i.e. “green”)
 - Attempts to standardise the practice of external review and improve trust in external reviewers by introducing a voluntary registration and supervision regime – with extensive rules for registration and supervision.

3_Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector – see <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088>

4_Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 - see at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852>

5_ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0391>

6_ https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en

UK

(although may provide guidance helpful to firms in other jurisdictions as many of the regulatory expectations articulated are likely to be generally applicable)

With an increased appetite among the public for “green” products and services, regulatory bodies such as the UK Advertising Standards Agency (ASA) and Competition and Markets Authority (CMA) are alert to the increased risk of greenwashing.

In September 2021, the CMA published a Green Claims Code⁷ to provide practical guidance for businesses and help them ensure any environmental claims do not fall foul of regulatory expectations. The code follows draft guidance issued in May and a review of online green claims revealing that 40% of claims could possibly be misleading.

Critically, the code notes: *“Consumers are increasingly demanding products and services which minimise harm to, or have a positive effect on, the environment. As a result, there has been a proliferation of products, services and businesses which claim to meet that demand. ... Consumer protection law does not prevent businesses from making environmental claims about their products and services, provided they do not mislead consumers.”*

The Code provides six key principles, many of which are intuitive, giving examples of how each of them applies and case studies. The guidance also sets out the legal framework on which the principles are based.

In fact, the Code is tremendously helpful in setting out some “rules of the road” for firms in terms of what is likely to be acceptable vs not in a greenwashing context.

According to the principles:

- (1) claims must be truthful and accurate.** E.g. businesses must live up to the environmental claims they make about their products, services, brands and activities. In other words, don’t “overstate or exaggerate the sustainability or positive environmental impact of a product, service, process, brand or business.”;
- (2) claims must be clear and unambiguous.** The meaning consumers are likely to take from key documents and marketing materials should match what the relevant product or service actually delivers.;
- (3) claims must not omit or hide important relevant information.** E.g. *“Claims should not just focus on the positive environmental aspects of a product, service, process, brand or business, where other aspects have a negative impact and consumers could be misled. This is especially so if the benefits claimed only relate to a relatively minor aspect of a product or service or part of a brand’s or a business’s products and activities. Cherry-picking information like this is likely to make consumers think a product, service, process, brand or business as a whole is greener than it really is.”*;
- (4) comparisons must be fair and meaningful;**
- (5) claims must consider the full life cycle of the product or service;**
- (6) claims must be substantiated.** E.g. “Businesses should ... be able to back up their claims. They should hold robust, credible, relevant and up to date evidence that supports them. Where they compare their products or activities to one or more competitor’s, that evidence should cover all of them.”.

⁷ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1018820/Guidance_for_businesses_on_making_environmental_claims_.pdf



FCA guidance – funds⁸

On 19 July 2021, the FCA published a letter it had sent to various UK authorised fund managers setting out its expectations as to the design, delivery and disclosure of ESG and sustainable investment funds.

It also noted (emphasis added):

*“It is therefore essential that funds marketed with a sustainability and ESG focus describe their investment strategies clearly and **any assertions made about their goals are reasonable and substantiated**. We have seen numerous applications for authorisation of investment funds with an ESG or sustainability focus. A number of these have been **poorly drafted and have fallen below our expectations. They often contain claims that do not bear scrutiny**. Also, we would have expected questions raised at the authorisation stage to have been asked (and addressed) in the product design phase. Such applications are likely to fail to meet the applicable requirements as set out further in the annex to this letter. We expect to see material improvements in future applications. We also expect clear and accurate ongoing disclosures to consumers where funds make ESG-related claims, and we want to see funds deliver on their stated objectives and/or strategy. We include in this letter a set of guiding principles that explains our expectations in this area.”*

It gave three examples to illustrate its concerns:

- A proposed passive fund had an ESG-related name that the FCA found misleading as it was looking to track an index that did not hold itself out to be ESG-focused. It also had very limited exclusions from the index, based on high-level ESG criteria.
- A fund application claimed to have a strategy to invest in companies contributing to ‘positive environmental impact’. The fund intended to invest predominantly in companies that, while reporting low carbon emissions, would not obviously contribute to the net-zero transition. The FCA had expected to see a measurable non-financial objective alongside the financial objective or strategy with information on how that impact would be measured and monitored.
- Instances where it was challenging to reconcile the fund’s proposed holdings with statements made setting expectations for consumers. One example was a sustainable investment fund containing two ‘high-carbon emissions’ energy companies in its top-10 holdings, without providing obvious context or rationale behind it (eg, a stewardship approach that supports companies moving towards an orderly transition to net zero).

The FCA’s guiding principles comprise four principles, each of which is supported by further explanation and guidance.

Overarching principle: Consistency – A fund’s ESG/sustainability focus should be reflected consistently in its design, delivery and disclosure. A fund’s focus on ESG/sustainability should be reflected consistently in its name, stated objectives, its documented investment policy and strategy, and its holdings.

Principle 1. The design of responsible or sustainable investment funds and disclosure of key design elements in fund documentation

“References to ESG (or related terms) in a fund’s name, financial promotions or fund documentation should fairly reflect the materiality of ESG/sustainability considerations to the objectives and/or investment policy and strategy of the fund.”

The guidance then provides a “deep dive” on topics such as fund naming, fund strategies, objectives and policies, and stewardship, plus practical guidance and examples. Some of this guidance is likely to be helpful to firms outside the UK where they reflect views likely to be held among regulators generally – e.g. see the following:

“Where a fund might hold securities, potentially at a reduced weighting, that an investor might not expect, given the ESG/sustainability focus of the fund, this should be made clear in the prospectus, including the circumstances when such securities might be held and the purposes for which they would be held.”

Principle 2. The delivery of ESG investment funds and ongoing monitoring of holdings

“The resources (including skills, experience, technology, research, data and analytical tools) that a firm applies in pursuit of a fund’s stated ESG objectives should be appropriate. The way that a fund’s ESG investment strategy is implemented, and the profile of its holdings, should be consistent with its disclosed objectives on an ongoing basis.”

The guidance then provides a “deep dive” on topics such as resources, data and analytic tools, and holdings. As regards greenwashing risk, it notes: “Where a fund pursues ESG/sustainability characteristics, themes or outcomes, the [firm] should take into account whether a reasonable investor would consider that the fund’s holdings reflect any ESG/sustainability characteristics, themes or outcomes that have been disclosed or claims that have been made.”

Principle 3. Pre-contractual and ongoing periodic disclosures on responsible or sustainable investment funds should be easily available to consumers and contain information that helps them make investment decisions

“ESG/sustainability-related information in a key investor information document should be easily available and clear, succinct and comprehensible, avoiding the use of jargon and technical terms when everyday words can be used instead. Funds should disclose information to enable consumers to make an informed judgement about the merits of investing in a fund. Periodic fund disclosures should include evaluation against stated ESG/sustainability characteristics, themes or outcomes, as well as evidence of actions taken in pursuit of the fund’s stated aims.”

The guidance then provides a “deep dive” on what it expects in pre-contractual disclosures and how those disclosures should be prepared, what periodic reports and KPIs it would expect to see, and how stewardship should be dealt with.

FCA consultation – TCFD reporting by asset and fund managers⁹

The FCA has proposed new climate-related financial disclosure rules for asset managers (e.g. authorised portfolio managers, UK UCITS managers and AIFMs), life insurers, and FCA regulated pension providers (e.g. SIPP operators). This is subject to exceptions for smaller firms. It is also important to note that non-UK AIFMs are not in scope.

The intention of the new regime is (among other things) to protect consumers from buying unsuitable products – i.e. mitigating greenwashing risk. The regime contemplates two types of disclosures: one relates to all relevant assets managed or administered by the relevant firm (to be disclosed via a TCFD entity report), and the other is product specific (to be disclosed via a TCFD product report). As regards the latter, however, the position is nuanced: e.g. they are mandatory and required to be made public in certain cases only (e.g. if the product is a UK UCITS). In certain cases, they must be provided “on-demand” (e.g. if a portfolio management client requires the disclosure to meet its own regulatory or legal disclosure obligations). In other cases, they are “encouraged” only.

The regime will be introduced via a new sourcebook – to be called the Environmental, Social and Governance Sourcebook or ESG – to be expanded over time to include new rules and guidance on other climate-related and wider ESG topics.

The proposals are based on the recommendations of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD). It is also important to note that the regime will not mirror SFDR (for better or worse), although the FCA appears to wish to develop a regime that is complimentary, bearing in mind the duplication and overlap for groups with both EU and UK operations.

Final rule are due to be published in Q4 2021 and the regime is currently proposed to come into force in phases, beginning on 1 January 2022.



New UK “Sustainability Disclosure Requirements” (SDRs) and “sustainable investment” label

In a speech in July 2021,¹⁰ the UK Chancellor announced:

- proposed new “Sustainability Disclosure Requirements” (SDRs) – this is a plan to require companies, pension schemes, financial services firms and their investment products to report on the impact they are having on the climate and environment - as well as the risks and opportunities facing their business. In part, this will apparently address greenwashing risk by ensuring “consumers and investors have the information they need to make informed investment decisions ...”; and
- a new sustainable investment label will be created, intended to act as a quality stamp; and
- On 18 October 2021, the Government published “Greening Finance: A Roadmap to Sustainable Investing”¹¹ which sets out the long-term ambition to green the financial system. The document focuses on phase one - namely, that decision-useful information on sustainability is available to financial market decision makers. This will be delivered through the new economy-wide SDRs. For more detail on the implementation pathways and the requirements, please refer to our blog entry which can be found here.¹²

UK taxonomy

- Limited parts of the EU Taxonomy Regulation were onshored as part of the UK’s preparations for Brexit.¹³
- In June 2021, the UK government announced as follows (emphasis added):¹⁴

“New independent group to help tackle ‘greenwashing’

The UK’s net zero economy goal was boosted today (9 June 2021) with the appointment of a new expert group whose work will support investors, consumers and businesses to make green financial decisions. ...

The Green Technical Advisory Group (GTAG) will oversee the Government’s delivery of a “Green Taxonomy” – a common framework setting the bar for investments that can be defined as environmentally sustainable.

The Green Taxonomy will help clamp down on greenwashing – unsubstantiated or exaggerated claims that an investment is environmentally friendly – and make it easier for investors and consumers to understand how a firm is impacting the environment.

With hundreds of new sustainable investment funds coming to market each year and sales to UK retail investors tripling from 2019 to 2020, consumers and investors of all sizes will be able to make more informed decisions, and businesses will be supported as they plan to transition to net zero.

The Green Taxonomy is an important step in the Government’s efforts to boost investment in projects that accelerate the transition to a sustainable economy, create green jobs and support the UK’s environmental goals. ...”

- More information on the UK taxonomy and the work of the GTAG were set out in the Government’s Greening Finance Roadmap - please refer to the section above for more detail on that.

10_ <https://www.gov.uk/government/news/chancellor-sets-out-how-uk-financial-services-can-create-prosperity-at-home-and-project-values-abroad-in-first-mansion-house-speech>
11_ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1026224/CCS0821102722-006_Green_Finance_Paper_2021_v5_Bookmarked_48PP.pdf

12_ <https://www.allenoverly.com/en-gb/global/blogs/countdown-to-cop/uk-greening-finance-roadmap>

13_ For the amendments made in the onshoring process, Ssee EXITING THE EUROPEAN UNION FINANCIAL SERVICES AND MARKETS The Securities Financing Transactions, Securitisation and Miscellaneous Amendments (EU Exit) Regulations 2020 (No. 1385) (UK). Note: The disclosure obligations under the EU Taxonomy Regulation were not onshored – these only entered into force after 31 December 2021 and therefore did not form part of retained EU law in the UK.

14_ <https://www.gov.uk/government/news/new-independent-group-to-help-tackle-greenwashing>



IMF

In October 2021, the IMF released its global financial stability report. Chapter 3¹⁵ of that report focuses on fostering the transition to a green economy in the context of investment funds. The IMF concludes that: *“the sustainable investment fund sector can be an important driver of the global transition to a green economy but, at the current juncture, is too limited in size and scope to have a major impact and faces challenges related to greenwashing.”* In order for the sustainable funds sector to become an effective driver of the transition, the IMF states that policymakers should *“ensure proper regulatory oversight to prevent greenwashing”*.

International Organization of Securities Commissions (IOSCO)

In October 2018, IOSCO launched a sustainable finance network which has been progressing a programme of work since that date. IOSCO also established a Board-level Sustainability Task Force. One of its key aims is to improve sustainability-related disclosures made by issuers and asset managers; in particular, it will identify and develop categories of disclosure which are material for investors (“decision useful”). It will also prepare case studies and an analysis on transparency, investor protection, greenwashing and other relevant issues.

In June 2021, IOSCO published a Consultation Report¹⁶ focused on investor protection issues and proposes that securities regulators consider setting regulatory and supervisory expectations for asset managers regarding sustainability-related risks and opportunities. The Report outlines the types of greenwashing at the asset manager and product levels, describes the different regulatory approaches taken by securities regulators to address sustainability-related risks and opportunities and provides an overview of the financial and investor education initiatives conducted by regulators.

Ashley Alder, IOSCO Chair and Chief Executive Officer of the Securities and Futures Commission (SFC) of Hong Kong, stated: *“The number of ESG investing and sustainability-related products has risen significantly in recent years, magnifying some crucial challenges, including concerns about the consistency and comparability of sustainability-related information and greenwashing. This report sets out IOSCO’s view of the regulatory and supervisory expectations needed to support asset managers in addressing these challenges.”*

U.S.

In March 2021, the US Securities and Exchange Commission (SEC) announced¹⁷ the creation of a climate and ESG Taskforce within its Enforcement Division. The Taskforce will proactively identify ESG-related misconduct in the context of investor disclosures, in recognition of increased investor appetite for ESG investment strategies, as well as increased investor reliance on climate and ESG-related disclosures. It will initially focus on “greenwashing” by identifying material gaps or misstatements in investor disclosure materials. It will also analyse disclosure and compliance issues relating to fund managers’ (and their funds’) ESG strategies.

Existing SEC Commission Guidance Regarding Disclosure Related to Climate Change sets an expectation that issuers consider climate change risks within corporate disclosures and provides example climate change issues and the impact to consider, such as possible manufacturing disruption caused by extreme weather. The SEC is expected to issue new, more extensive climate change disclosure rules shortly. However, it is clear that the SEC does not expect public companies to wait for those revisions and that companies should be complying with the current requirements.

In September 2021, the Corporate Finance Division of the SEC published¹⁸ a sample letter to companies regarding climate change disclosures and confirmed that it may issue the letter to companies regarding inadequate disclosures that form part of SEC filings.

15 <https://www.imf.org/en/Publications/GFSR/Issues/2021/10/12/global-financial-stability-report-october-2021>

16 <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD679.pdf>

17 https://www.sec.gov/news/press-release/2021-42?utm_medium=email&utm_source=govdelivery

18 <https://www.sec.gov/corpfin/announcement/announcement-sample-letter-climate-change-disclosures>

HONG KONG

In June 2021, the Hong Kong SFC published¹⁹ an amended circular providing guidance to asset managers on enhanced disclosure expectations for funds which incorporate ESG factors as a key investment objective and/or strategy. From January 2022, ESG funds, and climate-focused funds products will have to disclose how they incorporate ESG factors, report and reference ESG criteria, showcase portfolio measurement approaches and release periodic assessments annually.

The SFC has reviewed the EU's SFDR and noted that UCITS funds will be ESG funds in Hong Kong if they incorporate ESG factors as their key investment focus. This is irrespective of whether they are classified as Article 8 or Article 9 under SFDR. Where UCITS funds meet SFDR requirements under Article 8 and 9 they will be deemed to have generally complied with the SFC requirements – however the SFC may vary the requirements as they deem fit at any time.

¹⁹<https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/products/product-authorization/doc?refNo=21EC27>

Recommendations

For a financial services firm that has products or services with a green or ESG badge of some kind, or that otherwise makes disclosures relating to the firm's green/ESG footprint or credentials, some actions for you to consider:

Training

Focus on staff awareness building and training on greenwashing risk, so the firm's position on this (and the potential consequences of greenwashing) are well understood – and from a cultural perspective, the firm's position is clear and transparent. Ideally this should include worked examples or real life scenarios, so the firm gives clear guidance on good vs poor behaviour, and staff receive practical assistance as to “where the line is”.

Product governance policies and procedures

“Kick the tyres” to ensure these are “fit for purpose” in the context of greenwashing risk, and give clear guidance on how it can be avoided.

This should be led by the front office, with support from compliance, risk and possibly internal audit.

Record keeping

If an issue does arise, having records to demonstrate you followed a robust process will be key. It may therefore again be worth sense checking your internal policies and procedures to ensure there is a robust audit trail to evidence any green or ESG related claims made in external facing documents.

Market developments

Stay on top of industry developments to ensure you pick up any “lessons learnt” and understand what regulators are saying and what they want to see.

How can A&O help?

Please get in touch with your usual A&O contact if you wish to discuss greenwashing risks or issues, or we can help further in any way with product governance issues, training or due diligence.

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