YPOG-Briefing
Greenwashing - European Supervisory Authorities Present Common Understanding

Hamburg, 5 June 2023 | Lennart Lorenz, Florian Thrun, Antonia von Treuenfeld, Anne Maria Weiske

I. Progress Report on Greenwashing

The European Securities and Markets Authority (the ESMA) as part of the European Supervisory Authorities (EBA, EIOPA, and ESMA – together the ESAs) has released its https://www.esma.europa.eu/sites/default/files/2023-06/ESMA30-1668416927-2498_Progress_Report_ESMA_response_to_COM_RfI_on_greenwashing_risks.pdf in the financial sector, which focuses on the issue of greenwashing in the growing market of ESG-related financial products in the EU.

With increasing demand for sustainable investments, market participants are striving to enhance their sustainability profiles, sometimes leading to misleading practices. In response, the European Commission requested input from the ESAs on the definition of greenwashing in the financial sector, on the risks greenwashing can pose to investors and financial markets, on the implementation of sustainable finance policies aimed at preventing greenwashing, as well as on potential improvements to the regulatory framework.

The report by the ESMA (the Report) focuses on four key sectors (issuers, investment managers, benchmark administrators and investment service providers) within ESMA's remit and aims to provide a better understanding of greenwashing and identify areas of the sustainable investment value chain that are more susceptible to such risks. It emphasizes the importance of effective monitoring, prevention, and remediation of greenwashing. While the Report presents preliminary remediation actions, it does not specify timelines or preferred legal forms for implementing potential changes to the regulatory framework.

Special attention is drawn to the areas specifically vulnerable for greenwashing for investment managers identified by ESMA (see III. below). Albeit it being only a preliminary report, these areas are of high practical relevance and should be considered by investment managers when implementing an ESG strategy going forward.

II. Common high-level understanding of greenwashing

Based on the analysis of existing references in currently applicable legislation and responses, the ESAs have developed a common high-level understanding that greenwashing is a practice where

> *sustainability-related statements, declarations, actions, or communications fail to transparently and accurately reflect the true sustainability profile of an entity, financial product, or financial services. This practice has the potential to mislead consumers, investors, and other market participants.*

It can occur both intentionally and unintentionally. Importantly, greenwashing can happen within or outside the EU regulatory framework, and it does not require actual harm to investors.

ESMA further expanded on its understanding of the core characteristics:

- Misleading Communications: Sustainability-related statements, declarations, or communications can be misleading due to the omission of relevant information necessary for decision-making, such as partial, selective, unclear, unintelligible, vague, oversimplistic, ambiguous, or untimely information. It can also involve providing false or deceiving information, including mislabelling, misclassification, mistargeted marketing, and inconsistent information.
- Misconduct and Actions: Greenwashing is a form of misconduct that extends beyond misleading claims to include misleading actions. Examples include identifying clients with sustainability preferences for a product that lacks sustainability features during the product design phase or failing to consider clients' sustainability preferences in the advice phase.
- Intentional or Unintentional Spread: Sustainability-related misleading claims can occur and spread intentionally or unintentionally. Intentionality, negligence, and the adequacy of due diligence efforts may be considered as aggravating factors in supervisory and enforcement actions.
- Levels and Stages of Greenwashing: Greenwashing can occur at the entity level (related to sustainability strategy or performance), financial product level (related to sustainability strategy or performance), or financial service level, including advice. It can occur at various stages of the business cycle, such as manufacturing, delivery, marketing, sales, and monitoring, within the sustainable finance value chain.
- Applicability and Scope: Greenwashing may occur concerning specific disclosures required by the EU sustainable finance regulatory framework or general principles outlined in EU financial legislation. It can also extend to entities outside the current scope of EU sustainable finance legislation.
- Triggers and Responsible Parties: Greenwashing can be triggered by the entity responsible for sustainability communications, the entity manufacturing the product, the entity providing advice or information about the product, or third parties such as ESG rating and data providers or third-party verifiers.
- Implications and Trust: Greenwashing may or may not immediately harm individual consumers or investors, but it can lead to unfair competitive advantages. If left unchecked, it has the potential to erode trust in sustainable finance markets and policies.

III. Investment managers

Next to issuers, benchmark administrators and investment service providers, investment managers are part of the four focus sectors analysed by the ESMA.

The Report highlights that the highest areas of greenwashing risk for investment managers are associated with claims made about funds and the overall ESG profile of asset managers.

The specific high-risk areas identified include impact claims, statements regarding engagement with investee companies, an asset manager's ESG strategy and credentials (such as ESG labels, ratings, or certifications), fund names, and claims concerning governance around ESG. Common forms of misrepresentation involve exaggeration, ambiguity, the absence of meaningful assumptions and omission. Notably in this respect is that ESMA takes the view that where a fund discloses under Article 6 SFDR and claims to integrate ESG factors (beyond the integration of sustainability risk) can also be considered guilty of misrepresentation through omission.

The channels through which these claims are transmitted, and thus most exposed to greenwashing risks, include prospectuses, marketing materials (such as factsheets, sustainability and impact reports, and engagement reports), and labels.

ESMA further points out that the current version of the Sustainable Financial Disclosure Regulation (SFDR) may be an underlying driver of misleading sustainability claims. One concern is the lack of clarity in certain concepts, such as "sustainable investment", the criteria used for the Do No Significant Harm (DNSH) test and the measurement of contribution to a sustainable objective. Additionally, regulatory gaps exist, such as the absence of a clear disclosure regime for sustainability outcomes like investors' impact and engagement, as well as inconsistencies between SFDR, the Taxonomy Regulation (TR), and the Benchmark Regulation (BMR). Other factors that contribute to greenwashing include the lack of transparency in ESG ratings methodologies and the absence of reliable EU-level labelling schemes. The flexible nature of SFDR's definition of "contribution to a sustainable objective" without a quantitative threshold allows for varying levels of ambition among Article 9 SFDR products. This creates a possibility for asset managers to construct products with potentially unambitious sustainable objectives.

ESMA re-emphasizes that the SFDR was designed as a disclosure regulation and not as a specific criteria-based framework like the Taxonomy Regulation, highlighting the neutral nature of its disclosures. However, market practices have misused the SFDR by categorizing products into "dark green" "light green" and "brown" based on their sustainability characteristics, which is not endorsed by regulators. Another gap in the sustainable finance framework is the lack of clear requirements for engagement claims, leaving room for unsubstantiated or ambiguous references to engagement with investee companies.

Lastly, inadequate integration of ESG risk in the investment process is identified as another driver of greenwashing.

IV. Remedial actions and next steps

The Report suggests several preliminary remediation actions to address the identified issues. These actions include reinforcing the regulatory framework by clarifying key concepts and expanding on transition finance, sustainability impact, and engagement. Market participants are also urged to make substantiated claims and communicate sustainability information in a balanced manner. Enhancing transparency on ESG data methodologies, verification, and auditing is recommended to improve the reliability of sustainability data.

Further, to increase retail investors' participation, establishing a reliable labelling scheme for sustainable financial products and addressing ESG literacy gaps are seen as beneficial.

A Final Report will be published in May 2024, providing a comprehensive assessment of supervisory powers, resources, and actions to address greenwashing risks, along with final recommendations for potential changes to the EU regulatory framework.