A&L Goodbody

ASSET MANAGEMENT & INVESTMENT FUNDS

Greenwashing for Investment Funds

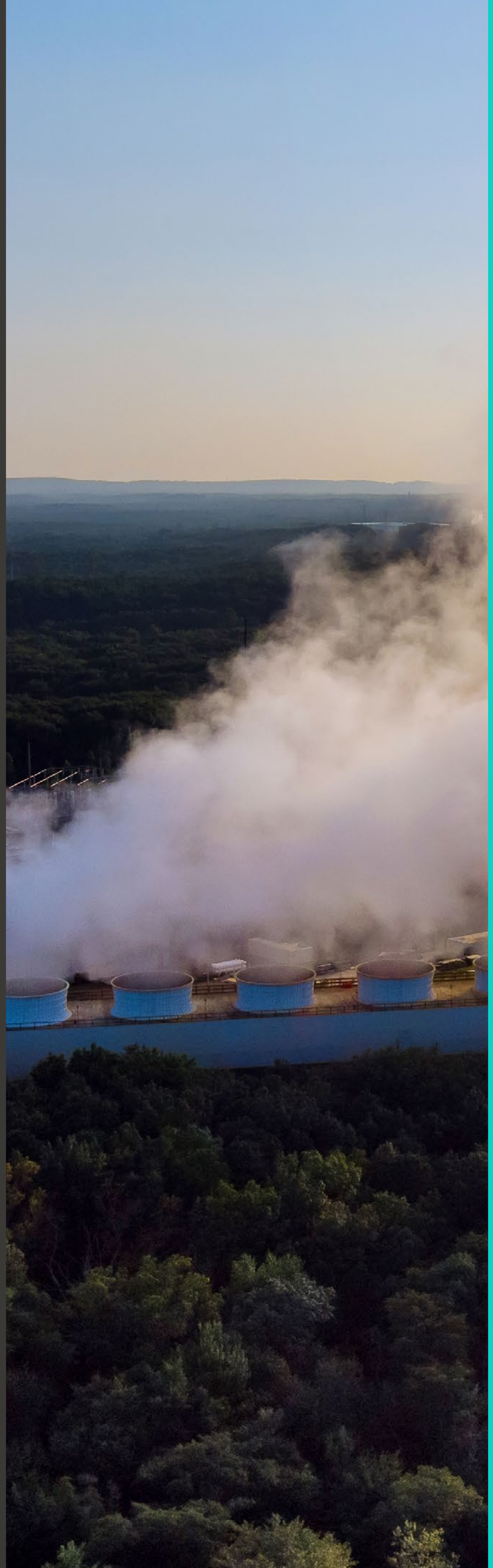
With a combination of increased investor demand for sustainable investment product offerings and evolving regulatory regimes, the European Supervisory Authorities (**ESAs**) are gearing up to tackle a potential increase in greenwashing claims across the EU financial services sector.

6 MIN READ

What is greenwashing?

While there is currently limited reference to greenwashing in certain sustainability-related EU financial services legislation, there is no generally applicable and binding definition of what is considered to be greenwashing.

The European Securities and Markets Authority (**ESMA**) includes in its sustainable finance roadmap 2022-2024 that greenwashing may be defined in a number of ways. ESMA states that intuitively greenwashing refers to intentional and unintentional market practices, whereby the publicly disclosed sustainability profile of an issuer and the characteristics and/or objectives of a financial instrument or financial product, by action or omission, do not properly reflect the underlying sustainability risks and impacts. As such, greenwashing can give rise to detriment to investors who wish to allocate resources to sustainable investments. Greenwashing could therefore, according to ESMA, be generally identified as misrepresentation, mislabeling, mis-selling and/or mispricing.



Building scrutiny

International regulatory focus has been rising steadily over the past couple of years and all the signals are that it is about to enter a new phase of action. In its renewed sustainable finance strategy of July 2021, the European Commission laid out its expectation that supervisors play an essential role in identifying, preventing, investigating, sanctioning and remediating greenwashing.

Priority number one in ESMA's sustainable finance roadmap is tackling greenwashing and promoting transparency. Priority number two is building the capacity of national competent authorities (**NCAs**) to supervise the area of sustainable finance, which will undoubtedly result in a focus on greenwashing risks and the sanctioning of offenders. ESMA followed this with a supervisory briefing in May 2022 which provided that regulatory intervention, including administrative measures and enforcement, may be appropriate to combat greenwashing. ESMA also issued a consultation paper on guidelines on funds' names using ESG or sustainability-related terms highlighting the relevance of greenwashing where funds are named green or socially sustainable. The ESA's call for evidence on better understanding greenwashing published in November 2022 and which closed in January 2023 (discussed below), sought to gather input from stakeholders on how to understand the key features, drivers and risks associated with greenwashing and to collect examples of potential greenwashing practices.

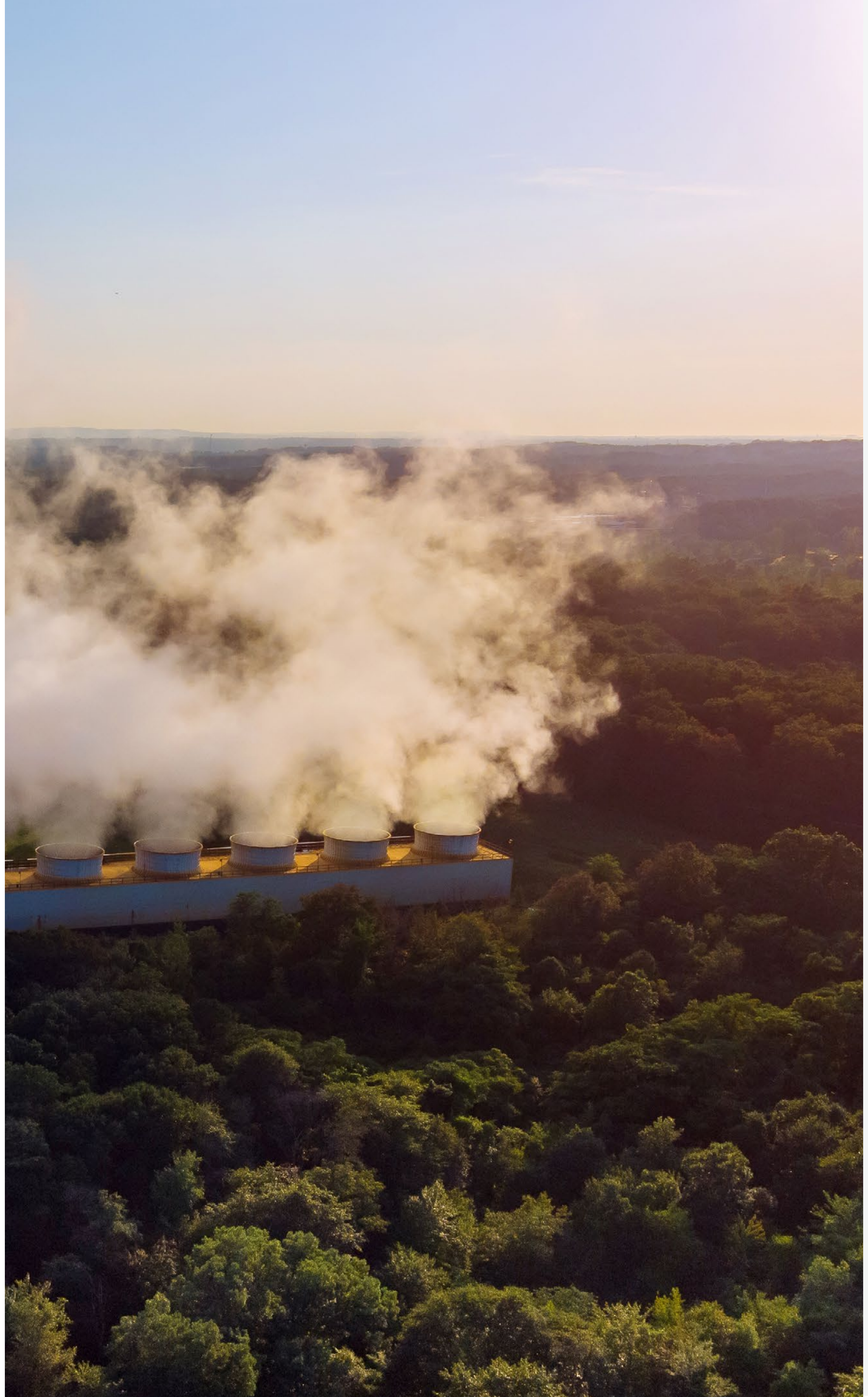
ESMA also plans to conduct a common supervisory action on sustainability risks and disclosures during 2023. In addition, ESMA has announced a common supervisory action on the application of MiFID II disclosure rules with regard to marketing communications across the European Union for 2023 through which it will look to collect information on possible greenwashing practices in marketing communications and advertisements.

In keeping with the EU focus on greenwashing, the Central Bank of Ireland (**CBI**) has communicated its expectations of the funds sector with respect to sustainable finance. Enhancing the governance, oversight and investor outcomes in the funds sector, including the implementation of new ESG requirements and measures to mitigate greenwashing risks, features in the CBI's 2023 financial regulation priorities. The CBI also indicated in its November 2022 publication, Sustainable finance in the asset management sector – disclosures, investment processes & risk management, that supervisory engagement will focus on Article 8 funds with a low proportion of their portfolio promoting environmental and/or social characteristics, which therefore may give rise to greenwashing. The CBI also provides that fund managers need to carefully consider a fund's classification under the Sustainable Finance Disclosure Regulation (**SFDR**) to ensure that it is aligned with both the letter and intention of the legislative requirements.

This focus on ESG practices is not limited to European regulators and NCAs. Funds and their managers are subject to scrutiny from other stakeholders too such as:

- **Investors** – active ownership is on the rise. There is currently a focus by active investors on the ESG practices of operating companies. However, we can expect to see this grow to encompass the practices of investment funds. Investors may interrogate ESG claims and take action where they suspect greenwashing.
- **Media** – there are already several examples of articles exposing the individual holdings of funds disclosing under Article 8 of SFDR. While these may not amount to greenwashing practices and are probably more indicative of a lack of alignment between stakeholders as to what it means to promote environmental or social characteristics, it is indicative of an appetite to investigate and expose wrongdoing.
- **Whistleblowing** – the latest generation of employees are likely the group with the strongest vested interest in promoting robust ESG practices and accordingly have the highest expectations of their employers. They may call out what they perceive as greenwashing and will have the benefit of the enhanced whistleblowing protections implemented across the EU as a result of the Whistleblowing Directive.

Investment funds committed to sustainability can expect the regulatory landscape to continue to evolve.



Call for evidence on greenwashing

In November 2022, the ESAs issued a call for evidence (**CfE**) on better understanding greenwashing. The aim of the CfE is to gather information, including evidence relating to greenwashing practices and potential greenwashing risks, in connection with sustainability claims regarding entities and products or services by requesting:

- views from stakeholders on how to understand greenwashing and the main drivers of greenwashing
- examples of greenwashing practices relevant to various segments of the sustainable investment value chain and product lifecycle
- any available data to help the ESAs gain a concrete sense of the scale of greenwashing and identify areas of high greenwashing risks

It is clear from the CfE that while the environmental pillar in ESG has always been prominent when considering greenwashing risks, the social and governance pillars should not be ignored.

The CfE will help inform policy making and supervision by obtaining a more granular understanding of greenwashing. A progress report is expected to be delivered by the ESAs to the European Commission by the end of May 2023 and a final report including recommendations delivered by the end of May 2024.

SMSG advice to ESMA

In the context of the CfE, the Securities and Markets Stakeholder Group (**SMSG**) has recently published advice to ESMA on additional questions relating to greenwashing. The SMSG's advice includes recommended principles to define greenwashing and a proposed holistic definition of greenwashing: "the practice of misleading investors, notably (but not limited to) in the context of gaining an unfair competitive advantage, by making an unsubstantiated ESG claim about a financial product or service". The SMSG also advises ESMA to monitor greenbleaching, to monitor and examine the decline of Article 9 funds, and to consider the relevance of intent in the definition of greenwashing.

Key components to a greenwashing claim

In the CfE, the ESAs identify dimensions of greenwashing:

1. The role of market participants as a trigger, spreader or receiver of a sustainability-related claim.
2. Greenwashing arising from claims about:
   - an entity's governance and remuneration around sustainability and about an entity or a product's dedicated resources to sustainability matters
   - sustainability strategy, objectives, characteristics or qualifications of a product, an entity, or a service
   - from sustainability-related metrics (historical or future).
3. Sustainability-related claims can be misleading because of selective disclosure or cherry-picking positive information and/or omitting relevant negative information, exaggerated claims and/or failure to deliver on such claims; omission or lack of disclosure; vagueness or ambiguity or lack of clarity; or poor advice etc.
4. The channels through which the sustainability-related claims are communicated, providing examples of regulatory documents, ratings/benchmarks/labels, product information and marketing materials.

> *"The CfE will help inform policy making and supervision by obtaining a more granular understanding of greenwashing.*

What is driving greenwashing?

Fund promoters are under increased pressure from distributors and investors to make green funds available. More than half of EU funds launched during 2022 disclosed under Article 8 or 9 of the SFDR.

At the same time, the expectations from investors to deliver returns in the face of global market headwinds remain.

This demand means that funds may be intentionally or unintentionally represented as green notwithstanding that the infrastructure to support this claim is lacking for a variety of reasons such as:

DATA-RELATED ISSUES

- **Unintentional:** disclosure obligations of funds have preceded obligations to be imposed on their underlying investments. This is just one component which has led to data challenges in compiling and interpreting ESG related data.
- **Intentional**: these data issues can be used to cherry pick data which is not truly representative of the fund's ESG practices or manipulate portfolio compositions at key measurement points to manipulate results.

LACK OF EXPERTISE AND SKILLS

- Skills and expertise in ESG matters across the organisational structure, including portfolio management, risk management, operations, internal audit and compliance, and oversight, including management company and fund directors.
- This further applies in the selection of service providers who may provide data or ratings.

CHALLENGES IN APPLICATION OF NEW RULES

- Inconsistent interpretations of legal regimes and financial literacy gaps are just some of the challenges associated with the expanding and evolving plethora of ESG rules and regulations.

Where sustainability-related claims might be made in the context of a fund

Misleading or unsubstantiated claims could be made through labels, offering documents, periodic reports or marketing materials.

For example funds could:

- use ESG or sustainability-related terms in their names
- claim to promote environmental or social characteristics under article 8 of SFDR
- claim to pursue a sustainable investment objective under article 9 of SFDR
- claim to make a certain level of environmentally sustainable investments under SFDR and the Taxonomy Regulation

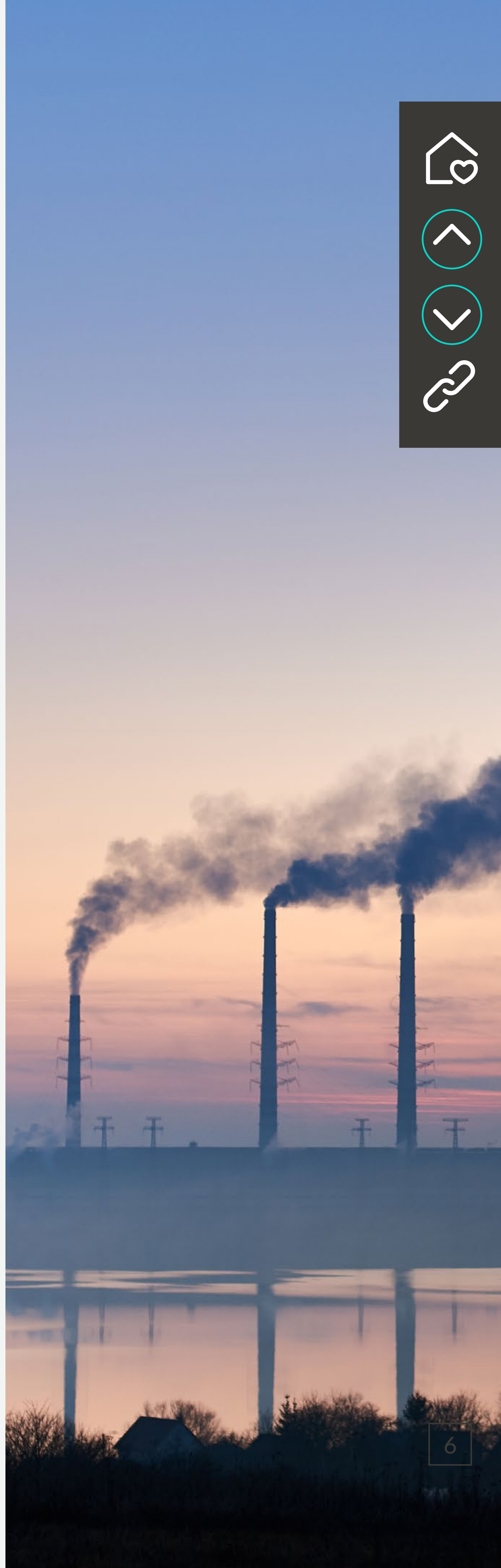
How can ALG help?

ALG is a full service corporate law firm. This allows us to collaborate across practice areas and leverage the specialist expertise of our ESG & Sustainability and our Knowledge teams in advising and providing legal services.

ALG's ESG & Sustainability group comprises experts from practice areas spanning asset management and investment funds, insurance, finance, renewable energy, climate action, corporate governance, environmental and planning, employment, construction, dispute resolution and regulatory investigations, among others, and provides additional specialist expertise to our clients on ESG and sustainability matters.

Our Asset Management and Investment Funds Group has market leading experience advising on a broad range of ESG strategies implemented by funds. It is critical that the fund name, disclosure in offering documents, claims in periodic reports and marketing materials contains accurate information that can be evidenced. We can work with funds to review and draft these disclosures.

Leveraging the expertise of other practice areas, such as financial regulation and corporate governance, we can advise managers seeking to establish robust risk management frameworks to guard against greenwashing through the development of policies and procedures and contractual protections with ESG data and rating providers.



A&L Goodbody

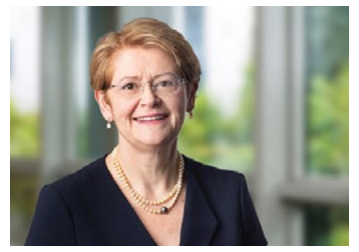
Key contacts

Brian McDermott
Partner
+353 1 649 2307
bmcdermott@algoodbody.com

Michael Barr
Partner
+353 1 649 2327
mbarr@algoodbody.com

Stephen Carson
Partner
+353 1 649 2165
scarson@algoodbody.com

Kerill O'Shaughnessy
Partner
+353 1 649 2422
koshaughnessy@algoodbody.com



Nollaig Greene
Knowledge Lawyer
+353 1 649 2359
ngreene@algoodbody.com

Yvonne McGonigle
Knowledge Lawyer
+353 1 649 2734
ymcgonigle@algoodbody.com

Aifric Treacy
Senior Associate
+353 1 649 2237
atreacy@algoodbody.com

Chris Bergin
Senior Associate
+353 1 649 2021
cbergin@algoodbody.com

Nicola McCaffrey
Senior Associate
+353 1 649 2743
nmccaffrey@algoodbody.com

Claire Donnelly
Associate
+44 207 382 0834
cpdonnelly@algoodbody.com

Michelle Nagle
Associate
+44 207 382 0820
mnagle@algoodbody.com

Sarah-Louise Butler
Associate
+44 207 382 0824
slbutler@algoodbody.com

Resources

- ESMA sustainable finance roadmap 2022-2024 — READ MORE
- ESMA supervisory briefing sustainability risks and disclosures in the area of investment management — READ MORE
- ESMA consultation on funds' names using ESG or sustainability-related terms — READ MORE
- ALG insight on ESMA Consultation on funds' names using ESG or sustainability-related terms — READ MORE
- ESMA consultation on guidelines on funds' names using ESG or sustainability-related terms — READ MORE
- ESA's Call for evidence on better understanding greenwashing — READ MORE
- Sustainable Finance in the Asset Management Sector – disclosures, investment processes & risk management — READ MORE
- SMSG advice to ESMA — READ MORE