Walking the walk on ESG: Mitigating greenwashing risk on the path to investing sustainably

Stephen Carty
Partner
Maples Group, Ireland
Email Stephen Carty

Brian Clarke
Partner
Maples Group, Ireland
Email Brian Clarke

Investor demand, alongside a range of new regulatory developments, is driving the importance of integrating environmental, social and governance (ESG) considerations into asset managers' investment capabilities.

As this regulatory and commercial pressure ramps up, the risk increases that firms deliberately or inadvertently misrepresent their ESG credentials.

In this article, we discuss some practical measures for asset managers to effectively manage and mitigate this risk.

EU sustainable finance action plan

In the area of sustainable finance, a number of key measures come into effect in the EU shortly:

- From 2 August 2022:
    - Sale agents or distributors authorised in the EU under the MiFID regime are required to take into account any sustainability preferences of a client (in addition to the client's investment objectives and risk tolerances) when assessing the suitability of financial services or products for recommendation.

      Systematically asking investors at the outset of the sales process to indicate if they have a preference for ESG products, as envisaged, could cause a radical shift in the demand levels for ESG products.
    - EU authorised UCITS management companies and AIFMs must specifically factor the consideration of sustainability risks into their investment due diligence processes, risk management processes, and conflicts of interest policies.

      This will require the integration of sustainability considerations and factors into firms' investment processes and risk management processes for all investment funds managed, not just ESG-focussed funds.

- 1 January 2023:
    - The introduction of the secondary phase (or Level 2) of the EU Sustainable Finance Disclosure Regulation (SFDR).

      This will require EU financial products that seek to promote ESG characteristics or have a sustainable investment objective, i.e. 'Article 8 financial products' and 'Article 9 financial products' respectively, to make detailed pre-contractual and financial statements disclosures in a prescribed and easily comparable form.

Room for misalignment

As asset managers prepare for these regulatory changes and investor demand continues to gather pace, it is becoming increasingly commercially compelling for many EU asset managers to both enhance and promote their ESG credentials.

EU regulators have acknowledged this issue and appreciate the risks it presents. In its Sustainable Finance Roadmap 2022-2024 issued in February 2022, ESMA stated:

"The combination of growing investor demand, a fast-evolving market and legislative/regulatory measures which can only apply with a certain time lag creates ***room for misalignment*** *between demands for investments that can make a sustainability impact and the available investing opportunities marketed as sustainable. "*

ESMA noted that this *"room for misalignment"* creates *"the risk of mis-selling"*.

Consistent with this, concerns have been expressed publicly, by senior EU policy makers that investment funds are being categorised as Article 8 financial products or Article 9 financial products "not because the nature of the assets underlying those funds are necessarily more sustainable, but because it is just a commercial imperative to become more visible and more active in the sustainability space".[1]

Greenwashing

In an EU financial services context, ESMA consider 'greenwashing' to be market practices where a financial product's publicly disclosed sustainability features do not properly reflect the underlying sustainability risks and impacts. In simple terms, an asset manager engages in greenwashing where the sustainability claims it makes are untrue or overstated. This can occur both intentionally and unintentionally, and in that regard, greenwashing can also occur where claims are made without proper foundation, and where they cannot be reasonably substantiated.

1 Comments attributable to Alain Deckers, Head of the Asset Management Unit at the European Commission. Source: Ignites, 10 May 2022.

Factors driving greenwashing risk

The risk of unintentionally misstating ESG credentials is greater in the current context due to a combination of factors including: (i) new and quickly evolving law and regulation; (ii) varying levels of sustainable finance expertise across the industry (including within regulators); and (iii) gaps in ESG data / inaccurate or unverified data from investee companies.

As noted above, the 'commercial imperative' presents a risk that asset managers will present their investment funds or services as more sustainable, without being able to deliver in practice.

Where investors choose financial products or services on the basis of untrue or overstated sustainability claims, this can potentially have a range of negative implications for the relevant asset manager, including:

- *Investor legal recourse* – an investment fund or its manager could be held liable for false claims made on sustainability related issues in the prospectus or associated pre-sales marketing materials. In Europe, so far, there have been a limited number of actions for greenwashing but this will likely change with the evolving regulatory environment, and as investors become more sophisticated and focussed on sustainability. In many EU jurisdictions, liability for misstatements in prospectuses and statutory causes of action already exist - allowing consumers to pursue damages against regulated financial service providers. This will be enhanced further in early 2023 with the introduction of the EU Collective Redress Directive.

- *Regulatory sanctions* – in 2021 the European Commission's Renewed Sustainable Finance Strategy called on EU regulators to ensure that investors and consumers are protected against unsubstantiated sustainability claims. In its Sustainable Finance Roadmap in February 2022, ESMA noted the "real need [for regulators] to address greenwashing without delay" and referred to the key role regulators have in "monitoring compliance with sustainable finance regulation and making full use of their legal mandates and powers to ensure that investors and consumers are protected against unsubstantiated sustainability claims." Regulatory scrutiny of ESG-related disclosures in fund documents is set to increase significantly. Additional supervisory initiatives such as thematic inspections can also be expected. Where regulators identify failures in firms' practices in this regard, the outcome could include fines and public censure.

- *Reputational harm*– through various means including investigative journalism and whistleblowing (as well as media coverage of any investor actions or regulatory sanctions, as considered above), asset managers making untrue or overstated sustainability claims run the risk of it being exposed publicly, with significant adverse reputational and credibility ramifications.

Given these wide-ranging potential implications, asset managers should consider assurance measures to effectively manage and mitigate the risk of greenwashing.

Three key areas for consideration to mitigate greenwashing risk

(i) Operational framework

It is critical that firms put in place an effective operational framework that takes into account the need to substantiate sustainability claims throughout the fund lifecycle, from initial concept and design onwards.

A key element initially will be to agree the parameters of the fund's sustainability focus and ensure this is factored into the fund's investment guidelines. This should also be factored into the operational due diligence, oversight of the portfolio manager and investment reporting.

Assurance testing of sustainability criteria should also be built into the compliance and risk monitoring framework.

Operational ESG controls should also be factored into staff training, the complaints handling process and, where relevant, the internal audit programme.

Any sustainability statements that are integral to the investment strategy should be carefully considered. All statements (particularly quantitative statements) should be assessed for codifiable elements that can be independently verified. Open-ended and unverifiable statements should be avoided. This may involve limiting the level of ESG-related 'sales speak'.

(ii) Monitoring disclosures

Once the text on ESG credentials is constructed, it should be deployed consistently through all fund materials, i.e. sales and marketing material, prospectus, KIID, financial statements and regulatory submissions.

This may merit a centrally controlled library of disclosures as well as a control framework to monitor consistency across all fund materials.

For SFDR Level 2 projects, a large amount of work will be required to develop the mandatory disclosure templates for (i) prospectuses; and (ii) periodic reports for investment funds qualifying as Article 8 financial products and Article 9 financial products.

These two aspects should be looked at side-by-side as they are effectively ex ante and ex post disclosures of the same detailed information.

So if, for example, a prospectus promises a minimum proportion of sustainable investments, the annual report will need to disclose whether this commitment was met or not during the relevant reporting period.

This brings a level of accountability to the disclosures and emphasises the need to consider, from the outset, the ultimate deliverability of sustainability claims being made.

(iii) Governance controls

There should be a robust review of ESG aspects of investment strategy in the fund launch phase, including specific consideration of this element, as part of the board approval.

In simple terms, a framework and culture should pervade the firm in order to self-regulate any claims or representations being made on sustainability.

Conclusion

As we move into this critical phase of the EU sustainable finance action plan implementation and pressures mount for asset managers to factor ESG credentials into their offerings, it is important to ensure that any sustainability claims made are accurate and can be validated now and in the future.

Firms should take the time to evaluate the implications of operating in this space across all aspects of their business as they move towards investing sustainably.