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Greenwashing risks in asset management

Staying one step ahead

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Contents

Executive Summary

Greenwashing is a key regulatory concern – asset management firms will need to take a holistic approach

Greenwashing has been described by the UK government as "misleading or unsubstantiated claims about environmental performance" made by firms about their products or activities. It is becoming an increasingly important regulatory issue in the UK and EU, as well as globally, particularly given the rapidly increasing investor demand for sustainable products. Regulators are concerned that the pressure on asset management firms ("firms") to remain competitive and at the forefront of a growing and profitable market might cause them to overstate the positive attributes of sustainable products. However, there are a number of other channels through which greenwashing may arise.

Conventionally greenwashing is seen as a conduct risk, in the same category as deliberate mis-selling or misrepresentation of financial products. There are longstanding regulatory requirements in relation to treating customers fairly and ensuring that communications are clear, fair and not misleading.

These are relevant to greenwashing and firms will already have governance and control structures to give effect to these requirements. However, firms will also have to adapt these structures for the specific characteristics of greenwashing, some of which are less familiar, and ensure that all relevant staff across the three lines of defence are properly trained.

Moreover, even in the absence of deliberate misconduct, greenwashing may still arise, or stakeholders may perceive that it has happened. This could happen if investment decisions are based on sustainability data which is currently often non-standardised and incomplete, and/or the firm's communications are not clear about what sustainability terminology means in the specific context of the firm and its funds. Using overly technical language to explain non-financial performance (e.g. reduction in carbon emissions) in on-going reporting documentation may also lead end-investors who are unfamiliar with new terminologies and metrics to believe that funds intend to have a greater positive environmental impact than they do.

Responsibility for addressing the risk of greenwashing extends well beyond firms' compliance and risk functions. Firm and fund boards will need to consider this risk in the context of setting firm-wide and fund specific strategies for issues such as sustainable investing and the use of sustainability data from third parties. Implementing effective strategies at fund level should reduce greenwashing risk. An approach involving all the relevant functions at firms across each stage of product development and interaction with end-investors is consistent with the approach that the Financial Conduct Authority (FCA) and EU regulators expect firms to take to avoid greenwashing. A recent FCA letter speaks of the importance of transparency and accuracy in the design, delivery and disclosure of sustainable funds and the EU Sustainable Finance Disclosures Regulation (SFDR) has stipulated rules around both pre-contractual and on-going documentation.

Greenwashing can occur at the firm as well as the fund or product level. The focus of this paper is on the latter.

> "[In the context of embedding ESG across organisations]…we will identify where firm practices do not meet our expectations (e.g. greenwashing) and intervene swiftly to protect consumers."
>
> **FCA Business Plan 2022/2023, April 2022**

What are the key regulatory initiatives?

- The key EU initiative aimed at tackling greenwashing is the SFDR. The SFDR aims to "strengthen investor protection for end-investors by reducing information asymmetries and improving disclosure regarding sustainability related matters" by creating various categories ("Articles") for funds. The SFDR has been in effect since 10 March 2021 and will be supplemented by more detailed standards from 1 January 2023.

- The FCA released a Dear AFM Chair Letter in July 2021 containing guiding principles for avoiding greenwashing which span the design, delivery and disclosure of funds purporting to have sustainability characteristics, themes or objectives.

- The FCA also published a discussion paper on a new Sustainability Disclosures Requirement for investment products in the UK in November 2021. The proposals envisage a framework of multiple disclosures including:

  - a consumer facing product level disclosure aimed at retail investors which will set out the basic sustainability characteristics of the investment product;

  - two detailed disclosures on matters such as data limitations and sustainability risk (the potential impact of ESG risks on investment valuations), one at product level and one at firm level, both of which will be aimed at institutional investors; and

  - a five-pronged labelling regime to be used for all investment products which is intended to reflect the level of sustainability the product has.

What are the key steps firms can take to prevent greenwashing?

Sustainability data
Sustainability data is of vital importance as it underpins firms' regulatory disclosures and reporting on non-financial objectives, as well as investment decision making. Firms should ensure they:

- undertake appropriate due diligence on third party sustainability data and ratings providers;
- enhance their in-house capabilities for analysing data and identifying limitations, including having clear triggers for when they will seek third-party assurance of data;
- make data limitations clear in pre-contractual documentation; and
- proactively assess whether any divestment or engagement needs to take place where new sustainability data emerges that affects funds' ability to perform on sustainability objectives, and also update fund documentation if appropriate and alert intermediaries and end-investors.

Clear language and communications
Regulators are often concerned about the language firms use to describe, market and otherwise communicate about their products. Communication is particularly significant for sustainable investing as it is a new and evolving landscape of unfamiliar terminology. Firms should ensure that:

- fund-specific documentation and firm-wide sustainability related policies are specific and easily digestible by both retail and institutional investors;
- any communications take account of the FCA's requirement to be "clear, fair and not misleading" and its proposals in its Consumer Duty consultation to "make sure they equip customers to make effective, timely and properly informed decisions".

Firm-wide policies and pre-contractual fund-specific documentation
Firms have an obligation to disclose a wide variety of information to end-investors. Firms should ensure that:

- they provide thorough fund documentation that draws clear links between fund names, objectives and strategies, that are in turn backed by comprehensive firm-wide policies;
- firm-wide policies include information about the firm's overall stance on sustainable investing, key sustainable investment strategies used by the firm and how the firm governs this area; and
- fund documents should contain specific data limitation disclaimers and any pertinent information regarding issues that might hinder the fund from achieving the environmental impact it promises.

On-going reporting
Regulators will expect firms to provide end-investors with information to assess whether a fund is achieving its objectives on an ongoing basis. Firms should ensure that:

- metrics used to measure non-financial performance are presented in a way that is easily digestible for end-investors; and
- they are pro-active about informing intermediaries and end-investors about changes in strategies and objectives in sustainable funds.

Complaints handling
Regulators already expect any complaints to be assessed fairly, consistently and promptly, and that this due attention is given to whether the complaint should be upheld and whether and what redress should be provided. With respect to greenwashing complaints, firms should ensure that:

- compliance, or other relevant complaints handling staff are trained in sustainability investing, sustainability data and related terminology and analysis so that they can determine whether greenwashing may have occurred;
- there is a robust analysis of whether the situation triggers the definition of an FCA complaint (i.e., financial loss, material distress or material inconvenience), on what grounds, and whether financial compensation is required;
- if greenwashing has been deliberate, it should be handled in a manner similar to other serious instances of misconduct.

Conclusion
Ultimately, thorough fund documentation that draws clear links between fund names, objectives and strategies, and is in turn backed by clear and comprehensive firm-wide policies is at the core of mitigating greenwashing risk. This should be supplemented by robust due diligence of sustainability data. A collaborative effort between portfolio managers, marketing/sales functions and compliance/risk functions is required to ensure that any misalignment between objectives and strategies, and potential for confusion and exaggeration, are identified and addressed promptly.

Introduction

Recent years have seen a significant increase in the number of funds which describe themselves as sustainable.[1] New funds (both active and passive) are being launched every week, and rising investor interest has led to unprecedented flows into such products, particularly in the UK and EU. According to Morningstar, assets in funds that have sustainable objectives or promote environmental or social characteristics reached EUR 4.05 trillion at the end of December 2021, representing 42.2% of all funds sold in the EU.[2]

Increasing investor demand for sustainable products, combined with a rapidly evolving sustainable finance regulatory framework, are two of the main factors driving the trend towards sustainable investing. This growing interest in sustainable finance presents **asset management firms ("firms")** with new opportunities, but as with any new and fast-growing sector, there are risks as well. There is no standardised definition of what makes a product sustainable, and market participants are still in the process of understanding and implementing new regulatory definitions and disclosure requirements. This combined with the fact that the data required to support the investment selection for such funds is often incomplete and/or is obtained from unregulated providers has made regulators, investors and firms alike concerned about the risk of greenwashing.

"Greenwashing" describes a situation in which a firm makes misleading or exaggerated claims about the environmental benefits of its products or services. In its October 2021 roadmap to greening finance, the UK government defined greenwashing as **"misleading or unsubstantiated claims about environmental performance …made by businesses or investment funds about their products or activities."** This could result in investors buying the wrong products, undermining trust in the market and leading to misallocation of capital intended for sustainable investments.

Notwithstanding widespread concerns about the risk of greenwashing, both in the UK and elsewhere, there is as yet no FCA rule which refers to greenwashing in specific terms. However, there are longstanding FCA requirements to ensure that investors are treated fairly and that communications are clear, fair and not misleading, all of which are relevant to greenwashing. This means that firms will already have control structures in place to identify and deal with some of the underlying issues. But they will also have to adapt those structures to the specifics of greenwashing. In addition, the reputational and litigation risk for firms which engage in or are perceived to engage in greenwashing is also high. The emergence of special interest groups actively following the contribution of the financial services industry to a more sustainable economy could make firms increasingly vulnerable to co-ordinated actions.

Conventionally, greenwashing is seen as a conduct risk, in the same category as deliberate mis-selling or misrepresentation of financial products. However, even in the absence of deliberate misconduct, greenwashing may still arise, or stakeholders may perceive that it has happened. This is for two reasons. First, all market participants are having to deal with sustainability data concerning investee companies which is reported in a non-standardised form, incomplete and continually being updated. These data challenges arise for a number of reasons including that investee companies are building their capabilities to identify and measure sustainability data, they may publish data less frequently than is ideally needed by firms, and regulations requiring standardised data have not fully bedded in. This is a known risk, and numerous initiatives are underway to find ways to tackle data quality and verification.[3] However, in the meantime, as firms structure and market sustainable funds they need to identify data limitations, address their significance and explain them clearly to end-investors. In the absence of such a control structure, incomplete and/or inaccurate data about an investee company may lead firms to classify it as sustainable when it is not.

Second, sustainable investing has a wide array of new terminology, and retail investors or other stakeholders may have strong personal views about what certain terms such as “impact”, “green” or “clean” mean. If the names of funds and any associated terminology in fund documentation are not clearly explained in the context of the specific fund, some end-investors who have a particular view of what counts as “sustainable” or “green” may conclude that the fund does not meet their definition and that it is therefore greenwashing. In such cases, even if it transpires that there has been no breach of a regulatory requirement, the firm(s) concerned may still suffer considerable reputational damage from any associated media coverage.

These considerations, together with the rapidly growing sustainable finance market and the evolving nature of the regulatory requirements surrounding it, lead us to the view that firms will need to take a broad and cautious view of what might constitute greenwashing.

Regulators are on high alert with regards to greenwashing. **The FCA issued a Dear AFM Chair letter (“the FCA letter”)** in July 2021 setting out guiding principles for managers of sustainable funds. The FCA has stated that whilst it supports innovation in the sustainable funds market, it has seen a number of poor-quality sustainable fund authorisation applications. Specifically, it found that applications often do not contain sufficiently clear information explaining their chosen strategy and how this relates to the assets selected for the fund. At times claims made about sustainability were unsubstantiated. The aim of the guiding principles is to help Authorised Fund Managers (AFMs) comply with existing requirements by ensuring that fund disclosures accurately reflect the nature of the fund’s responsible or sustainable investment strategy. Whilst the letter does not use the term greenwashing, in substance it is clear that this is the phenomenon it seeks to address.

Furthermore, in November 2021, the **FCA issued a discussion paper with proposals for new domestic Sustainability Disclosure Requirements (SDR DP)** and accompanying sustainable investment labels for investment products. The SDR DP proposes four types of disclosures for investment products and firms: a product-level labelling regime, a basic consumer disclosure and two detailed disclosures, one at the product level and the other at firm level.

The labelling regime intends to mitigate greenwashing via standardised terminology. The product-level consumer disclosure is intended to provide information about the key sustainability-related attributes of the product. The two detailed disclosures at product and firm level will build upon the Task Force on Climate-related Financial Disclosures (TCFD) disclosures and will require consideration of sustainability related risks in firms’ governance, strategy and risk management. Metrics and targets used to assess such risks will need to be disclosed alongside UK Taxonomy alignment and performance against targets. The FCA’s intention is for the guiding principles in the FCA letter to be factored into the disclosures proposed in the SDR DP.

Several of the EU’s sustainable finance regulatory initiatives, in particular the EU Taxonomy and the SFDR, are intended to mitigate the risk of greenwashing. The EU taxonomy serves as a classification system for which economic activities are environmentally sustainable. The SFDR requires funds to disclose various sustainability related parameters, which in turn drives their classification as an Article 6, 8 or 9 fund. The asset management industry expects further guidance from the European Commission and supervisory precedent from other national EU regulators around the implementation of SFDR once the SFDR level 2 regulations (Regulatory Technical Standards) take effect in January 2023. A serious concern for firms is having to re-label their funds as a consequence of supervisory intervention, which may result in significant reputational risk. Once there is sufficient supervisory precedent and examples of how supervisors think categorisation should work in practice, inappropriate categorisation could also lead to regulatory penalties. Most recently the European Securities and Markets Authority (ESMA) published its own Sustainable Finance Roadmap 2022-2024 which lists tackling greenwashing as a key priority.

Separately, the International Organization for Securities Commissions (IOSCO) has stated that setting regulatory and supervisory expectations for firms is fundamental to reducing the risk of greenwashing. It has also set out recommendations for practices, policies, procedures and disclosures for firms in this area.

Greenwashing can occur at various stages in an investor's journey with a firm. We have identified three such stages:

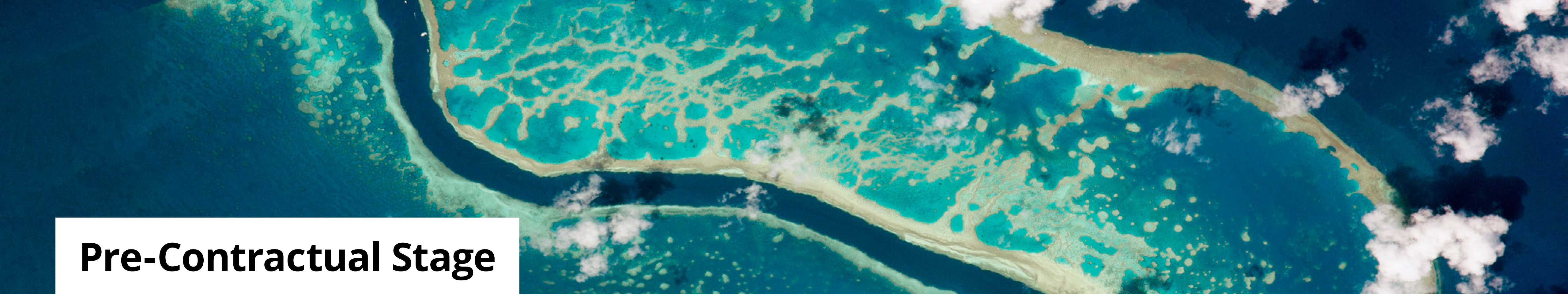
Stage #1
Pre-Contractual Stage

Stage #2
Post-Investment Stage and Ongoing Reporting

Stage #3
Complaints Handling

We identify the key challenges that firms face in mitigating greenwashing risk at each stage in the fund/product lifecycle[4], relevant regulatory requirements and guidance and the key actions they may wish to consider.

As this paper is mainly UK focused, the key regulatory requirements and guidance we consider are the guiding principles set out in the FCA letter and the SDR DP. We also refer to the EU's SFDR, given that it will apply to UK firms which market their products in the EU.



Pre-Contractual Stage

In the pre-contractual stage, a potential (or existing) investor becomes aware of a firm's sustainable fund offerings through documents such as the prospectus and KID. This is a crucial stage for firms in terms of communicating clearly about the nature and objectives of sustainable funds, because in most current business models, firms mainly communicate with investors either through this pre-contractual documentation and website disclosures or via third parties (such as platforms or IFAs). The lack of dialogue between the firm and the investor increases the potential for misunderstanding in an area of finance which is already complicated by rapidly evolving terminology which individual firms deploy in different ways, regulations that have not fully bedded in and vary significantly between countries and a wide range of investment strategies.

This section explores some issues for firms to consider to ensure that they communicate clearly with investors at this stage of the asset management journey. Clear communication is essential in reducing the risk of greenwashing.

Regulatory context

The FCA letter emphasizes the need for a fund's focus on sustainability to be reflected consistently in its name, stated objectives, documented investment strategy and holdings. It also expects firms to provide comprehensive information on their investment strategies and stewardship approaches. Portfolio managers are encouraged to consider whether an investor would reasonably expect the fund to hold the investments it does, given its stated objectives. Stewardship policies should be developed in compliance with COBS rules (COBS2.2B.5) and clarify how stewardship contributes to meeting the fund's sustainability objectives. The FCA's SDR DP proposes five labels for categorising funds:

1. Not promoted as sustainable.
2. Responsible (may have some sustainable investments).
3. Transitioning (low allocation to UK Taxonomy-aligned sustainable activities, with the intention of it increasing).
4. Aligned (high allocation to UK Taxonomy-aligned sustainable activities).
5. Impact (objective of delivering positive environmental social impact).

In addition, consumer facing disclosures aimed at retail investors will provide the most salient sustainability characteristics of products including the objective, strategy, proportion of UK Taxonomy-aligned sustainable investments, approach to stewardship and wider sustainability performance metrics. Detailed disclosures at product and firm level aimed at institutional investors would then require further granular information on various topics such as data limitations and assessments of sustainability risks, opportunities and impacts.

The SFDR requires several disclosures on firms' websites and in pre-contractual fund documentation. Website disclosures include sustainability due diligence (the principal adverse impacts of the firm's investment decisions) and sustainability risk (the potential impact of ESG risks on investment valuations). Remuneration policies must also be updated to account for the integration of sustainability risks and published on firms' websites. Where Article 8 and 9 funds are concerned, detailed disclosures are required on both websites and in pre-contractual documents on investment strategies, objectives, top holdings, due diligence, data sources and limitations to methodologies and data.

Sustainability data

Sustainability data is of vital importance as it underpins firms' regulatory disclosures, reporting on non-financial objectives, as well as investment decision making.

The role of boards

Firm boards have an important role to play in setting firm-wide sustainability data policies. The policies will steer a firm's analysis and oversight of sustainability data, which is particularly important in the current environment where there is little regulatory oversight of sustainability data and ESG ratings providers. It would be useful for sustainability data policies to cover the strategy for obtaining sustainability data e.g., what types of data vendors should be engaged, how often the engagement should be reviewed, to what extent should analysis on the data be conducted in-house and to what extent should it be bought in. Firm-wide policies could also cover how the process of obtaining, analysing and using the data is governed by senior management and how often the process should be reviewed. Given that investee companies are not currently providing complete or standardised data, firm boards should also consider how to incorporate any risks arising from insufficient data in their risk management frameworks, including their risk appetite.

Individual fund boards should scrutinise their funds' use of sustainability data to ensure it is aligned with firm-wide policies.

On an ongoing basis, both firm and fund boards should be made aware of limitations in data and what portfolio managers are doing to bridge the gaps. Firm and fund board members will need to appraise themselves of the various types of data and the challenges with availability in order to gain a sound understanding of what the issues are and how they might affect the firm's sustainable fund offering.

Regulatory context

Regulators are focused on ensuring that pre-contractual disclosures on websites and fund documentation convey accurate information to end-investors. Regardless of the type of sustainable investment strategy pursued, or of the regulations under which disclosures are being made, one key challenge for all firms is obtaining, analysing and using sustainability data to make investment decisions. If the data is inconsistent or incomplete, firms may classify certain investments as "sustainable" when they are not, leaving them exposed to claims of greenwashing.

In a speech in November 2020, the FCA emphasised the importance of ensuring that financial services firms' communications with end-investors about products and services are clear, fair and not misleading (in line with Principle for Businesses 7), and acknowledged the challenges posed by limitations in investee company data. The FCA aims to increase the availability of data through its new rules for mandatory application of the TCFD disclosures for premium listed issuers and asset managers. The rules apply to asset managers with more than £50bn under management, life insurers and pension providers with more than £25bn under management and premium listed issuers from 1 January 2022 with a first reporting deadline on 30 June 2023. Firms with assets between £50bn and £5bn will then become subject to the rules from 1 January 2023 with a reporting deadline of 30 June 2024. The EU aims to do the same through the Corporate Sustainability Reporting Directive (CSRD) which extends the Non-Financial Reporting Directive (NFRD) to all companies listed on regulated markets as well as large non-listed companies and requires more detailed sustainability disclosures. At the time of writing, the CSRD is likely to apply from 2024, with a reporting period of financial year 2023. The FCA is also considering the regulation of ESG ratings providers in due course in order to bring transparency to the methodologies used to create the ratings.

In the absence of such disclosures for the time being, firms face a variety of challenges in obtaining the sustainability data they need. Firms struggle to obtain complete data from investee companies, and what data they do receive is not standardised. Moreover, funds with internationally diversified portfolios will find that data is available for investee companies from certain countries but not for others.

Reliance on data providers

Firms therefore need to enhance their capability to obtain and analyse sustainability data. At present many firms rely largely on external ratings providers to provide them with information on the sustainability credentials of many companies. The methodologies used by these ratings providers are often opaque. In its consultation and subsequent final report on sustainability data and ratings providers IOSCO found a lack of transparency in methodologies and uneven coverage of products offered across geographies and industries. These providers are also currently unregulated – although this may change with both ESMA and IOSCO having called for regulation. Opaque methodologies and non-standardised ratings on sustainability credentials of investee companies further increase the risk of greenwashing by asset managers, as they use these ratings to inform investment decisions

Moreover, without appropriate data it may also be difficult for firms to measure whether sustainable funds which aim to have a positive impact on the environment are having the intended effect. This means that firms could either overstate or understate a fund's impact. Even if fund documentation and performance measurement processes are audited, lack of data will be a persistent issue in terms of measuring environmental impact until investee companies make complete and accurate disclosures.

Where possible, firms should also avoid relying on a single data provider and should look to obtain and compare data from a variety of different sources, to identify and, if necessary, resolve any discrepancies between them. Comparing data providers and the data they use will inevitably highlight differences, This means that firms should also consider how to enhance their ability to validate data received from providers. Third party sustainability data providers source data in varying ways and also make use of models to update values and at times use proxies for missing values. This is not to suggest that using proxies is the wrong approach, however firms themselves are ultimately responsible for how the data is used for investment decisions, for validating it and for disclosing limitations. The challenge is significant as most sustainability data providers supply in excess of 500 ESG data fields and a structured, formal approach is required to assess which data requires the highest level of verification.

Disclosing data limitations

Disclosure of data limitations is a key regulatory concern in relation to sustainable investing. SFDR requires disclosures on data limitations in pre-contractual documentation for Article 8 and 9 funds, whilst the FCA's SDR DP proposes disclosure of granular product level information on data limitations and methodologies, aimed at institutional investors. In addition, the FCA letter recommends disclosing in prospectuses instances whereby firms rely exclusively or largely on sustainability data provided by a third party.

Faced with these requirements, it is essential that firms specify data limitations in their pre-contractual disclosures and explain their implications for end-investors in the fund. Disclosures/disclaimers that set out the specific limitations in the data, alongside what action the firm is taking to address this issue (or a link to such information), are likely to be most useful for end-investors. As data can include unfamiliar jargon and complex metrics, the content in such disclosures should be presented in a way that is easily digestible by retail investors. Firms should avoid using general boilerplate data disclaimers, as these are likely to be viewed by regulators and other stakeholders as a "tick-box" approach to this issue.

The role of control functions

Since portfolio managers will be analysing data, determining investment strategies and making investment decisions on a daily basis, they will be first to become aware of data limitations. This information should be fed promptly to the control functions i.e. compliance and risk, so that they can determine whether effective due diligence is being carried out on third party data providers and ratings agencies, and whether certain strategies are viable in light of data limitations.

In our view, compliance can conduct periodic reviews of whether the requirements in firm-wide sustainability data policies are being observed and whether data disclosures are presented in a way that is appropriate for retail investors. Furthermore, in order to facilitate transparency for end-investors they should periodically review whether data disclosures are up to date as and when data availability changes and has different implications for non-financial performance.

Compliance and risk functions can also assist with creating procedures for performing governance and oversight on data procured from third parties. Regular collaborative efforts between the first and second lines of defence may be beneficial in conducting periodic reviews of which data providers are being used and whether this needs to change. Upskilling of the compliance/risk departments so that they understand key data points and the analytics around them will be crucial in facilitating important second line reviews.

An important role for the third line of defence i.e. internal audit, would be to do periodic reviews, on a more holistic level. These should look at whether the different parts of the firm are acting in accordance with sustainability data policies set by the board. Instances where this has not happened should be highlighted to portfolio managers and control functions and escalated in line with usual procedures.

Timeline of key regulations that will affect the availability of sustainability data

2021

01 Jan 2021
Premium listed companies are required to include a statement in their annual report for accounting periods beginning on or after 1 Jan 2021 setting out, on a comply or explain basis, their TCFD disclosures

10 Mar 2021
SFDR Level 1 became applicable

03 Nov 2021
The FCA published a discussion paper on its new “Sustainability Disclosures Requirement” for investment products

2022

01 Jan 2022
TCFD became applicable on a mandatory basis for UK asset managers managing assets more than £50bn and UK asset owners managing assets over £25bn

Standard listed companies and issues of Global Depositary Receipts (GDRs) are required to include a statement in their annual report for accounting periods beginning on or after 1 Jan 2022 setting out, on a comply or explain basis, their TCFD disclosures

Q2 2022
FCA consultation on “Sustainability Disclosures Requirement” expected

2023

01 Jan 2023
SFDR RTS (level 2) to become applicable

TCFD becomes applicable on a mandatory basis for asset managers with assets under £50bn and more than £5bn

30 Jun 2023
First reporting deadline for UK firms for which TCFD became applicable on 01 Jan 2022

2024

2024
Corporate Sustainability Reporting Directive (CSRD) to become applicable

30 Jun 2024
First reporting deadline for UK firms for which TCFD becomes applicable on 01 Jan 2023

Lessons learned from other industries

Work by regulators in other industries suggests that firms are right to be concerned about the quality of investee companies' sustainability related disclosures, and the risk that some companies are making unfounded or inflated claims about how sustainable they and their products are.

The UK's Competition and Markets Authority (CMA), working with other global regulators, **investigated the impact of green marketing** (by a wide range of sectors including food, beverages, beauty products and cleaning products) on consumers and found that 40% of green claims made online could be misleading. The CMA has said that this could mean "thousands of businesses could be breaking the law and risking their reputation". The CMA has stipulated that examples of misleading behaviour could include : (i) exaggerating the positive environmental impact of a product or service; (ii) using complex or jargon-heavy language; and (iii) implying that items are eco-friendly through packaging and logos when this is not true.

In response, the CMA published a number of documents, including a "Green Claims Checklist" – a list of statements to which a business should be able to answer "yes" before making a claim to be "green":

- The claim is accurate and clear for all to understand
- There's up-to-date, credible evidence to show that the green claim is true
- The claim clearly tells the whole story of a product or service; or relates to one part of the product or service without misleading people about the other parts or the overall impact on the environment
- The claim doesn't contain partially correct or incorrect aspects or conditions that apply
- Where general claims (eco-friendly, green or sustainable for example) are being made, the claim reflects the whole life cycle of the brand, product, business or service and is justified by the evidence
- If conditions (or caveats) apply to the claim, they're clearly set out and can be understood by all
- The claim won't mislead customers or other suppliers
- The claim doesn't exaggerate its positive environmental impact, or contain anything untrue – whether clearly stated or implied
- Durability or disposability information is clearly explained and labelled
- The claim doesn't miss out or hide information about the environmental impact that people need to make informed choices
- Information that really can't fit into the claim can be easily accessed by customers in another way (QR code, website, etc.)
- Features or benefits that are necessary standard features or legal requirements of that product or service type, aren't claimed as environmental benefits
- If a comparison is being used, the basis of it is fair and accurate, and is clear for all to understand

While this checklist is aimed at all consumer industries, firms could nevertheless use it as helpful starting point for assessing the completeness, accuracy and clarity of the disclosures they are required to make and adapt it to their specific needs.

Clear language and communications

The role of boards

The FCA, alongside many other financial regulators, has often been concerned about the language firms use to describe, market and otherwise communicate about their products. Communication is particularly significant in the arena of sustainable investing as it is a new landscape of unfamiliar terminology. Hence it is important, in order to prevent greenwashing, for fund-specific documentation and firm-wide sustainability related policies on websites to be specific, clear and easily digestible by both retail and institutional investors.

Firm boards will need to sign off on firm-wide sustainability and engagement policies. This may require careful consideration of the tone that will be used in such documents, the resources that are available for the sustainable fund offering and the firm's overall stance on sustainability. Fund boards on the other hand must ensure that the fund specific strategies being used by portfolio managers are aligned with these.

Regulatory considerations

The requirement for end-investor communications to be "clear, fair and not misleading" features in Principle 7 of the FCA Principles for Businesses and the FCA's Financial Promotion Regime (COBS 4). In a consultation published in December 2021 on its new Consumer Duty, the FCA has set out four key outcomes, as part of which it has reiterated a need for robust communication, but has gone one step further and highlighted the value of "consumer understanding". The FCA has stipulated that "firms will need to consider their overall approach to communicating information to make sure they equip customers to make effective, timely and properly informed decisions". In the context of greenwashing, this is a particular challenge if retail investors are unfamiliar with the terminology used in sustainable investing and yet need to be provided with sufficient information to enable them to understand what a sustainable fund is trying to achieve.

There is further scope for confusion if the fund range on offer is large, and funds have been given various proprietary names. This is because in the field of sustainable investing, certain terms such as "green" and "clean" (amongst others) are used regularly in fund names. Different firms might use different variations and combinations of such terms in naming their funds, and what one firm might mean by "clean" or "green" might be different to what another firm means by them. This will be confusing for retail investors that are comparing such funds and might give the impression that funds from different firms have the same objectives. The best way to alleviate such confusion is for fund prospectuses to be very clear about what funds are trying to achieve and the investment strategy used. The FCA letter has stipulated that the FCA will not authorise funds with sustainability related wording in their names unless it is clear that the investment objective matches the name.

> "… it is not the FCA's role to dictate where firms invest. But we need to make sure firms describe their strategies clearly to consumers. Firms must not make misleading claims about the ESG credentials of their products."
>
> **FCA speech, November 2020**

The FCA SDR labels and the SFDR Article categories may also assist with reducing the scope for confusion as the definitions of the labels/Articles are standardised and two funds from different firms that display the same label/Article categorisation will give retail investors a basis for comparison. However, in our view firms should not take too much comfort from this, given that the definition of what can be included in these categories is broad. This means that two quite different funds could still be put in the same category.

Firm-wide information

The FCA's SDR DP proposes firm-level disclosures for firms that use the proposed Responsible, Transitioning, Aligned or Impact labels. This demonstrates the FCA's interest in a holistic firm-level approach and the FCA is likely to require firms which use these labels to meet a higher threshold for compliance in areas such as governance, systems and controls, identifying how ESG considerations are integrated into investment processes to minimise risks, and stewardship. Whilst the format of these firm-level disclosures is not yet finalised, portfolio managers and marketing/sales functions should consider how best to set out the firm's approach in these areas in relevant, firm-wide policies.

It appears to be common practice for firms that offer sustainable funds (including those not subject to SFDR) to have a sustainability policy or statement on their website. However, in some cases it appears that firms have provided several different sustainability documents including for example, their framework for sustainable investing, their annual sustainability report, a sustainability policy and a document setting out their historical commitment to sustainability. A retail investor who, having read the prospectus, might be looking for more information about the firm's approach to sustainable investing might find it difficult to navigate a website that has so many documents.

While it is good to provide information on the different aspects of a firm's sustainable investing agenda, firms may want to direct retail investors towards a main overarching document which sets out in clear and accessible language what sustainability is and what it means for the firm, its fund offering, and its end-investors. In this type of overarching document, firms should endeavour to provide clear and relevant information which allows both retail and institutional investors to make informed decisions about the sustainable funds on offer. Below are some examples of information to promote end investor understanding and prevent the perception of greenwashing:

- The firm's definition and interpretation of sustainability and how this applies to the firm's fund offering.
- Clear definitions of all relevant SDR labels and SFDR categories and other terminology used by the firm in the context of sustainable investing, and what these mean for objectives, investment strategies and impact on sustainability-related issues.
- A clear explanation, potentially in the form of a table or chart, of which funds and sub-funds fall under which SDR labels and SFDR categories.
- Information on the distinction between funds that integrate sustainability considerations into their mainstream investing, and those funds that go beyond this and have sustainability objectives – and which specific funds in the firm's fund range belong to each of these categories.
- Information on stewardship commitments and how engagement with investee companies informs investment decision making.
- Information on data sources and data limitations, and what the firm is doing to address such limitations.
- The type of governance and oversight on sustainable investing.
- Contacts for end-investors.

Firm-wide information and policies on websites will empower end-investors by providing them with context, key definitions and information about the firm's overall approach to sustainable investing. However, if claims of greenwashing arise in relation to certain sustainable funds, regulators will review fund-specific documents and disclosures in the first instance. It is therefore essential for fund-specific documents (which we discuss further below) to be sufficient on a stand-alone basis in terms of equipping end-investors with the key information they need about sustainable funds.

Fund-specific documents and disclosures

The FCA's proposed labelling regime for funds has been informed by research findings suggesting that retail consumers are strongly influenced by what they consider to be objective and reliable product labels. The FCA is particularly interested in objective and descriptive labels based on quantifiable, measurable metrics and intends to propose quantifiable thresholds for the labels in due course. Firms that use the Responsible, Transitioning, Aligned or Impact labels will need to ensure that they have clear, objective and measurable justifications for doing so. Portfolio managers and compliance/risk functions should ensure that relevant staff are trained on the prescribed technical thresholds under each of the proposed labels, so there is a sound in-house understanding of the FCA's expectations.

In addition, portfolio managers and marketing/sales functions should ensure that the proposed consumer-facing disclosures which cover the salient sustainability-related characteristics of funds are phrased in a way that they are easily understood by less sophisticated end-investors. The FCA's proposals for a new Consumer Duty, which is likely to apply from April 2023, emphasize the regulator's focus on consumer understanding i.e., communications not only being clear, fair and not misleading, but also being reasonably likely to be understood by consumers[5].To this end the FCA is considering how best to explain key sustainability related terminology within disclosures and will provide guidance in due course. The FCA is also considering potential templates for consumer-facing disclosures. Templates are likely to assist with mitigating greenwashing risk, however portfolio managers will still be responsible for ensuring that objectives and strategies are worded in an accessible way.

As part of the Consumer Duty, the FCA has also proposed that firms should carry out tests to determine whether consumers actually understand communications in practice. Testing should be proportionate and take into account the type of communication, its purpose and context and the needs of consumers. With regards to greenwashing, firms may want to see how groups of end-investors interpret and understand their fund-specific documentation, particularly in relation to sustainability objectives.

In the meantime, while the FCA is consulting on its proposals in this area, firms should consider the following good practices in relation to fund- specific documents.

- Fund prospectuses are likely to focus on fund-specific information. However, both retail and institutional investors may also benefit from high-level descriptions of what certain labels, categories and terminologies mean and what the firm's approach to sustainable investing is. Prospectuses could include links to firm-wide sustainability policies that house such information. Suggestions on what such policies could contain have been provided in the "firm-wide information" section above.

- Fund documentation pertaining to specific funds or fund ranges should use the same language and definitions as those used in firm-wide policies, and information in both locations should be consistent – this is so that end-investors looking for further information are able to follow a clear thread of information.

- Fund documents should contain specific data limitation disclaimers and any pertinent information regarding issues that might hinder the fund from achieving the environmental impact it promises – this will ensure that if environmental objectives are not met or delayed, end-investors have an understanding of the issues that may have caused this.

- If specific metrics will be used to measure the fund's non-financial performance, they should be explained in a non-technical manner – the objective of this would be to empower the end-investor to be able to determine for themselves, at least to an extent, whether environmental objectives are being achieved.

- Fund specific documentation should provide comprehensive information on the fund's objective and the strategies that will be used to achieve it.

- It would also be useful to provide potential future scenarios in prospectuses depicting how plausible future events may affect the fund's ability to achieve environmental objectives. Again, this will empower the end-investor in terms of having an understanding of the issues that might affect the fund's ability to achieve its objectives.

The role of control functions

Where website communication and fund specific documentation are concerned, there is a clear role for the compliance function. Whilst reviewing and signing off documents, compliance should ensure that documents can be easily understood by end-investors and that there is enough evidence for any claims which are made regarding the fund's non-financial objectives and any associated financial returns. Compliance could also flag whether there is a risk that the language used may convey a message that is exaggerated, or not aligned with the firm's overall tone or approach to sustainability. It would also be worthwhile for compliance functions to do a spot check on the consistency of information on websites and in prospectuses and whether end-investors can easily follow a trail of information.

In order for compliance to do these roles appropriately, staff will need to be trained in sustainable investing and related investment strategies and terminology. Internal audit can contribute an additional layer of governance by reviewing not only a sample of documents, but also a sample of previously completed compliance monitoring. This will help with arriving at a holistic view on whether documents are being drafted in line with firm-wide policies and whether the second line of defence is able to pick up on outliers.

Investment strategies

The role of boards

Firm boards will want to consider carefully the firm-wide strategy for sustainable investment. This might include consideration of what long-term fund performance may be in light of uncertainty around climate events and lack of evidence around financial returns associated with sustainable investing. For example, the board may decide that none of the firm's sustainable funds should invest in certain sectors, or that specific engagement will be undertaken in certain sectors rather than divesting. This will need to be made clear in firm-wide policies but must also be incorporated into to fund-specific strategies and explained in fund documentation.

Regulatory considerations

Regulators have not been prescriptive on what types of investment strategies funds can use to promote sustainability and, as regulators want to encourage growth and innovation in this area, we do not expect their stance to change. However, regulators will be paying keen attention to whether pre-contractual documentation provides enough information for end-investors to gain a good grasp of what the fund is trying to achieve and how. A crucial starting point for portfolio managers is to ensure that investment strategies and holdings are appropriate to the names of funds.

Investment strategies

Firms are currently using a variety of different investment strategies for sustainable investing, including exclusions (or negative screening), best-in-class investing, thematic investing and impact investing. Firms should consider the following points in order to mitigate the risk of greenwashing associated with different investment strategies.

"Best-in-class" investing sets certain thresholds for sustainability characteristics or ESG ratings/scores pertaining to investee companies and uses these to determine investments.

As previously discussed, methodologies for sustainability ratings are not currently fully transparent, and so where firms are using best-in-class strategies they can help mitigate the risk of greenwashing by making clear the limitations of using sustainability ratings for investment decision making. Boards will however have to satisfy themselves that it is appropriate to use sustainability ratings for this purpose, despite these limitations. They should also be prepared to explain to supervisors how they have done so.

"Exclusion" or "negative screening" strategies either completely exclude certain sectors or stocks, or only permit investment in companies with specified levels of revenue derived from unsustainable activities. As an example, a fund might exclude companies that derive more than 5% of their revenue from oil drilling. Portfolio managers should also provide clarity (subject to availability of information) on whether exclusion or inclusion is based solely on the activities of the company itself or whether it takes into account other entities in its supply chain or with which it partners. This may prevent greenwashing claims in scenarios whereby end-investors discover through media or other channels that certain entities associated with the investee company do not follow the same standards.

"Impact investing" strategies are those that aim to have a positive impact by achieving specific (in this case environmental) objectives such as promoting access to renewables. Conversely, "thematic investing" is a strategy that picks stocks based on predicted macro-level trends. Stocks are not chosen based on a sector or region but rather on their alignment to the specific themes such as low carbon energy. Where thematic and impact investing are concerned portfolio managers should endeavour to be very specific about what the fund's objectives are and on what basis stocks are chosen. It would also reduce the likelihood of greenwashing claims if fund specific documents are clear about the time horizon in which objectives might be achieved and whether achievement of the objectives is contingent on certain events transpiring in the future.

Companies that are currently engaging in unsustainable activities, but which are investing heavily in the transition towards more sustainable operations pose particular challenges. Funds may be investing in such companies in order to direct capital towards an area which is likely to make the greatest contribution to transitioning to a more sustainable economy. However, if end-investors are not made aware of this in advance, they might conclude that a sustainable fund is greenwashing because it invests in companies which are conventionally (and currently) considered to be damaging the environment. Clear disclosures by portfolio managers of investment strategies in pre-contractual fund documents are key to addressing this concern. However, firms should also consider giving information about how the operations of these types of companies are evolving, as part of performance reporting.

The FCA's new labelling regime may help to address this challenge by introducing a "Transitioning" label for funds that are investing in such stocks. However, portfolio managers will still need to ensure that they have done adequate due diligence and analysis to support the claim that the companies are transitioning in a manner that is aligned with the fund's stated objectives.

The role of control functions

As mentioned previously, compliance/risk functions could provide their opinion on whether certain investment strategies are viable, given data limitations in relation to the underlying holdings. Compliance functions could also monitor whether holdings and allocation percentages in funds are compatible with the fund's stated objectives. Where there might be room for doubt or confusion, a collaborative effort between the first and second lines of defence might be beneficial in making investment strategies clearer on fund documentation or adjusting allocations as appropriate. The compliance/risk functions could also monitor whether holdings and strategies are consistent with the firm-wide sustainable investment strategy set by boards and this could also be an area of focus for any internal audit reviews.

Conflicts of interest

The growing consumer demand for sustainable products and increasing market values mean that there are significant financial rewards available to firms and individual portfolio managers from selling sustainable funds/products. This can lead to firms and individuals feeling pressured to communicate positively about their product offerings to take advantage of investor demand and maximise their revenues.

In the introduction, we discussed that whilst greenwashing is often seen as a deliberately misleading act, it might also arise from incomplete data and unclear language in disclosures. Regulators will be particularly concerned about cases where they judge that firms have intentionally misled investors about the nature of the products. Consequently, firms should ensure they can evidence any sustainability related claims and that they have the right culture and processes to allow staff to speak up if they have misgivings about particular claims being made about a fund.

As discussed throughout the paper, firms will benefit from having strong governance structures and oversight from boards, senior managers and the control functions, to identify and manage the inherent conflict of interest between remaining competitive in a profitable and growing market for sustainable funds and providing accurate information to end-investors. Firms should place themselves in the shoes of end-investors and consider whether the claims they are making are clear, fair and not misleading. Alongside many of the specific steps discussed in different parts of this paper, a consumer centric firm culture is likely to prove particularly important in mitigating the risk of greenwashing.

SFDR and greenwashing

Whilst SFDR is an EU initiative, it will apply to UK firms that intend to market their funds to EU customers. UK based firms will also have to comply with the FCA's proposed SDR and labelling regime for funds marketed in the UK. Where firms are required to implement both the SFDR and SDR, they should carefully consider how the various categories and labels should be displayed to avoid confusing end-investors. Furthermore, they should be particularly mindful to address any difficulties that might arise while implementing requirements set out by the different regimes on the same set of funds. In its SDR DP the FCA has suggested how its new five-pronged labelling regime might map onto the SFDR's three fund categories The FCA has described this mapping as "indicative" and we expect further clarification later this year. In our view, clear and descriptive fund-specific information will be the antidote to end-investor confusion that may arise from the same fund displaying labels and categories from different regimes.

SFDR introduces a variety of fund categories which will be unfamiliar to both retail and institutional investors. Portfolio managers and marketing/sales teams may decide to include within their firm-wide documentation on their website a summary of the SFDR including what Article 6, 8 and 9 categories mean and exactly which of firm's funds fall into which category. Prescribed pre-contractual documents for Article 8 and 9 funds, which may not have the space to provide general SFDR definitions, could then refer back to the general information on the website for those end-investors who are seeking further context.

The hurdle for classifying a fund as Article 9 (those that pursue a sustainable objective) is higher than for Article 8 (those that promote environmental or social characteristics). The broad definition of Article 8 funds has caused some in the industry to **question** whether many of the funds currently labelled as Article 8 have any substantive environmental characteristics and may be an example of greenwashing.

Following this commentary, the European Commission published a **Q&A** on SFDR in July 2021, in which it addressed concerns around possible greenwashing in Article 8 funds. The Q&A confirmed that, for Article 8, SFDR does not prescribe minimum investment thresholds, investment targets, investing strategies tools or methodologies and hence Article 8 funds can pursue a combination of styles including screening, exclusion, using best-in-class, or thematic investing. The European Commission clarified that the term "promotion" includes direct or indirect claims as well as "an impression" that the investments consider environmental/social characteristics in any and all marketing communication. This clarification may reduce some of the concerns around greenwashing in Article 8 funds. However, firms need to be mindful of the fact that even if a fund is able to justify why it has been categorised as Article 8, it could still be subject to claims of greenwashing if it transpires that the management of the fund is not consistent with the sustainability claims it makes in fund-specific documentation. In April 2022, Natasha Cazenave, Executive Director at ESMA, further **reiterated in a speech** that whilst SFDR is primarily intended to be a transparency regulation, both fund managers and investors are increasingly treating the disclosure categories as product classification. She also indicated the need for ESMA to provide further criteria for categorisation as Article 8 because "Article 8 products have been called out for less ambitious environmental and social characteristics".

Water-tight fund-specific documentation is particularly important in an environment where there is almost no precedent for how supervisors expect categorisation to work in practice. At the time of writing, most national supervisors and the European Commission have yet to explain how they will interpret and enforce the SFDR categorisations in practice. The European Commission's main **steer** since SFDR Level 1 rules came into effect on 10 March 2021 is that the regulation is "not intended to be a marketing tool".

This comment is aligned with the SFDR's purpose as stipulated in the regulation itself i.e. that its objective is to strengthen investor protection for end-investors by reducing information asymmetries and improving disclosure regarding sustainability related matters. In our view, the European Commission's remark indicates that where funds are categorised as Article 8 or 9, regulators will be looking closely at details in fund documentation to determine whether the categorisations are justified or whether they are being used purely as a marketing tool. The main **review** on how implementation has proceeded has come from the Dutch Authority for Financial Markets (AFM) which reviewed fund-specific documentation for 46 funds that were classed as either Article 8 or 9. The AFM found that information provided in documents required under Articles 8 and 9 was often too general and the objectives of the funds were too vaguely defined. In particular the AFM stated that for funds that had classified themselves as having sustainable investing as their objective (Article 9), it often appeared that portfolios were not exclusively aimed at sustainable investing. This had not been made clear to end-investors.

Third party distribution

The role of boards

Firm boards should approve the overall strategy and parameters for how the firm works with third party distributors such as IFAs and help set the firm's overall risk appetite for engaging with them. These should include the level of due diligence the firm must undertake in scrutinising third parties, their expertise in relation to sustainable products and how the third parties will be kept informed about the firm's sustainable fund offering.

Individual fund boards should periodically review whether up to date fund-specific documentation is made available to third parties in a timely manner. Fund boards should also periodically review whether there is evidence of problems with third parties not understanding the sustainability characteristics of specific funds and, if there is, what action is needed to address this.

Regulatory considerations

The involvement of third parties, such as IFAs, in the distribution of a firm's sustainable funds to end-investors means that firms depend on the third party to provide end-investors with accurate information. PROD 3.2 of the FCA Handbook requires manufacturers of financial products that are distributed through other firms to determine the needs and characteristics of the end clients. Furthermore, a manufacturer must make available to distributors all appropriate information on the financial product and the product approval process, the identified target market of the product and appropriate channels for distribution. Manufacturers may consider, with regard to each distributor channel or type of distributor, what information the distributors of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs.

PROD 3.3 requires that distributors (such as IFAs) must obtain materials from manufacturers of funds to understand the financial products they intend to distribute and should ask the manufacturer for additional training or information where this seems necessary to understand the financial product.

As part of its SDR proposals, the FCA is minded (subject to consultation) to require IFAs to consider sustainability matters in their investment advice and ensure their advice is suitable (taking account of the end-investors' sustainability related needs and preferences). In addition, the FCA is contemplating disclosures for IFAs, without specifying what form they will take.

Key considerations

Firms that have a business model that relies heavily on IFAs to market their funds should be pro-active in ensuring that accurate and up to date fund documentation is readily available to them. This will ensure that if new sustainability data has emerged that has resulted in a change in certain objectives and strategies, IFAs are aware of this in good time. Firms should also be pro-active in providing additional training where they think it might be required e.g where new types of investment strategies are concerned or where there are particular uncertainties around non-financial performance. Staff at IFA firms may need training to understand the new sustainable investing terminology, how investment strategies work and how they are applied across the various sustainable funds. Regular conversations with firms and staying abreast of any fund updates might assist IFAs with ensuring that they understand a fund's limitations.

Post-Investment Stage and Ongoing Reporting

Role of the board

The role of firm and fund boards continues at the post-investment and on-going reporting stage. Where on-going reporting is concerned, fund boards will want to ensure there is a consistent strategy around which non-financial metrics must be used and how they must be displayed. Fund boards need to ensure that they are obtaining the requisite information about non-financial metrics and reporting from portfolio managers so that strategies can be set around how the fund prefers to do this. In cases where new sustainability data on investee companies in funds emerges unexpectedly from various sources and could potentially affect the fund's objectives, firm boards may want to consider whether to employ a strategy of third-party assurance on the data. Both firm and fund boards must also receive regular MI on the number of greenwashing complaints that have arisen, and if the number is large and/or increasing, should consider commissioning a root cause analysis and, if need be, review existing firm-wide policies on sustainable investing.

Regulatory Context

SFDR requires periodic disclosures for Article 8 and 9 funds which set out how environmental/social characteristics have been promoted (for Article 8 funds) or how sustainable objectives were being attained (for Article 9 funds), declarations that no significant harm of sustainable objectives has taken place (Article 9), the fund's top holdings and actions taken to achieve objectives.

The FCA letter suggests firms should provide ongoing performance reporting on how well a fund is meeting its stated objectives. Relevant information that has been used to facilitate investment decisions should also be easily available on an ongoing basis. The letter also suggests that the firm should apply appropriate resources in pursuit of a fund's stated sustainability objectives, and the profile of its holdings should always be consistent with its disclosed objectives.

> "If consumers understand the basis on which sustainability claims are being made by AFMs, and can monitor whether those claims are being met, this should improve the functioning of the market."
>
> **FCA Dear AFM Chair Letter, July 2021**

Key considerations

Post-investment sustainability data

The challenges that arise with obtaining and analysing data are set out in the previous section. A related but separate point is monitoring the emergence of new data from investee companies in the post-investment stage of an end-investor's asset management journey. As discussed previously, sustainability data from investee companies is often incomplete or available infrequently. Therefore, investment decision making in sustainable funds will always be to some extent be based on incomplete data. As such, it might be the case that data emerges that affects a fund's ability to deliver on its environmental objectives or deliver within the time horizon stipulated in fund documentation.

It is therefore essential that firms have in place systems that allow them to scan and identify information that emerges about the companies in which their sustainable funds invest, and also have the requisite relationships with data providers that can promptly update them. Firms should be aware that such information can emerge from a variety of different sources (such as reports from charities, think-tanks and universities) and channels (including social media).

If a situation arises whereby a sustainable fund cannot meet its objectives, it is important for firms to be on the front foot and send an update to end-investors or relevant intermediaries as soon as possible. In some cases, this will need to explain what action the firm intends to take and the effect these actions might have on financial returns and non-financial performance. If the availability of new data results in a situation whereby it becomes difficult to deliver on the fund's objectives, portfolio managers will need to consider whether this will affect the fund's SFDR categorisation and/or proposed SDR labels, make changes where required, pro-actively update websites and fund documents, and alert end-investors and intermediaries.

Occasionally, new data or information may come to light that indicates that an investee company may be pursuing unsustainable practices or is not following through on its sustainability commitments.

Where this new information suggests that an investee company is no longer eligible for inclusion in a particular fund, the portfolio manager should assess how this will affect the fund's ability to deliver on its sustainability objectives. While in some cases engagement and active stewardship may be appropriate, in others this may ultimately require divestment. Any decision, and the new information that has triggered it, should then be reflected in any fund documentation and be promptly communicated to end-investors and intermediaries, so they are kept up to date on any changes to the fund's holdings and/or weightings and what this means for the fund's objectives.

The role of control functions

Where a fund changes its holdings due to new information coming to light, compliance functions should review communications to ensure that the investors are informed of any decisions in an appropriate and in a timely manner. Compliance should check whether any decisions regarding changes in investments have been explained clearly and that no exaggerated claims have been made regarding these changes. Compliance will also want to satisfy themselves that appropriate due diligence has been done on the sources via which new data has been received. Internal audit has an important role in relation to end-to-end reviews of funds which include an assessment of whether claims, strategies and ongoing reporting for funds are consistent.

Ongoing reporting

The FCA letter and the SFDR stipulate that end-investors should be able to assess whether a fund is achieving its objectives on an ongoing basis. COLL already requires authorised fund managers' reports to contain, among other things, information on performance, gains and losses, the investment objectives of the authorised funds, the policies and strategies for achieving the objectives, a review of the investment activities during the period to which the report relates, and information about important changes. However, where sustainable funds are concerned, portfolio managers will need to take extra care to determine the right metrics to use to illustrate non-financial performance. These metrics are not standardised and, depending on what the fund is trying to achieve, may be complex and technical.

Illustrating the fund's sustainability related performance through clearly defined metrics in a way that is easy for both retail and institutional investors to digest may prevent greenwashing claims from arising, as end-investors will be able to understand what progress the fund has made in achieving its objectives. This process should be led by portfolio managers and reviewed by compliance/risk functions. The FCA letter suggested that non-financial outcomes must be reported on in a measurable and quantifiable way and its SDR DP indicated that it is in the process of creating standardised metrics for measuring such outcomes.

Non-financial aims which are difficult to quantify could be supported with examples of actions taken by investee companies and investment decisions taken by portfolio managers in pursuit of these aims, so that measurable actions can be demonstrated to end-investors. This would be particularly useful where the firm is engaged in proactive stewardship; end-investors would benefit from knowing what actions have been taken by portfolio managers to guide the decisions of investee companies. This is consistent with the SFDR's requirement to report on actions taken to achieve sustainable objectives or promote environmental characteristics.

Portfolio managers should provide information in a way that is succinct and, where possible, allows clear lines to be drawn between actions and results. If non-financial performance is falling short of expectations, or certain sustainability objectives are not currently being met, portfolio managers should consider providing explanations as to why this is and what is being done to improve things.

The role of control functions

As with other disclosures, compliance has a clear role to play in conducting periodic formal reviews that ongoing reporting documents are reporting performance accurately. Compliance will want to perform spot checks of performance data included in ongoing reporting documents against internal performance data. A compliance department that has the right technical knowledge can also identify where non-financial performance is depicted in a way that may be unclear.

Complaints Handling

Regulatory context

The FCA DISP rules that apply to asset managers define a complaint as "an expression of dissatisfaction, whether justified or not, from, or on behalf of, a complainant about the provision of, or failure to provide a financial service...which alleges that the complainant has suffered (or may suffer) financial loss, material distress or material inconvenience".

DISP also requires that the subject matter of complaints is assessed fairly, consistently and promptly, and that the same consideration is given to whether the complaint should be upheld and whether and what redress should be provided. There are time limits for responses; responses to complainants should be fair, clear and not misleading; and complaints handling policies must be maintained.

Greenwashing complaints could arise in a number of ways. It could be the case that it is not clear to end-investors whether sustainability objectives are being met because investment strategies and time horizons have not been explained properly in prospectuses, or because non-financial performance reporting is too technical. Greenwashing complaints are unlikely to trigger the "financial loss" aspect of the FCA's complaint definition as the claim would essentially be about the complainant maintaining that the product claimed a greater environmental impact than it is able to deliver (or has delivered).

"Material distress" would be triggered if the end-investor appears to be genuinely affected at an emotional level – this would be a matter of judgement by the firm or the Financial Ombudsman Service (FOS) in cases where the firm or end-investor refer the complaint. The most likely scenario is that the complaint definition is triggered under "material inconvenience", which might occur if the end-investor asks for their investment to be moved to a different fund or firm, which might require time and effort. Even if at a technical level, greenwashing complaints fail to trigger the current FCA definition for complaints, we expect that firms will give serious consideration how to address end-investors' concerns and improve operations internally as greenwashing is a key regulatory concern. Separately, if various SFDR categories and SDR labels that have been used are not explained to end-investors properly, they may conclude that funds are more sustainable than they actually are. It might also transpire that the media may criticise certain funds for holding stocks that are currently transitioning away from unsustainable practices – end-investors who do not understand this type of strategy and have not read relevant disclosures may potentially complain. If greenwashing is taking place, this is likely to become clear over time when ongoing reporting does not match the claims made by funds in fund specific documentation and will prompt complaints.

Currently there is no specific guidance from the FCA or the FOS on how firms should deal with complaints about greenwashing. In order to investigate complaints about sustainable funds thoroughly, compliance functions will need to ensure they have expertise on sustainability data and non-financial performance metrics to determine whether objectives are being met, and whether ongoing investment decisions are aligned with the stated aim.

Key considerations

Given the rapid growth of the sustainable funds market, and the associated risk of greenwashing, the FCA will expect firms to have robust processes in place to handle greenwashing related complaints. However, firms may face some challenges in how they handle initial claims of greenwashing. To begin with, compliance or the relevant function handling complaints within the firm will need to determine whether, and to what extent, greenwashing has occurred, and the reasons for it. This could include an investigation of whether communication in fund documentation and websites was clear and appropriate or whether there was exaggeration, and whether the sustainability data on which investment decisions, objectives and strategies were based had some serious deficiencies and whether this was disclosed to end-investors.

A key consideration for firms would be what the compensation should be for such complaints i.e. whether or not it should be monetary and, if monetary, then how much. The FOS has provided some guidance and case studies on how material distress or inconvenience have been compensated in the past with remedies ranging from a simple apology to an award of £5000 or more for instances of extreme distress. The case studies suggest that some factors firms should look at are whether the distress/inconvenience amounted to minor irritations that did not affect the complainant's daily life, and whether there was a significant ongoing impact on them which affected their lifestyle or affected them psychologically on an ongoing basis. This might be particularly complex and subjective in greenwashing claims as the distress/inconvenience caused to the end-investor is likely to depend on how they interpreted the objectives of the fund and the firm's role in this, and the particular set of beliefs the end-investor has on sustainability. Financial compensation is a less likely outcome for firms in this area than reputational damage. In many cases, end-investors may ultimately require firms to apologise and commit to improve the sustainable investing methodology in their products and/or their manner of marketing.

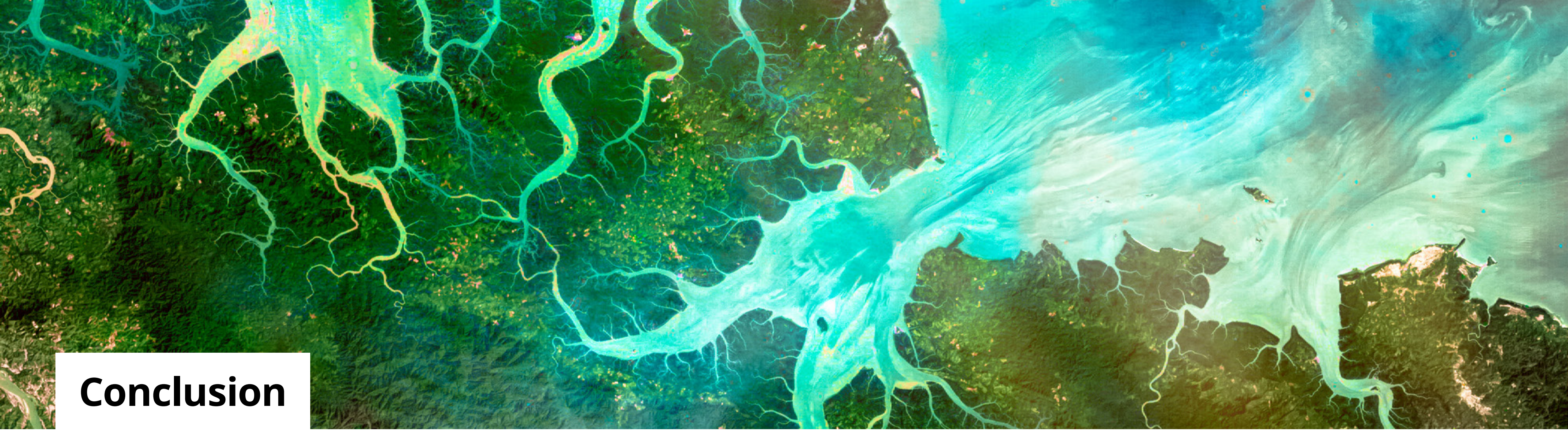
To aid with such complaints, compliance or other relevant departments should consider creating guidance or criteria to investigate claims of greenwashing and judge whether it has occurred. Any complaints of greenwashing should be handled on a case-by-case basis. For example, if a perception of greenwashing has arisen because a fund is only partially achieving the impact it had intended on sustainability related matters, but is not going far enough in doing so, there might be a scope for discussion within the firm, and between portfolio managers and compliance specifically, around whether the approach or investment strategies can be amended, or whether the expected time horizon for achieving certain objectives needs to be amended, to prevent further instances of similar complaints.

Firms can foster trust with end-investors by giving a clear account of the investigation and shedding light on why greenwashing did (or did not) occur, or why there was an appearance of it occurring, alongside details of any remedies. Fostering trust in this way may go some way in ensuring that end-investors rely on information provided by the firm more than the media or public opinion.

Given the regulatory interest in greenwashing, compliance staff, or staff in other relevant departments, should amend their compliance monitoring procedures to include periodic monitoring of all fund documentation to determine whether greenwashing is occurring or is likely to occur in any of the sustainable funds on offer.

It is common practice in financial services firms for compliance teams to impose breaches or penalties on portfolio managers when complaints against them are upheld. It will be important for firms to be proportionate and considered in respect of upheld complaints about greenwashing. They will want to strike the right balance between encouraging innovation and ensuring that any instances of greenwashing are taken very seriously and dealt with appropriately. A key determinant of the level of breach or penalty levied should be whether the greenwashing was deliberate or inadvertent. If greenwashing has arisen due to lack of clarity in language, data limitation or another reason, training could be provided to relevant individuals so that they can understand the issues at hand. If the greenwashing is deliberate, it should be handled in a manner similar to other serious instances of misconduct.

If the firm has a conduct committee that oversees complaints, it could carry out periodic reviews of the number and nature of greenwashing complaints and consider what they imply for the accuracy and clarity of fund disclosures. Given that greenwashing is likely to be a high profile issue for some time, looking at greenwashing complaints in isolation outside of the business-as-usual complaints process and conducting thorough root cause analysis might allow various stakeholders including portfolio managers, compliance and conduct committees to manage the relationship and take charge of the narrative with end-investors, the media, and regulators. Regular oversight of the trend of greenwashing complaints may also help the firm identify promptly whether there is a systemic greenwashing issue which requires large-scale remediation.



Conclusion

Greenwashing is conventionally seen as an act of deliberate misconduct. However, greenwashing (or claims of greenwashing) can also arise for reasons such as incomplete data or new and unfamiliar terminology, and firms will need to incorporate controls against this happening into their overall risk management frameworks. Greenwashing is high on regulators' agendas and new disclosure regimes are intended to foster trust in sustainable investments and facilitate efficient capital allocation in the long run.

Thorough fund documentation that draws clear links between fund names, objectives and strategies, and is in turn backed by clearly written and comprehensive firm-wide policies is at the core of mitigating greenwashing risk. However, a collaborative effort between portfolio managers, marketing/sales functions and compliance/risk functions is required to ensure that any misalignment between objectives and strategies, and potential for confusion and exaggeration, are identified and addressed promptly.

Incomplete sustainability data is likely to remain a key challenge for some time. Clear disclosures about limitations and actions being taken to address these limitations are likely to facilitate clarity for end-investors. However, firms must be careful not to rely unduly on general disclaimers. Fund-specific data limitations in disclosures are likely to go further in terms of mitigating greenwashing risk.

Firm boards need to be aware of these challenges and should be given appropriate MI regarding how greenwashing risk is being tackled throughout the pre-contractual, post-investment and complaints handling phases. This includes MI on how many complaints are arising, and how they are being dealt with. This may assist boards with assessing whether their firm-wide sustainability policies are appropriate.

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Endnotes

1. For the purposes of this paper, we define sustainable funds as those that seek to have a positive environmental impact, in addition to a financial return.
2. "SFDR Article 8 and 9 Funds: 2021 in Review", Morningstar Manager Research. © 2021 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; (3) does not constitute investment advice offered by Morningstar; and (4) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. Use of information from Morningstar does not necessarily constitute agreement by Morningstar, Inc. of any investment philosophy or strategy presented in this publication.
3. https://www.cityoflondon.gov.uk/assets/Business/digital-sandbox-sustainability-use-cases-methodology-and-insights-july-2021.pdf
4. This paper does not consider the firm's disclosures about the sustainability of its own operations. Many firms have committed to a net zero transition under the Net Zero Asset Managers initiative. The UK government has also indicated that disclosure of transition plans is likely to become mandatory and the FCA has stated its intention to "clarify expectations" around net zero transition. Greenwashing could potentially occur if firms misrepresent their performance against their published net zero plans.
5. In the context of this paper "consumer" as defined in "A new Consumer Duty" can be taken to mean retail investor

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