LEGAL DEVELOPMENTS RELATING TO GREENWASHING

UNIVERSITY OF LUXEMBOURG
8TH INCLUSIVE AND SUSTAINABLE FINANCE RESEARCH CONFERENCE

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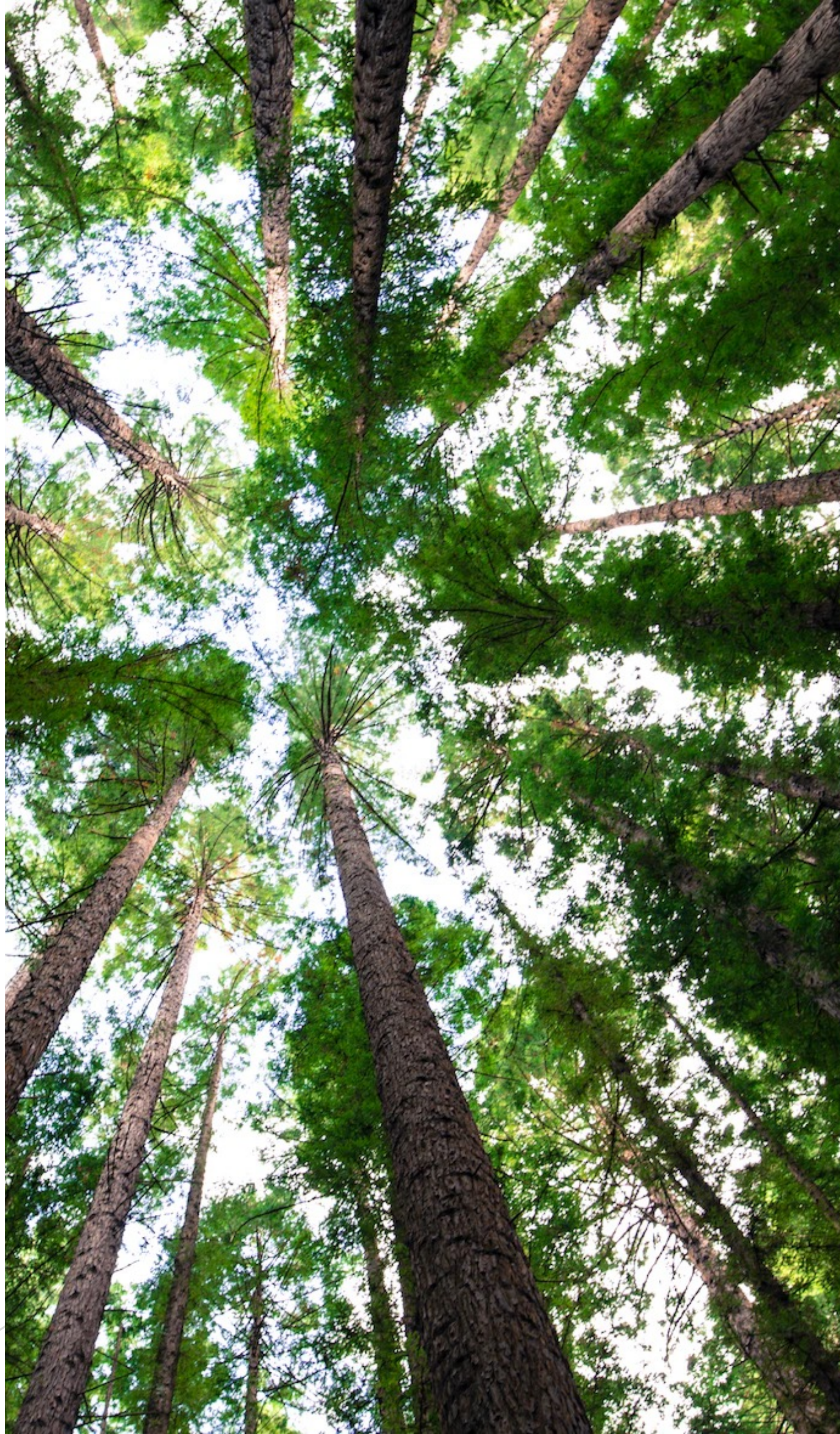
UNDERSTANDING GREENWASHING

- Term '**greenwashing**' originally **coined** in the 80s by environmentalists in the context of the **hôtellerie**

- In **banking and finance** - practice of **presenting financial products**, or in general investments, as **if they had environmental** or green or ESG **characteristics when in fact they don't**

- A case of **misrepresentation** potentially leading to **mis-selling** of financial products which could **harm investors** looking for environmental or green investment opportunities



MARKET REALITY

Growing demand for green/sustainable financial products

Limited number of taxonomy-aligned investment oppurtunities

Push for financial market participants to **greenwash**

SOME KEY LEGAL ISSUES

1. **Complex** and new (mostly untested) **legal framework**

2. **Lack** of a clear and all-encompassing **definition of greenwashing**

3. **Doubts** on availability of **effective supervisory and enforcement tools**

COMPLEX AND NEW LEGAL FRAMEWORK

- New EU **sustainable finance framework** (Taxonomy, SFDR, CSRD etc) **complex** and mostly **untested**

- **Ambigous definitions** concerning key terms, such as **DNSH, sustainable investment(s)**, promotion of environmental and social characteristics

- **Misuse** of some key provisions (e.g. **artt. 8 and 9 SFDR**)

THE DEFINITION OF «SUSTAINABLE INVESTMENT» UNDER THE SFDR

The definition is **very broad** → investments that pursue ESG goals.

It refers to two sub-categories:

- Environmentally-sustainable investments
- Socially-sustainable investments

Both these categories need to fulfill some additional common requirements:

- They must not significantly harm sustainability-related objectives (**«DNSH principle»**) → social objectives are also included under the SFDR
- The investee companies must follow good governance practices in terms of management structures, employee relations, staff remuneration and compliance with tax laws

But there are **no measurable indicators to assess contribution to sustainable objectives** → FMPs left free to set them.

FINANCIAL PRODUCTS UNDER THE SFDR

Article 8 products

- «**Light green**» financial products → **promote environmental and social characteristics**
- Disclosure: environmental and social characteristics promoted, how they are met, how they are assessed, measured and monitored; information on any reference index

Article 9 products

- «**Dark green**» financial products → have **sustainable investment as their objective**
- Disclosure: information on reference index, if any; otherwise, how the sustainability objective is being attained, what is the impact, how it is being assessed, measured and monitored

Key issue → up **to financial market participants to determine how to identify environmental and social characteristics** (Article 8) **and how to attain sustainable investment objectives** (Article 9)

→ **Risk of greenwashing!**

THE MISUSE OF ARTICLES 8 AND 9 SFDR

- **Articles 8 and 9** SFDR **interpreted** as assigning **«labels»** to financial products depending on their degree of sustainability.

- **Lack of clear indications on the features and thresholds** has enabled the creation of products with **different financial strategies**, including products with no substantial exposure to sustainable activities.

- E.g. → interpretative issue of exclusion lists:

  - Are they sufficient for an investment fund to qualify as an Article 8 product?
  - If they are not binding, there could be a mismatch between the fund's strategy as it is presented *vs* how it is actually implemented.

LACK OF A CLEAR DEFINITION OF GREENWASHING

Several references are made to greenwashing, which are inadequate.

Recital 11 of the Taxonomy Regulation → «*the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met*».

Recital 16 of Commission Delegated Regulation 2022/1288 → «*the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards*».

References focused on the disclosure and advice **of financial products**, while greenwashing can occur at different stages of the product lifecycle and it can also relate to **entity-level claims.**

LACK OF SUPERVISORY AND ENFORCEMENT TOOLS

There is currently an **enforcement gap**, → a **lack of supervisory oversight exercised on sustainability-related claims, leading to limited sanctions.**

This enforcement gap **lowers the expected costs of greenwashing** and of non-compliance with key provisions of the EU regulatory framework.

This may **incentivise market participants to avoid** the potential costs associated to allocating resources needed **to tackle greenwashing risks.**

GREENWASHING DRIVERS

Source: ESMA Progress Report

EUROPEAN COMMISSION’S EFFORTS

European Commission requested the **ESAs to give input on greenwashing risks** and **supervision,** focusing on 4 key areas:

- **Definition** of greenwashing in the financial sector
- **Risks** that greenwashing can pose **to investors and financial markets**
- Implementation of **sustainable finance policies aimed at preventing greenwashing**
- **Potential improvements to the regulatory framework**

ESAs COMMON DEFINITION OF GREENWASHING

‘*A practice where* ***sustainability-related statements, declarations, actions or communications do not*** *clearly and fairly* ***reflect the underlying sustainability profile*** *of an* ***entity****, a* ***financial product*** *or* ***financial service****. This practice might be* ***misleading to consumers, investors and other market participants***’**.**

Also pointed that **misleading claims can occur and spread either intentionally or unintentionally and greenwashing does not require investors to be harmed.**

ESMA UNDERSTANDING OF GREENWASHING

Dimensions	Detailed parameters used to analyse greenwashing risks under each dimension			
Roles	Trigger	Spreader		Receiver
Sustainability topics (and sub-topics) about which a claim is communicated	**Governance and resources** • **Board and senior management role** (governance-related elements of entity-level ESG policies) • **ESG resources and expertise** (incl. ESG dedicated staff)	**ESG strategy** • **ESG strategy, objectives, characteristics** (integration of sustainability in strategy, ESG characteristics, sustainable objectives, taking into account clients' sustainability preferences) • **Sustainability management policies** • **ESG credentials** (qualifications, labels, certificates): adherence to (voluntary) reporting frameworks (e.g. UNPRI, TCFD), labels, ratings, awards, certifications • **Engagement with stakeholders** (proxy voting and active engagement)		**Sustainability metrics and targets** • **ESG performance to date:** ESG results, metrics for real-world impact • **Pledges about future ESG performance: ESG targets** (incl. net zero targets), transition plans
Qualities through which the claim is misleading investors or consumers	**Misleading through provision of information** • Empty claims (exaggeration and/or failure to deliver on claims) • Inconsistency • Irrelevance • Outright lie (false) • Suggestive non-textual imagery and sounds • Suggestive use of ESG-related terminology		**Misleading through omission of information** • Selective disclosure / cherry-picking • Omission or lack of disclosure • Vagueness or ambiguity or lack of clarity • Lack of fair and meaningful comparisons, thresholds and/or underlying assumptions • No proof (unsubstantiated) • Outdated information	
Channels through which the claims are communicated	Regulatory information (e.g. Prospectuses, Financial statements, Mandatory sustainability disclosures, Issuers' press releases etc.)		Marketing materials (including website, social media, presentations to investors)	
	Ratings (inc. ESG ratings) and Benchmarks & Labels	Intermediary/advice information	Product information (including internal classifications)	Voluntary reporting, falling outside previous categories

Source: ESMA Progress Report

REMEDIATION ACTIONS

1) **Clarification of what constitutes sustainable investment(s)**, providing elements to **measure and compare 'contribution to sustainable objectives'**

2) **Clarification of DNSH under SFDR**, possibly in line with DNSH under taxonomy

3) **Identification of social factors**, to build the concept of contribution to social objectives and DNSH to social objectives (e.g. through a **social taxonomy**)

4) **Recognising transition finance**, through the deinition of transition investment(s) to link to some investment labels

5) **Labelling scheme for sustainable financial products**

SCORECARD APPROACH AS A LABELLING SCHEME

The scorecard approach we developed would allow for a taxonomy extension.

Under the scorecard approach, **economic activities** are **scored based on a more granular system of environmental thresholds.**

- ‘**Environmentally harmful**’ activities: score of **0**.
- ‘**Environmentally neutral**’ activities: score of **1**.
- ‘**Environmentally beneficial**’ activities that make a positive contribution to an environmental objective, albeit not substantial: scores **between 2 and 5.**
- ‘**Best-in-class**’ activities, that make a substantial contribution to an environmental objective : scores **between 6 and 9**.

Building on the taxonomy framework, investments funding those activities and financial products making those investments can be accordingly labelled.

THE «SCORECARD APPROACH»

Scorecard example for electricity generation from renewable non-fossil gaseous and liquid fuels

Quantitative thresholds: Life-cycle GHG emissions	Main factor qualification	Contribution to climate change mitigation	DNSH	MLSS	Transition strategy	Score	Investment label
<100 g CO_2 e/kWh	Best-in-class	Substantial contribution	+	+	n.a.	9	EU Env. sustainable
			-	+	Y	8A	Environmentally sustainable
					N	8B	
			+	-	Y	7A	
					N	7B	
			-	-	Y	6A	
					N	6B	
100 to 120 g CO_2 e/kWh	Environmentally beneficial	Positive contribution	+	+	Y	5A	Environmentally beneficial
					N	5B	
			-	+	Y	4A	
					N	4B	
			+	-	Y	3A	
					N	3B	
			-	-	Y	2A	
					N	2B	
n.a.	Environmentally neutral	Zero contribution	n.a.	n.a.	1	1	Environmentally neutral
> 120 g CO_2 e/kWh	Environmentally harmful	Harmful impact	n.a	n.a	Y	0A	Environmentally harmful
					N	0B	

Legend: 1) DNSH: compliance with the 'do no significant harm' test; 2) MLSS: compliance with minimum legal and social safeguards; 3) Transition strategy: the category signals that an issuer has adopted a transformative strategy aimed at the transition towards best-in-class requirements in the future; and 4) Impact: relevance to impact investors (focus: climate change).

THE SCORECARD APPROACH: TRANSITION-RELATED INFORMATION

The **score** could also **indicate whether** the issuer has adopted a **transition strategy**.

‘A’ signals the existence of a transition strategy.

For instance, **8A signals that an activity scores very high** for its contribution to one environmental objective, **yet fails the DNSH test**, **but the issuer seeks to change this impact and has adopted a formal strategy** (including an investment plan) aiming to pass the DNSH test in the foreseeable future as disclosed in the plan.

Accordingly, **static investments (which receives a score of B) are separated from dynamic investments (scoring at A).**

SCORECARD APPROACH AND PORTFOLIO COMPOSITION

By assessing economic activities relative to their environmental performance, the **scorecard approach** can be used as a **tool to set portfolio composition requirements** and accordingly **assign labels** (particularly to investment funds).

Mirroring, to some extent the **UCITS regulatory approach**, **rules** can be drafted **as to which securities** (and inherent amount) **can be bought** by investment funds **to obtain a given sustainability-related label.**

There will be **different labels given to investment funds** also using terms such as green, sustainable, ESG.

A **ranking** will be created **on the basis of the sustainability ambitions** of the fund's underlying investments to be **determined relative to the scorecard approach**.

While introducing **rigidity** as to portfolio composition, this regulatory approach, unlike the ESMA's fund names proposal, will provide **clarity and uniformity** on the market.

THANK YOU

M. Bodellini, *Greenwashing and the Misapplication of Articles 8 and 9 of the Sustainable Finance Disclosure Regulation,* ERA Forum, 2023, 1

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D.A. Zetzsche - M. Bodellini, *Addressing the 'Winner-Takes-All' Character of Sustainability Taxonomies*, University of Luxembourg Law Research Paper No. No. 2023 – 04

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