

**MEMO# 35339**

June 8, 2023

# **EU ESG: ESAs Published Progress Reports on Greenwashing in Financial Sector**

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TO: ICI Global Members

EU Sustainable Finance Disclosure Regulation Working Group

Europe Regulatory and Policy Committee SUBJECTS: ESG

International/Global RE: EU ESG: ESAs Published Progress Reports on Greenwashing in Financial Sector

On 1 June 2023, the European Supervisory Authorities (ESAs)[\[1\]](#) published their progress reports[\[2\]](#) on the monitoring and supervision of greenwashing, in which they put forward a common definition of greenwashing applicable to market participants across their respective remits – financial markets,[\[3\]](#) banking,[\[4\]](#) and insurance and pensions.[\[5\]](#)

The ESAs have defined greenwashing as: "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 may be misleading to consumers, investors, or other market participants."

The progress reports build on the ESAs' Call for Evidence on Greenwashing launched in November 2022.[\[6\]](#) ICI Global responded to the Call for Evidence,[\[7\]](#) noting that "greenwashing" has been used loosely to cover a wide range of different issues and situations. We recommended that, instead of defining "greenwashing" and thereby creating a new legal term, the EU authorities should describe the conduct or circumstances of concern. In our view, this approach would have better facilitated assessing the extent to which existing EU and national provisions and regulatory frameworks may be used to address the issues.

## **ESMA Progress Report on Greenwashing**

The ESMA progress report considers the risk of greenwashing across the sustainable investment value chain, comprised of issuers, investment managers, benchmark administrators and investment service providers, and identifies possible remediation actions. ESMA will further consider, adjust and refine as needed, these possible remediation actions and publish a final report in May 2024, which may include recommendations for

changes to the EU regulatory framework.

Notably, some of the potential remediation actions are associated with ESMA's proposals on ESG fund names<sup>[8]</sup> and the amendments to the Regulatory Technical Standards (RTS) under the Sustainable Finance Disclosure Regulation (SFDR).<sup>[9]</sup>

## **Key Greenwashing Risks Relevant to Investment Management Sector**

The ESMA progress report identifies possible greenwashing risks in the investment management sector:

- Unsubstantiated, exaggerated, and inconsistent claims on impact for funds and asset managers: There is a lack of clarity about how "impact" is factored, or achieved, in the investment processes, as well as an absence of rules regulating the use of impact-related terms.
- Misleading statements about the engagement strategy of a fund and an asset manager: Details about the progress of engagement, e.g., buy or sell decisions based on specific engagement outcomes, are insufficient. There is also a lack of comparability of the quality of the engagement across funds and asset managers given the variety of approaches and level of details provided in relation to engagement strategy.
- Misleading fund names: Rules on the use of ESG terminology in product names are unclear. In particular, the unclear definition of "sustainable investment" in the SFDR contributes to the misleading and inconsistent use of the term "sustainable" in fund names. The misuse of SFDR as a labeling regime also results in the misrepresentation of a fund's ESG characteristics.
- Lack of commitment and specificity on a fund's sustainable objectives or characteristics: Regulatory disclosures required under the SFDR contain vague statements on the extent and nature of a fund's consideration of ESG characteristics, for instance, the non-binding statements about how principle adverse impact (PAI) indicators are taken into account to demonstrate compliance with the "do no significant harm" (DNSH) principle.
- Misleading claims on ESG governance: There is insufficient governance among asset managers in monitoring how they implement their ESG policies. ESMA separately highlights that greenwashing will continue to exist as long as ESG duties are not treated as importantly as other fiduciary duties.
- Exaggerated and/or incomplete claims about ESG credentials: The actual significance of the ESG credentials, including being a signatory to a voluntary reporting framework, and receiving an ESG award or ESG external rating, may be overstated. In particular, ESMA highlights that, despite gaining membership in net zero alliance, asset managers may not have changed their businesses or investment processes to reflect the ESG focus.
- Lack of transparency about expected portfolio holdings: ESMA notes that this could create a gap between an investor's expectations of a fund's strategy and the actual portfolio holdings, in turn, leading to perceived greenwashing.
- Lack of transparency on underlying methodologies of ESG ratings and data: The lack of clarity on data limitations and underlying methodologies of ESG ratings and data could hinder the investors' comparisons across funds and managers. ESMA also notes that entities that issue, manufacture, or distribute financial products may cherry-pick ESG ratings that present them in the best possible way from a sustainability standpoint.

## **Key Greenwashing Risks in Other Parts of Sustainable Investment Value Chain**

**Issuers:** ESMA identifies issuers' forward-looking information and pledges about future ESG performance as most exposed to greenwashing risk. In particular, on transition plans, there is a credibility gap due to (i) insufficient resources allocated to support the plans, (ii) the absence of intermediary milestones, and (iii) the absence of regular progress monitoring. ESMA further highlights that misleading forward-looking information provided by issuers could create challenges for asset managers to meet their own transition plans and targets, thus contributing to greenwashing in the investment management sector.

**Investment Advice:** Misleading claims about the extent to which advice offered to retail investors takes sustainability into account is the most significant greenwashing risk related to investment advice. Further, advisors may provide misleading or unsuitable personalized advice when presenting the sustainability features of products.

## **Preliminary Remediation Actions Under Consideration**

### **Harmonize Definitions and Requirements across the EU Sustainable Finance Framework**

ESMA notes that the regulatory framework should be reinforced to make it more robust against greenwashing risks, and acknowledges the importance of enhancing interoperability and consistency across various regulatory frameworks and international standards. In particular, ESMA suggests harmonizing the definition of "sustainable investment" in the SFDR and the definition of "environmentally sustainable activities" in the Taxonomy Regulation.

Echoing the ESAs' proposed amendments to the SFDR RTS,[\[10\]](#) ESMA reiterates the need to better align the DNSH assessment among the SFDR, Taxonomy Regulation, and Benchmark Regulation to address confusion among market participants and thus greenwashing risk in the industry. ESMA also suggests considering changes to these regulations to entail the same definitions of "equivalent information" or types of estimates applicable across the EU sustainable finance framework. The ESAs also proposed in the review of SFDR RTS to align the wordings on the use of estimates with that in the Taxonomy Regulation.

### **Enhance the Definitions of Key Concepts and Relevant Expectations**

ESMA sees merit in clarifying the definition of "sustainable investment," for example, by requiring additional disclosure on how contributions to ESG characteristics or sustainable objectives are defined and measured. This could be considered in a separate criteria-based framework, such as financial product labels, given that the European Commission clarified in the recent SFDR Q&A that it would not prescribe a specific approach to calculating sustainable investments under the SFDR.[\[11\]](#) Nevertheless, ESMA notes it is considering setting out minimum expectations on sustainability claims, including best practices for defining minimum contribution to a sustainable objective under the SFDR and selecting of sustainability indicators used to measure such contribution.

ESMA also suggests including the definitions of "impact" and "transition investment" in the current EU sustainable finance framework. In particular, ESMA sees value in better differentiating types of impact in terms of additionality, materiality and measurability.

## **Improve Current Disclosure on ESG Elements and Expected Portfolio Holdings**

ESMA notes that actions are needed to encourage market participants to make a distinction between the binding and non-binding elements of a product's ESG characteristics and sustainable objectives, as well as the indicators used to measure the characteristics and objectives attained. Market participants should be further discouraged from making excessive reference to ESG characteristics and sustainable objectives to which there are no concrete commitments in the regulatory disclosures.

Moreover, ESMA suggests increasing the granularity of disclosure in relation to engagement efforts at both entity and fund levels. With respect to portfolio holdings, ESMA suggests requiring funds to provide a more detailed profile of the expected portfolio holdings, including sector, industry, and capitalization breakdown and their ESG profile, in order to enhance the transparency to investors and address the perceived greenwashing. Funds could also disclose their exposures to green or transition companies, activities, or sectors covered under the SFDR and Taxonomy Regulation.

## **Enhance the Reliability and Comprehensiveness of Sustainability Data**

**Auditing sustainability claims:** In ESMA's view, requiring external validation or assessment of the ambition and credibility of sustainability pledges made by financial market participants may help mitigate greenwashing in relation to forward-looking information. It suggests a stock-take of the existing options to audit Taxonomy-alignment disclosures under the SFDR to inform future regulatory provisions regarding the role of auditors in validating sustainability data and information.

**ESG data providers:** ESMA suggests the need for additional transparency around ESG metrics used by funds and benchmarks, enabling fund investors and benchmark users to compare the ESG profiles of different products. ESMA notes that ESG data providers should publicly disclose their methodologies in line with the recommendations of the International Organization of Securities Commissions (IOSCO).[\[12\]](#) Further, asset managers should document decisions on which/how many data vendors they use, in order to avoid cherry-picking ESG ratings of the managers and funds.

## **Establish EU-wide Sustainability Labeling Scheme**

ESMA envisages that a new EU-wide investment product labeling or categorization could address the use of SFDR as a product label, and provide a comprehensible tool supporting sustainable finance and participation by retail investors. ESMA suggests that the development of the labeling scheme should (i) strike the right balance between "stringency" and "feasibility" of the requirements for attribution of the labels, (ii) establish controls to guarantee the requirements are respected, and (iii) avoid creating barriers to financial innovation and product differentiation as well as arbitrage opportunities among products.

Further, to avoid investor confusion, ESMA recommends aligning fund and benchmark names as much as possible by requiring passive funds and ETFs to seek consistency in their naming convention with that of the tracked benchmarks. ESMA also notes that it is reflecting on the next steps regarding its proposals on ESG fund names.

## Notes

[1] There are three ESAs, namely, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA).

[2] See ESAs put forward common understanding of greenwashing and warn on risks, 1 June 2023, available at <https://www.esma.europa.eu/press-news/esma-news/esas-put-forward-common-understanding-greenwashing-and-warn-risks>. ESMA, EBA, and EIOPA each published individual reports.

[3] ESMA Progress Report on Greenwashing (31 May 2023), available at [https://www.esma.europa.eu/sites/default/files/2023-06/ESMA30-1668416927-2498\\_Progress\\_Report\\_ESMA\\_response\\_to\\_COM\\_RfI\\_on\\_greenwashing\\_risks.pdf](https://www.esma.europa.eu/sites/default/files/2023-06/ESMA30-1668416927-2498_Progress_Report_ESMA_response_to_COM_RfI_on_greenwashing_risks.pdf).

[4] EBA Progress Report on Greenwashing Monitoring and Supervision (31 May 2023), available at [https://www.eba.europa.eu/sites/default/documents/files/document\\_library/Publications/Reports/2023/1055934/EBA%20progress%20report%20on%20greenwashing.pdf](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2023/1055934/EBA%20progress%20report%20on%20greenwashing.pdf).

[5] EIOPA Advice to the European Commission on Greenwashing - Progress Report (1 June 2023), available at <https://www.eiopa.europa.eu/system/files/2023-06/EIOPA%20Progress%20Report%20on%20Greenwashing.pdf>.

[6] ESAs Call for Evidence on Better Understanding Greenwashing (15 November 2022), available at [https://www.esma.europa.eu/sites/default/files/library/esas\\_call\\_for\\_evidence\\_on\\_greenwashing.pdf](https://www.esma.europa.eu/sites/default/files/library/esas_call_for_evidence_on_greenwashing.pdf).

[7] See ICI Memorandum [34814], dated 18 January 2023, available at <https://www.ici.org/memo34814>.

[8] ICI Global submitted response to ESMA's consultation on proposed guidelines on ESG fund names in February 2023. See ICI Memorandum [34964], dated 21 February 2023, available at <https://www.ici.org/memo34964>.

[9] See ICI Memorandum [35269], dated 1 May 2023, available at <https://www.ici.org/memo35269>. Also See Joint Consultation Paper on the Review of SFDR Delegated Regulation regarding PAI and financial product disclosures ("SFDR RTS Consultation Paper"), 12 April 2023, available at <https://www.esma.europa.eu/press-news/consultations/joint-consultation-review-sfdr-delegated-regulation>.

[10] See id., SFDR Consultation Paper at p.22.

[11] See European Commission Answers to questions on the interpretation of Regulation (EU) 2019/2088, submitted by the European Supervisory Authorities on 9 September 2022 (6 April 2023), available at

[https://www.esma.europa.eu/sites/default/files/2023-04/Answers\\_to\\_questions\\_on\\_the\\_interpretation\\_of\\_Regulation\\_%28EU%29\\_20192088.PDF](https://www.esma.europa.eu/sites/default/files/2023-04/Answers_to_questions_on_the_interpretation_of_Regulation_%28EU%29_20192088.PDF).

[12] See FR09/21 Final Report Environmental, Social and Governance (ESG) Ratings and Data Products Providers, November 2021, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>; ICI Memorandum [33922], dated November 24, 2021, available at <https://www.ici.org/memo33922>.

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