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EU ESG Framework – latest developments and further clarifications on greenwashing and sustainable investments

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Over the last few months, the European Commission and the European Supervisory Authorities ("**ESAs**") have published a number of press releases and reports that aim to clarify and provide further updates on concepts used within the EU Sustainable Finance Disclosure Regulation ("**SFDR**") as well the EU's wider sustainability framework. The developments would have direct impact on EU and non-EU asset managers and other financial market participants ("**FMPs**"). In particular, the following topics are featured prominently on the EU agenda:

1. Greenwashing;
2. Sustainable investment;
3. The consideration of principal adverse impacts ("**PAI**") within the disclosure process;
4. ESG ratings; and
5. The EU Taxonomy criteria.

The number of updates and reports that have been published recently demonstrates the European Commission's active commitment towards a more comprehensive framework for the EU green strategy. As highlighted below, the responsibility for ensuring that investments are more sustainable is shifting towards the asset managers. This shift of responsibility is particularly indicated by the lack of prescriptive guidance on sustainable investment strategies whilst also increasing scrutiny of the investment strategies in the disclosure process.

As these updates, reports and guidelines are new to the ESG framework, it is yet to be seen how they will be implemented in practice. However, it will certainly push asset managers to reconsider their current and future investment strategies.

Greenwashing

On 31 May 2023, the ESAs published their respective progress reports on greenwashing in the financial sector. In particular, these reports clarified the meaning of greenwashing and its associated risks to this sector, as well as providing an indication on how to overcome its challenges.

The ESAs defined greenwashing as the "*practice of presenting misleading or inaccurate statements in relation to the sustainability profile of an entity or financial product or service when communicating to consumers, investors or other market participants*". As a result, greenwashing presents various risks to the financial services industry, for not only the specific investors involved in the fund, but also for the wider financial sector and FMPs. Greenwashing leads to misinformed decision-making, with acts such as cherry-picking information or omitting certain statistics in communications, resulting in potentially irresponsible investments.

Although there is increasing pressure for firms to stay current with the ever-intensifying sustainability-related demands in the market, falsifying claims has severe repercussions, both in terms of the immediate damage to the investor or consumer involved, and in undermining trust in the wider sustainable financial market. It is critical for asset managers to present clear and accurate information in their communications, whether in their sustainability disclosures, the main fund documentation or wider marketing documentation.

The ESAs set out how greenwashing manifests itself in practice. This is through three roles that can be played by market players in the occurrence of greenwashing. These are (1) "triggers" who initiate the practice and consist of the issuers, investment managers and may also include the benchmark administrators; (2) "spreaders" of the misinformation (e.g. through fund marketing); and (3) "receivers" of the greenwashing (i.e. the investors/ wider financial sector and consumers). Each role plays a part in circulating false and potentially damaging information in the market, which can ultimately prevent addressing pressing environmental and/or social issues.

Furthermore, the ESAs set out a high-level overview of the various forms that greenwashing can take. Communications can be misleading due to the omission of information relevant to consumers, investors or other market participants' decisions. This includes "*partial, selective, unclear, unintelligible, vague, over simplistic, ambiguous or untimely information, and unsubstantiated statements*". Conversely, communications can also be misleading due to the actual provision of information that is *"false, deceives or is likely to deceive consumers, investors or other market participants (including, but not limited to, mislabelling, misclassification, mistargeted marketing and inconsistent information)".* The ESAs also highlight that greenwashing can also be in the form of misleading actions. This includes cases where clients who have sustainability preferences are recommended products that do not have any sustainability features, or ignoring clients' preferences for sustainable investments during the advising phase.

Of particular importance to asset managers, the report published by the European Securities and Markets Authorities ("**ESMA**") outlines how greenwashing arises from fund names using ESG-related terms. ESMA notes that fund names would include terms such as 'sustainable' in their name, despite potentially not making any sustainable investments. As a result, investors may believe that the fund would make sustainable investments and expect the required sustainable disclosures under the SFDR. Thus investors would be misinformed, as the appropriate disclosures would not be made, perpetuating the practice of greenwashing.

In order to tackle the problems that greenwashing present, the ESAs detail various recommendations. Of note, is the proposal to introduce guidelines on fund names, where certain quantitative thresholds of sustainable investment must be met in order for a fund to use an ESG-related term in their name.

Beyond this, the ESAs suggest tackling the ESG illiteracy that is currently present in the financial sector for investors to make decisions that are more informed, as well as increasing the transparency between different types of sustainable products.

Although these reports are helpful in indicating the direction that the regulators are taking in regards to greenwashing, the final reports are only expected in May 2024 and these will set out final recommendations to overcome greenwashing practices.

Sustainable investments

In April 2023, the ESAs published clarifications from the European Commission, which provide further guidance on the legal interpretation of certain aspects of the SFDR. Questions were submitted by the ESAs and included the following:

1. the definition of 'sustainable investment' within the context of the SFDR and its wider implications on how contributions to environmental and social objectives should be interpreted; and

2. how the consideration of PAI within the disclosure process should be understood.

Article 2(17) SFDR defines 'sustainable investment' as *"an investment in an economic activity that contributes to an environmental objective as measured, for example by key resource efficiency indicators on the use of energy… or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or…"*.

The ESAs sought a response on whether an investment in an investee company which has one economic activity, among several other economic activities which promotes ESG characteristics could be considered a 'sustainable investment' as a whole or in part. The ESAs asked this within the context of an investee company that has one economic activity, amongst others, and contributes to an environmental or social objective (where none of the economic activities significantly harms any environmental or social objective and the company follows good governance practices).

The European Commission provided a broad answer by not specifying an approach to determine the contribution of an investment to environmental or social objectives. However, they placed an increased emphasis on disclosing the methodology that asset managers and FMPs use to carry out their own assessment of sustainable investments.

The European Commission stated that the reference to 'economic activities' in the definition of sustainable investment set out in Article 2(17) SFDR seems to target cases in which funds are allocated to a specific project or activity, or to a company engaged in one single type of activity. However, FMPs in scope of the SFDR can invest in funding instruments that do not specify the use of proceeds, such as the general equity or debt of an investee company. Therefore, the notion of sustainable investment can also be measured at the level of a company and not only at the level of a specific activity, highlighting the breadth of the definition's scope.

In addition, the European Commission provided clarity on how to interpret *"contribution to an environmental and/or social objective"* within the context of the SFDR. The ESAs had specifically asked whether the economic activity being carried out by the investee company in itself contributes to an environmental or social objective; or whether any economic activity potentially contributes to an environmental or social objective simply because the investee company carries it on in a sustainable manner.

The European Commission stated that the SFDR does not set out minimum requirements that qualify concepts such as contribution, do no significant harm, or good governance, i.e. the key parameters of a 'sustainable investment'. FMPs must carry out their own assessment for each investment and disclose their underlying assumptions. This policy choice gives FMPs an increased responsibility and means that they should exercise caution when measuring the key parameters of a 'sustainable investment' given their responsibility to disclose their methodology.

Additionally, investments considered as *"sustainable"* under Article 2(17) SFDR should not significantly harm any of the objectives referred to in that Article. Therefore, referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future would likely not be considered sufficient and details that are more specifically oriented to how the investment is sustainable would need to be provided.

Considering PAI within disclosures

The European Commission and ESAs consistently emphasise the importance of transparency in sustainability disclosures; and this is especially significant given their recent focus on tackling greenwashing. Article 7(1)(a) of the SFDR requires FMPs to disclose whether, and if so, how a financial product considers PAI on sustainability factors. Given its importance, the ESAs sought clarification recently on whether this meant that a financial product is only required to disclose the relevant PAI of the investment (for example the total greenhouse gases emitted). Alternatively, the ESAs asked whether such disclosure also required disclosing the action taken by the FMP to address the PAI of the product's investments, such as engagement with investee companies and if so, whether there are any minimum criteria for such actions.

The European Commission confirmed that the disclosure obligation refers to how a financial product considers PAI on sustainability factors. More specifically, the European Commission stated that FMPs, whilst accounting for their specific circumstance, should consider the PAI (whether material or likely to be so) of investment decisions on sustainability factors. In doing so, FMPs should integrate their procedures, including within their due diligence processes, for considering the PAI alongside the relevant financial risks and relevant sustainability risks.

The European Commission also confirmed that FMPs should include information about these procedures and descriptions of the PAI on their websites. Consequently, the description related to the adverse impacts shall include both a description of the adverse impacts and the procedures put in place to mitigate those impacts.

This confirmation clearly affects the level of detail that is to be expected of FMPs when making their disclosures and although this will better inform future investors when comparing different investment products, it is not yet certain whether these guidelines will be welcomed by FMPs and the wider financial services industry.

ESG Ratings

ESG ratings play an important role and have a significant impact on the operation of the financial markets and on investor confidence in sustainable products. The ratings enable the proper functioning of the EU sustainable financial market by providing key sources of information for investment strategies, risk management and disclosure obligations by investors and financial institutions.

However, the European Commission has recently highlighted concerns surrounding the ESG rating market, in particular pointing to the lack of transparency of the characteristics of ESG ratings and their methodologies. The European Commission stated that the rating market *"suffers from deficiencies and is not functioning properly"* resulting in the *"confidence in ratings being undermined"*. Given the concerns of greenwashing set out above, the European Commission has been committed to take action to increase the transparency and thus the reliability of ESG ratings.

On 13 June 2023, the European Commission published their proposal for the ESG Ratings Regulations that aims to enhance the integrity of ESG rating providers; however, it does not go as far as prescribing requirements on the content or the methodology of ratings. The proposal introduces new governance and organisational principles and clear rules on the prevention of conflicts of interest. ESG rating providers will be required to have robust governance arrangements in place and clearly define the roles and responsibilities of those involved in providing the rating. To ensure the independence of activities, the proposal prohibits rating providers from engaging, amongst others, in consulting, auditing, or investing services.

Additionally, under the proposal, rated entities and other stakeholders will be able to challenge the specific ratings or the application of the methodology applied to arrive at the rating. Furthering the transparency agenda, ESG rating agencies will need to publicly disclose their methodology, models and key assumptions used in their ratings. ESMA will also have responsibility for authorisation and supervision of the rating providers and the proposal envisages that this oversight will enhance the trust on the operations of the ESG rating providers, with the power to enforce a fine of 10% of a provider's firm annual net turnover for breaching the rules.

This proposal may cause those firms selling ESG ratings to significantly restructure their business, however, it is ultimately hoped that the new rules will strengthen the credibility of the ratings and provide both investment managers and investors with better tools to assess, measure and compare between financial products.

EU Taxonomy criteria

The EU Taxonomy is integral to the EU's sustainable financial framework. It establishes criteria to identify economic activities substantially contributing to the EU's six environmental objectives. It provides FMPs with a common language to identify to what degree economic activities can be considered environmentally sustainable (i.e. 'green') and acts as a measuring tool to monitor the degree to which the investments are sustainable. It also requires FMPs to make statements about how their financial products and activities align with the taxonomy it specifies. This framework has been developing over the last few years, enhancing the usability of the framework and ensuring that quality information is consistently provided. For example, recently, the European Commission clarified that investments aligned with the current EU Taxonomy regulation were automatically considered sustainable under the SFDR, and this confirmation will enable FMPs to more accurately assess and subsequently disclose information on their financial products.

To further strengthen the usability of the framework, on 13 June 2023, the European Commission approved, in principle, a new set out of EU Taxonomy criteria for economic activities making a substantial contribution to one or more of the non-climate environmental (and potentially social) objectives, namely:

- sustainable use and protection of water and marine resources;
- transition to a circular economy;
- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

As a result of further clarifications and new requirements, the current sustainability assessment framework would need to be re-examined in near future to take into account the new set of requirements. Further rules will also provide more guidance around regulators' expectations for sustainable investments pursuing the remaining four environmental objectives.

Conclusion

The EU ESG legal framework continues to develop at high speed with new guidance, clarifications and rules expecting to lead to further substantial amendments to asset managers' and other FMPs' ESG related systems and controls. The most significant area of concern flagged in the latest updates is greenwashing and the misinformation that is currently spread across the industry. The European Commission's confirmations also serve to illustrate the shift of responsibility onto the asset managers for ensuring that their methodologies are appropriately disclosed. Given the European Commission's focus on their ESG agenda and the increasing public attention to ESG-related issues, the financial services industry will likely witness greater scrutiny around ESG investment strategies, data usage and methodologies used to achieved sustainability goals or characteristics.

There will undoubtedly be further questions and clarifications of this developing landscape. Paul Hastings is, and will continue to be, at the forefront of helping clients to navigate this challenging topic and assist with developing and implementing all appropriate steps to address all latest developments.

Links to relevant publications

- The ESAs' Progress Reports on Greenwashing:
  - *ESMA's Progress Report on Greenwashing*
  - *EBA's Progress Report on Greenwashing*
  - *EIOPA's Progress Reports on Greenwashing*
- The European Commission's clarifications on the SFDR:
  - *Questions on the interpretation of Regulation (EU) 2019/2088*
  - *Amendments to answers to questions on the interpretation of Regulation 2019/2088*
- *The Proposed ESG Ratings Regulations*
- *The European Commission's working document to enhance the usability of the EU Taxonomy*
- *European Commission's draft recommendation on facilitating finance for a transition to a sustainable economy*

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