November 2023

Follow @Paul_Hastings

FCA—Keep an Eye on the U.K. Regulator Who Clearly Does its Homework on Tackling Greenwashing

By Ruth Knox, Zachary Milloy, Arun Srivastava & Konstantin Burkov

On 16 November 2023, the Financial Conduct Authority ("FCA") published its findings from a review of how U.K.-Authorised Fund Managers ("AFMs") comply with existing regulatory requirements and expectations on the design, delivery and disclosure of Environmental, Social and Governance ("ESG") factors and sustainable investment funds[1].

This is the third dedicated missive from the FCA on tackling greenwashing: (a) the first being its "Dear Chair" letter from July 2021 (which contained a set of "Guiding Principles" on how AFMs should design and deliver the ESG and sustainability objectives of a fund, while providing disclosures that align with such claims) and (b) the second being its Asset Management Portfolio letter of February 2023 (which highlighted the increase in products which have ESG and sustainable investment characteristics).

The review focused on both active and passive authorised retail funds that include a reference to ESG and/or sustainability terms in their name including products managed by 12 AFMs of varying sizes. It has been closely followed by the release on 28th November of PS23/16 (the FCA's Policy Statement on the Sustainability Disclosure Requirements and investment labels[2]) and GC23/3 (the Guidance on the Anti-Greenwashing Rule[3]).

The key takeaways from the UK AFM review are that:

1. The FCA cites the link between ESG and the broad set of existing regulatory obligations in the FCA Handbook consisting of COBS, COLL, its Principles for Businesses, that are not specifically linked to ESG but would capture AFMs activities when designing, delivering and disclosing in respect of ESG factors and sustainable investment funds. These rules include the Consumer Duty[4], which requires firms to deliver good outcomes for retail customers and recently came into effect in July. The FCA specifically underlines COBS 4.2.1R – the need to be fair, clear and not misleading.

2. There were cases where the Guiding Principles had not been fully embedded:

   - key information on ESG was difficult to identify and was sometimes missing or presented in an unclear way; and

   - AFM's governance arrangements on ESG were maturing however there were specific challenges in the oversight of older funds (limited records of key governance decisions);

- despite using ESG in their name, some funds did not have an explicit ESG or sustainability objective;
- stewardship approaches were often difficult to identify and there was an absence of clear examples of progress resulting from engagement[5];
- there was a lack of explanation in respect of holdings inconsistent with the ESG or sustainability characteristics of the fund[6];
- firm-level disclosures were not easily reconcilable with fund-level disclosures e.g. how a fund contributed to firm-wide ESG and sustainability goals.

What are the Next Steps for AFMs?

The current scope of the FCA's Guiding Principles is limited to 'authorised fund managers' i.e. managers of funds authorised by the FCA (e.g. authorised unit trusts, authorised contractual schemes etc.), which are typically offered only to retail investors. However, what is interesting is how the FCA have linked these principles with more general obligations, which apply to a broader range of other authorised firms (i.e. financial promotions and COBS rules, the FCA Principle 12 Consumer Duty). As such, this review could very well be an indication of direction of travel around embedding ESG in investment funds more broadly. Indeed, the Guidance on the Anti-Greenwashing Rule guidance published on 28 November 2023 specifies that the rule applies irrespective of whether firms are captured by the Consumer Duty. In any event, the FCA commits to challenge firms at the fund authorisation gateway, where it finds applications, which are inconsistent with the rules or risk misleading investors.

In anticipation of the application of the anti-greenwashing rule to all FCA-authorised firms who make sustainability-related claims about their products or services from 31 May 2024, managers should conduct a review of:

- their oversight and controls frameworks on investment research;
- due diligence for asset selection, systems and controls to ensure data accuracy and methodological compliance (with support from ESG Counsel)

to ensure that they are identifying, managing and mitigating the risks or misleading or inaccurate information, and implementing the Guiding Principles, across all relevant sustainability disclosures.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

Ruth Knox
44.020.3321.1085
ruthknox@paulhastings.com

Arun Srivastava
44.020.3023.5230
arunsrivastava@paulhastings.com

Zachary Milloy
44.020.3023.5190
zacharymilloy@paulhastings.com

Konstantin Burkov
44.020.3321.1009
konstantinburkov@paulhastings.com

1 https://www.fca.org.uk/publications/multi-firm-reviews/testing-how-authorised-fund-managers-are-embedding-guiding-principles-esg-and-sustainable-investment

2 PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

3 GC23/3: Guidance on the Anti-Greenwashing rule (fca.org.uk)

4 AFMs should ensure their practices are consistent with delivering good consumer outcomes and enable consumers to understand the financial and non-financial objectives.

5 There is a strengthening narrative, which is critical of climate stewardship by managers, which will likely give rise to enhanced scrutiny of such approaches by investors.

6 The FCA specifically calls out the absence of disclosures and targets in respect of Scope 3 emissions, which many stakeholders consider ambitious and subject to methodological challenges.