Greenwashing risk: strategic options for fund marketing

IQ-EQ Regulatory Forum 2023

Introduction

Despite the introduction of the EU's pioneering Sustainable Finance Disclosure Regulation (SFDR) in 2021, designed to increase sustainability transparency through enhanced fund disclosures, ESMA issued a comprehensive greenwashing progress report on 1 June 2023 that highlighted a discrepancy between the escalating demand for environmental, social and governance (ESG) funds and the limited availability of sustainable assets, with the risk that managers could adopt competitive and potentially misleading strategies aimed at bolstering their sustainability profiles. In fact, although SFDR was intended to reduce the risk of greenwashing, ESMA's paper acknowledges that the complex regulation has actually contributed to greenwashing risk in a roundabout way.

A more exhaustive and detailed analysis of greenwashing risks and mitigation is anticipated in the final report, which is slated for release in May 2024.

Meanwhile in the UK, the Financial Conduct Authority (FCA) will enforce a new rule later this year under its evolving Sustainable Disclosure Regulation (SDR) fund labelling regime. This rule, which was originally set to take effect on 30 June 2023 but has been pushed back to Q4, mandates that sustainability claims made in client communications must align with the actual sustainability profile of the fund, devoid of exaggeration and, crucially, supported by verifiable evidence. Managers will be required to provide evidence of diligent monitoring metrics and the execution of stewardship initiatives relating to any ESG claims featured on their websites.

Given the significance of these developments, IQ-EQ sought the perspectives of industry experts in a panel discussion led by Andrew Shrimpton, Chair of IQ-EQ's UK Regulatory and Compliance Solutions. This dynamic session, held at the Shard in London in June 2023, saw the gathered experts give their thoughts on greenwashing as well as the newer concept of greenbleaching, discuss how best to rebuild investor confidence in sustainable investments, and share experience-based insight into overcoming the challenge of private market ESG data collection and substantiating sustainability claims at both a fund and portfolio company level.

Panelists

Andrew Shrimpton
Chair, UK Regulatory and Compliance Solutions, IQ-EQ

Lizzie Stazicker
Head of ESG, Exponent

Hanadi Jabado
Managing Partner, Sana Capital

Mark Seavers
CIO, Fund Management (Ireland), IQ-EQ

Lyons O'Keeffe
ESG Director, IQ-EQ

The greenwashing hurdle

SFDR aimed to bolster transparency and combat greenwashing in the finance industry. However, the well-intentioned regulation has created sizeable gaps in understanding and compliance, with firms struggling to keep up with the pace of regulatory change – in particular, the SFDR Level 2 requirements that took effect at the start of this year.

Regulatory authorities have, in fact, revealed a rise in greenwashing practices. ESMA's recent report underscored the heightened risk of misrepresentation and potential reputational damage associated with sustainability claims made by investment managers. Coinciding with these regulatory concerns, a recent poll conducted by IQ-EQ uncovered the inhibiting impact of greenwashing risk on ESG-focused investing.

Nearly two-thirds of respondents expressed apprehension in pursuing sustainability in their investment strategy or marketing their sustainable credentials, attributing their hesitancy to fears of greenwashing.

Are onerous SFDR requirements encouraging "greenbleaching"?

During our panel discussion, IQ-EQ's Mark Seavers outlined the distinction between Article 8 and Article 9 funds under SFDR. "Article 8 funds promote ESG characteristics without a specific sustainable investment goal, while Article 9 funds are those with a clearly defined sustainable investment objective," he stated.

Giving an example from IQ-EQ's fund management team in Ireland, of which he is Chief Investment Officer, Mark shared: "In the private credit market, we are developing a fund where the entire intention and conditionality of the loans that make up the fund are very specific; they're tied to greenhouse gas emissions, so you can easily see the climate-related objective of that fund and know that you're in Article 9 territory. It's quite demonstrable and easy to prove." Unfortunately, the same cannot be said for all funds with Article 9 potential. Evidence is not always so easy to come by.

Private equity firm Exponent's Lizzie Stazicker shared that, as a signatory to the UN's Principles for Responsible Investment (PRI), her firm was advised to highlight environmental and social characteristics in their approach. Consequently, they embraced an ESG programme to align with this guidance, positioning themselves favourably. However, when considering regulatory aspects such as taxonomy and principle adverse impacts (PAIs), her firm chose not to align with a specific taxonomy, like many mid-market firms. Their decision stemmed from the onerous reporting requirements associated with taxonomy alignment. Some of the firm's investors are mandated to report on such criteria, however, creating an expectation for Exponent to follow suit. "This is something we are navigating at the moment," noted Lizzie. Sana Capital's Hanadi Jabado echoed Lizzie's sentiments, highlighting the challenges of taxonomy alignment that extend beyond financial considerations. "The substantial time and effort required to comply with reporting demands add complexity to the decision-making process," she said.

Hanadi acknowledged the concept of "greenbleaching" that her firm has inadvertently encountered. Guided by the ethos of "capital to heal the world," Sana Capital originally intended to brand itself as ESG-focused. However, the complexities surrounding compliance, reporting and monitoring in relation to ESG commitments led them to opt for understating their ESG stance to navigate potential pitfalls.

Greenbleaching is a relatively new term in the sustainability regulation lexicon, referring to the rising phenomenon of cases where fund managers inadvertently understate their fund's sustainable credentials to avoid onerous reporting requirements. In the context of SFDR, Mark Seavers defined it simply as "doing the right thing, but not declaring yourself an Article 8 or 9 fund."

Andrew Shrimpton added that many Article 6 funds are not aware that as few as "one in 10" Article 8 funds align with the EU Taxonomy and less than "one in three" commit to making sustainable investments. IQ-EQ has found a widespread underestimation of the degree of flexibility in the Article 8 funds category. In addition to being able to opt out of taxonomy alignment and making any sustainable investments, they can decide not to disclose PAIs on sustainability factors as part of their disclosure.

Mark highlighted the importance of transparency and adherence to regulatory guidelines to relation to greenbleaching as well as greenwashing, however. "The point of SFDR is that investors can read the pre-contractual agreement, see all the evidence, and understand what the fund does," he observed. "If a fund manager is pitching a fund that is doing the right thing, but is not subject to any scrutiny, that should be a concern."

Andrew raised the topic of private markets, acknowledging the challenges of obtaining data to prove actual impact, particularly for impact funds. IQ-EQ's ESG Director, Lyons O'Keeffe, concurred that "private market data is hard to come by in proving what you're doing. If you're an impact fund, it can be hard to prove the actual impact." However, he countered, "the problem is the direction of capital and if people are not advertising their green credentials properly, then the capital flow will not go towards sustainable or transformational investments."

Lyons continued: "If you downgrade what you say you're doing and you're not advertising, then you're coming under less scrutiny. No one is asking if for example if you have reduced the carbon by 20% in your portfolio or if you're changing the composition of the board. There's a little bit less pressure and as a result, the portfolio companies are not really getting the attention they deserved, or indeed expected."

To address this issue, Andrew called on the industry to strike a balance and avoid both exaggerating and understating fund promotions. "That's the point of regulation," agreed Mark. "Ultimately, it's that people are not being misled. So, make it simple and do it. If you have plans for a very substantial sustainability and engagement process, then you should accept that the onus on you to prove it gets higher – and it should do."

How to rebuild investor trust in sustainable investments?

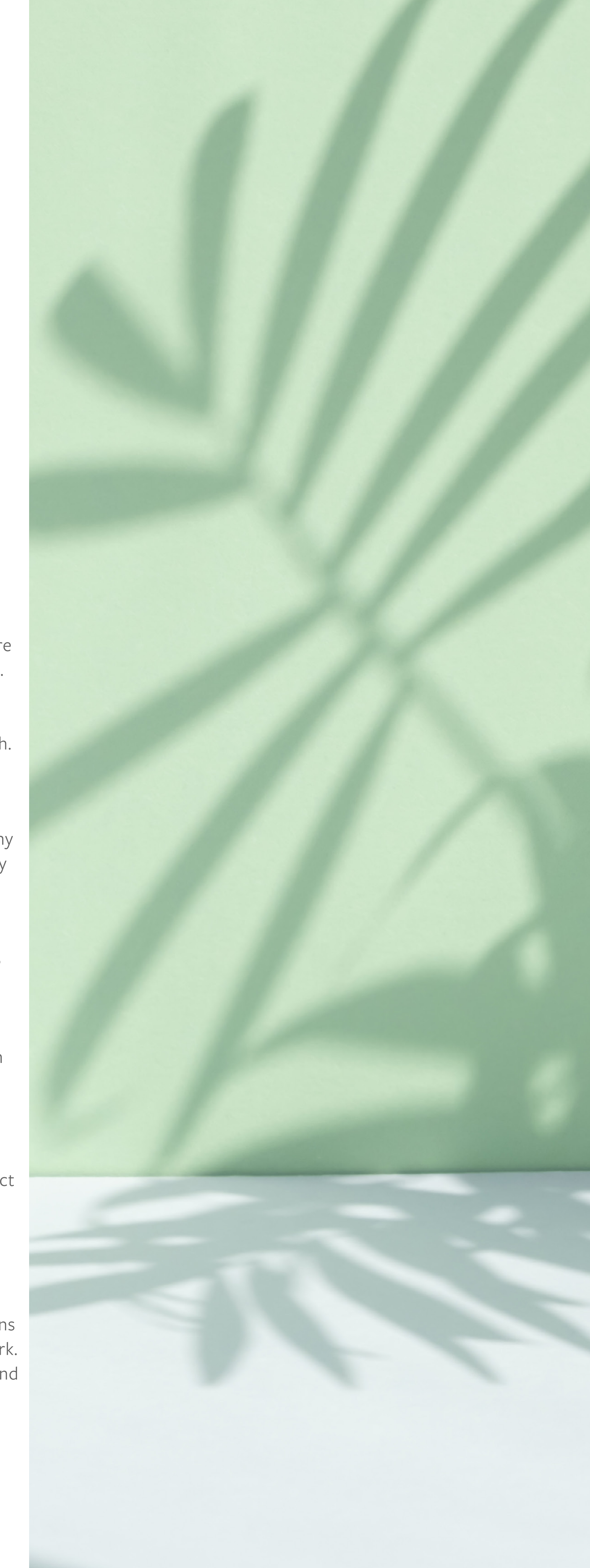
Throughout the panel session, Mark Seavers emphasised the significance of communicating sustainable practices with clarity and precision within contractual documents in order to show a genuine commitment to sustainability. For him, simplicity and observance of these commitments are instrumental in building trust with investors.

Lyons O'Keeffe highlighted the importance of combating greenwashing to enhance investor trust and facilitate a more targeted allocation of capital towards sustainable initiatives. He underscored the regulatory obligation to ensure that consumers and professionals receive transparent and accurate information, propelling genuine sustainable growth.

Lizzie Stazicker highlighted the importance of the finance industry uniting around global sustainability and climate goals. To achieve this, there is a need for heightened scrutiny in assessing and addressing environmental and sustainability issues. Reflecting on the FCA's efforts to combat greenwashing, Lizzie found alignment with the practices of regulated firms. She underlined the significance of promoting fair, clear and non-misleading claims to promote transparency and trust in the industry.

Hanadi Jabado acknowledged the prevailing challenge faced by investors due to the rise of misleading information and "green noise." She advocated for a clear and robust regulatory framework that not only benefits investors but also assists managers in navigating the complexities of sustainable investments. She stated that clarity and transparency in regulations are crucial to mitigate the impact of excessive information, allowing for better-informed decision-making.

Mark also agreed that regulatory intervention is crucial to rebuilding investor trust, especially when considering the competitive landscape of the industry, where narrow margins and diverse products demand a robust regulatory framework. Such intervention would help rebuild investor confidence and enhance the credibility of sustainable investments.



Substantiating ESG claims

As the discussion progressed, Andrew Shrimpton raised a question regarding transparency in the equity world, particularly concerning funds that claim to be ″ESG funds″ but merely engage in "tilting", which involves overweighting securities in the portfolio with higher ESG scores. Mark Seavers underlined the need for companies to be open and transparent in their disclosures. He advised that investors should have full clarity when reviewing pre-contractual documents before investing, as this is a crucial step in fostering trust and accountability. "Substantiate claims," he stated. "It can be a time-consuming process but there will be a lot of touch points that you can use to demonstrate what you're doing."

Andrew's inquiry led to a discussion on how to substantiate claims in the private markets given that, as previously acknowledged, this can be easier said than done.

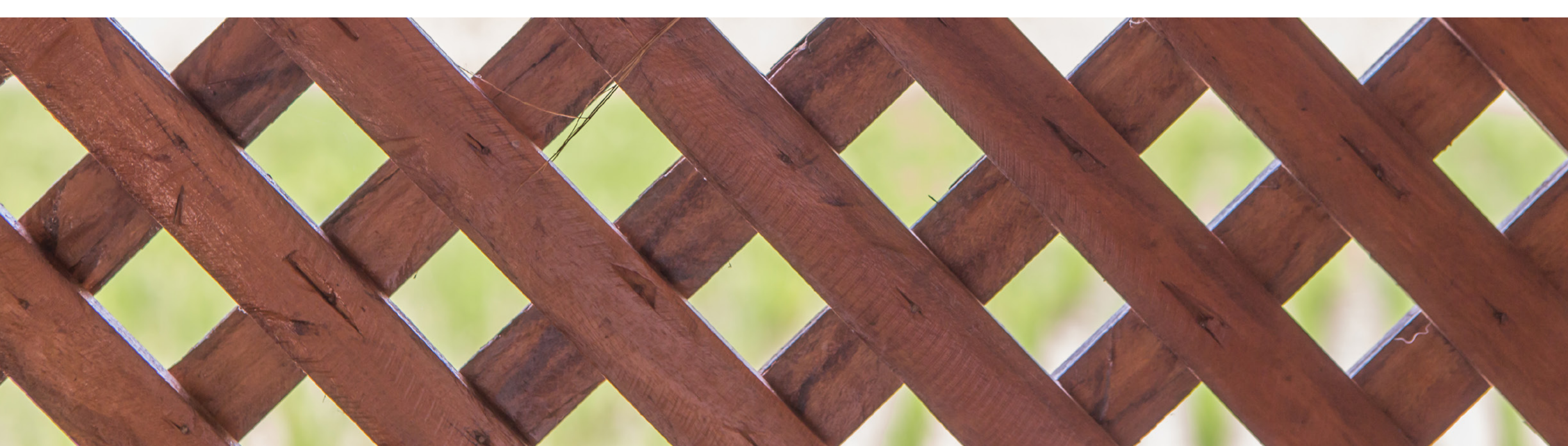
Lizzie Stazicker offered valuable insights, mentioning Exponent's annual ESG report, which includes detailed case studies on portfolio progress and developments. "Our responsible investment policy goes into detail on the strategy and governance that we have at a firm level and most private equity firms will have that on their website."

Ensuring claims can be substantiated at portfolio company level

Lizzie further expanded on her firm's approach to promoting sustainability and ESG within its portfolio companies. "We require each board to discuss ESG on a quarterly basis. We ask CEOs to discuss ESG in their presentation to partners and as part of their budget presentation. I also arrange annual ESG catch-ups, and I've recently met all the CEOs of our portfolio companies to make sure they're aligned. I think we're quite lucky in that a lot of our portfolio companies have dedicated ESG professionals, so on an almost daily basis I'll speak to companies and share best practices across the portfolio. I think this is really powerful and, increasingly, CEOs are becoming interested in that sense of purpose."

Hanadi Jabado highlighted a crucial aspect of her portfolio company collaboration, noting that many founders and leaders come from scientific or technical backgrounds rather than traditional business backgrounds. Given this context, the topic of sustainability requires education and awareness-building. "At Sana Capital, we are big advocates for diversity and some funds make it a condition to have a certain number of board members from different genders or ethnicities. It's hard to do, but we can educate and make it something that is integral to the nature of the company."

The discussion shifted towards displaying governance and investment due diligence. Lizzie Stazicker shared her focus on the active ownership phase, where quarterly board packs provide essential data, but noted that the primary emphasis lies in ensuring that each company has a tailored action plan. "Exponent does this by commissioning an external ESG review to help companies with an action plan, and we monitor that. This is quite important for us."



How valuable are external accreditations?

On the topic of substantiating ESG claims, Lizzie also highlighted the value of third-party accreditation. "Aligning with external frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD) can provide assurance to LPs but it is not the same as third party verification.

Andrew Shrimpton inquired about funds' adoption of frameworks like the PRI and B Corp. Mark Seavers confirmed that equity funds do sign up to these frameworks. However, he stressed the significance of such funds substantiating and demonstrating their commitment to these principles, as they serve as valuable resources when used effectively.

"A few of our portfolio companies are B Corp and a few more are looking into it," concurred Lizzie. "It can be time-consuming, but it does promote best practice."

Hanadi Jabado cautioned that while certifications can be reassuring for investors, there is a risk of companies merely engaging in token gestures and doing the bare minimum to achieve requirements without true dedication to sustainable practices. Lyons O'Keeffe echoed this sentiment, stating the importance of delving deeper into a company's ESG programme to assess the substance behind their claims, where "concrete data carries more weight than mere policy statements."

Andrew added that one pitfall that had come to light in greenwashing reviews is a lack of clarity in fund financial promotions in terms of whether managers were signatories to an external accreditation framework or were just voluntarily aligning with them. Managers that give an impression of being signatories when this is not the case run the risk of being sanctioned by regulators for greenwashing.

The ESG data collection challenge

When it comes to obtaining ESG data from listed equity investments, Mark Seavers expressed a positive outlook, stating that improvements are noticeable. "Things are getting better," he stated. "However, we don't feel it's the gathering of data that is the problem for listed equities. Creating a structure for using the data should be the basis of engagement. There could be more requirements in future, due to European regulators adding more adverse impact requirements that companies will need to disclose."

What about unlisted investments? The conversation shifted back to the challenges of collecting data from portfolio companies in the context of private markets. Lizzie Stazicker shared insights from her experience, highlighting that while her portfolio companies do comply with data reporting, there are variations in data quality, coverage and scope. "The quality depends on resource and if companies have a dedicated ESG person. It also depends on the maturity of the business in terms of how long we've owned that business, and we would expect the amount of information provided to increase over time. For example, for carbon reporting in the first year, companies might be focusing on getting their reporting processes in place. During the second year, they might have a UK footprint looking at Scope 1 and 2 CO_2 emissions, and then in year three, they might take more of a global outlook.

"There's a danger that when you just present the numbers, it doesn't necessarily convey the engagement that has occurred. Soliciting feedback is helpful and that can help guide our portfolio. Technology is a good enabler at Exponent and we're at that point where we can make the leap and help improve the accuracy of the data that we're collecting. Choosing the right data platform is key."

Hanadi Jabado added, "I think in the early stage, there is the issue of confidentiality as well, but also the lack of resources. More importantly, there's no standard. I think where we can help is giving companies a template for what to look for, what to collect and what to start thinking about, so that it's not an afterthought but in the fabric of the business, right from the beginning."

"Invest Europe has developed ESG reporting guidelines and a reporting template that aim to help venture capital (VC) and private equity (PE) firms" responded Lizzie. "There's also the ESG Data Convergence Initiative, which has a set of metrics that is universal across sectors. We're encouraging our investors to request those metrics so there is a bit more streamlining, which means the market becomes less fragmented. The extra advantage is that, over time, you'll be able to benchmark your portfolio companies by sector and size."

Andrew Shrimpton added that the key to avoiding data problems for a VC or PE fund is to identify which data can be collected from portfolio companies before committing to reporting on the "Sustainability Indicators" in the SFDR pre-contractual disclosure. PE funds that have majority ownership of portfolio companies tend to have high response rates to data requests, but it tends to be more challenging for VC funds that only hold minority interests.

How can an ESG data collection strategy help mitigate greenwashing risk?

Lyons O'Keeffe confirmed it can be difficult to measure the data but agreed that technology is making it easier. "If you can't measure what you're doing, then you can't really manage and improve, nor prove what you promised," he stated. "When we start working with our clients at IQ-EQ, we think very carefully and deeply with them about this data challenge to make sure that the data is obtainable, and our clients can prove what they're doing. You almost have to work backwards from the reporting to make sure what you are intending to claim in your strategy will ultimately be provable. Only then can you be really confident of avoiding greenwashing."

Hanadi Jabado believes in taking a proactive approach since the regulation can change in five to 10 years. "There's a lot of data that needs to be collected, not always because it's required but because it might be required. That is something I think about. In terms of the reporting, you also need to look at whether you can measure the impact of a 10-year or 15-year fund. It's worth thinking about the timeframe and whether you will see the impact within the lifetime of the fund."

Conclusion

It is crucial for asset managers to address greenwashing risk diligently and transparently. As Kermit the Frog aptly sang, "it's not easy being green," and exaggerated claims or understating actions should be avoided at all costs.

Transparency is the key to tackling this challenge effectively. Managers must openly disclose their actions and intentions in this area, leaving no room for ambiguity. To mitigate the risk of greenwashing, adopting a clear set of metrics and robust reporting is the most concrete way to substantiate claims.

While regulators may be expressing concerns about greenwashing, it is essential to acknowledge that the vast majority of industry stakeholders genuinely strive to uphold ESG principles. Clients are sincere in their efforts to report on their progress and hire experts. However, there appears to be a difference between the industry's self-assessment and the regulators' viewpoint.

This disparity between industry and regulatory perceptions presents danger. As such, greenwashing currently stands out as one of the most significant regulatory risks in the asset management industry. As we move forward, it is imperative for asset managers to collaborate closely with regulators, align their practices with clear metrics, and maintain complete transparency to maintain credibility and integrity.

Get in touch

Andrew Shrimpton
Chair, UK Regulatory and Compliance Solutions, IQ-EQ

E andrew.shrimpton@iqeq.com

Lizzie Stazicker
Head of ESG, Exponent

E lizzie.stazicker@exponentpe.com

Hanadi Jabado
Managing Partner, Sana Capital

E hanadi@sanacapital.co.uk

Mark Seavers
CIO, Fund Management (Ireland), IQ-EQ

E mark.seavers@iqeq.com

Lyons O'Keeffe
ESG Director, IQ-EQ

E lyons.okeeffe@iqeq.com

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