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Greenwashing in Investment Funds

by **David Naughton, David Williams, Katrina Smyth, Narita Woods, Mina Dawood**

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9th November 2023 | by David Naughton, David Williams, Katrina Smyth, Narita Woods, Mina Dawood

Tackling greenwashing is one of the key priorities in ESMA's Strategy on Sustainable Finance.

Assessing how investment funds promote themselves (through their names and documentation) and investigating whether issuers benefit from an ESG pricing effect are important first steps in detecting and monitoring greenwashing in the EU funds industry, according to ESMA.

In its findings, ESMA have confirmed the need for guidelines to ensure that fund names accurately reflect their portfolio from an ESG perspective (as suggested in a related consultation paper towards the end of 2022) and standardised disclosures in the form of templates. On the other hand, ESMA has found no evidence of a "greenium" pricing advantage (see below).

Background

Greenwashing stems primarily from misleading, confusing, or inaccurate claims in relation to a financial product's ESG credentials. For example, the name of a fund can be a source of greenwashing if the name does not reflect the fund's actual sustainability profile. Due to strong investor demand for ESG investment products, greenwashing has become a source of regulatory concern, particularly as there is no official EU label for ESG or sustainable investment products and SFDR focuses on disclosure rather than classification. ESMA seeks to foster investor confidence and trust in the accuracy of ESG disclosures to ensure that ESG products remain attractive.

In its bid to tackle greenwashing and boost investor confidence in the sector, ESMA conducted two analyses which culminated in the publication of the following articles:

1. TRV Article - ESG Names and Claims in the EU Fund Industry, 2 October 2023.
2. TRV Article – The European Sustainable Debt Market – Do Issuers Benefit From an ESG Pricing Effect?, 6 October 2023.

ESMA subsequently held a webinar to discuss the findings of the two articles and published the following presentations:

- ESG Names and Claims in the EU Fund Industry.
- The European Sustainable Debt Market – Do Issuers Benefit from an ESG Pricing Effect?

ESG Names and Claims in the EU Funds Industry

ESMA examined over 36,000 funds managing around €16 trillion of AuM (spanning from mid-2013 to mid-2023) for the use of ESG terms in their names; and the extent of ESG language used across 100,000 regulatory and marketing documents (available at the end of 2022) covering more than 18,000 funds. ESMA's key findings are as follows:

- Growing use of ESG-related language in fund names, increasing from 3% to 14% in 10 years and peaking in 2021-2022, with fund managers typically favouring generic words (such as "ESG" and "sustainable"), making it harder for investors to verify claims. Since mid-2017, numerous funds changed their name to include ESG words. These findings still hold when controlling for asset class

and geographical focus.
- Consistently high investor demand and preference for investment products with ESG words in their name.
- More recent funds and funds investing in equity are associated with more ESG language.
- Use of ESG-related language has increased especially in the investment strategy and KIIDs of SFDR Article 8 and 9 funds and funds with ESG in their names, which will not come as a surprise to many given the disclosure requirements of SFDR. Notably, however, this increase varies according to the type of document and target market. More ESG language is contained in the KIIDs of funds sold to retail investors than in the non-standardised documents (such as marketing material) that is issued to institutional investors. ESMA flags the importance of consistency across differing types of documentation, from an investor protection perspective.

European Sustainable Debt Market: Do Issuers Benefit from an ESG Pricing Effect?

The "greenium" is pricing benefits for sustainable debt issuers, where investors are willing to pay extra or accept lower yields in exchange for sustainable impact. Due to increased investor demand for sustainable financial products, the issuance of sustainable-labelled debt has rocketed in recent years and some research has suggested that debt issuers of such debt benefit from the greenium. However, the evidence has been inconclusive and confined to green bonds. In ESMA's article, it considers all ESG bond types, by constructing a unique dataset of outstanding ESG and conventional bonds from EEA issuers based on commercial data from Refinitiv Eikon and by conducting multiple model and sample specifications. It also considers the key factors involved in the greenium. ESMA's key findings are as follows:

- Standard factors drive bond prices and yields: credit risk, maturity, and liquidity risk.
- No evidence of a systematic and consistent pricing advantage for the sustainable bond category. This is not, however, a rejection of the possibility of such pricing advantages.
- ESG bond issuers benefitted from yield discounts in the past based on their issuer characteristics, however, this trend has not continued into the present.
- Public ESG commitments do not have any effect on bond yields overall.
- Encouragingly, financial stability concerns remain low.
- On the downside, there is a limited appetite in the market to forego returns in support of a transition towards a more sustainable economy.

Next Steps

ESMA's work is part of its ongoing efforts to develop innovative analytical tools for supervisory and regulatory purposes, including to identify and address greenwashing and feed into ongoing regulatory efforts regarding ESG disclosure requirements for funds.

ESMA will continue to scale up the monitoring and supervision of greenwashing and has suggested conducting an additional analysis of non-English documentation and documentation across the alternative investment fund market.

ESMA is also considering further research to investigate the conditions under which investors may be more willing to opt for sustainable investment instruments and forego returns, or to assess the margin of missed profits investors would be willing to accept to support a sustainable transition. ESMA will continue to monitor these and related market developments in the future.

Further Information

Please contact a member of our Financial Services team (David Naughton, David Williams, Katrina Smyth, Narita Woods or Mina Dawood) if you require further information on ESMA's findings and/or on ESG in the context of regulated financial products.

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