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The FCA Publishes Guidance on ESG Disclosures and Greenwashing

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The UK Financial Conduct Authority (FCA) has published a “Dear Chair” letter (here) (the “Letter”) setting out its “Guiding principles on design, delivery and disclosure of ESG [environmental, social and governance features] and sustainable investment funds” (the “Guiding Principles”). The Guiding Principles are especially important in expressing the FCA’s view of what constitutes “greenwashing” and how to avoid it.

Whilst the Letter and Guiding Principles are addressed to the chairs of Authorised Fund Managers—rather than the chairs of wholesale managers of unregulated alternative funds—they are instructive as to what the FCA’s expectations of fund managers more generally are likely to be.

Background

As we have previously discussed in this article, the FCA has recently published consultation papers setting out proposed new disclosure requirements, focused on climate change, for asset managers. In due course, it is expected that these disclosure requirements will be extended to cover other ESG topics. Other ESG disclosure regimes have been, or are in the process of being, established in other jurisdictions, including in the European Union under the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation.

In establishing these new disclosure regimes, however, a principal issue that managers are facing is precisely how these disclosures should be made. Whilst over time more guidance and templates are emerging, there is still some ambiguity as to precisely how regulators expect firms to comply with these new obligations.

In the absence of clarity in how to make disclosures, one notable risk for firms is that they will be criticised or held liable for the statements made, whether by regulators or investors. Firms may be tempted to make very general statements (particularly to avoid investor liability), but thereby could be held in default of their disclosure obligations by regulators.

It is in this context that the FCA has set out its Guiding Principles in order to assist firms in striking the right balance to making meaningful and clear disclosures which will satisfy a firm’s disclosure obligations.

Greenwashing

The FCA has given three examples of behaviour which has particularly spurred the issuance of the Letter, each of which could be described as some form of “greenwashing”, namely:

- A passive fund had an ESG-related name, even though it sought to track an index which was not itself ESG-focused, and exclusions from the index were only limited and based on “high-level” ESG criteria.
- A fund was stated to have a strategy to invest in companies contributing to “positive environmental impact”. The FCA found this misleading, however, since whilst the fund intended to invest in low carbon emissions reporting companies, the investments would not obviously contribute to the net-zero transition. The FCA said that it had expected to see a “measurable non-financial objective alongside the financial objective or strategy with information on how that impact would be measured and monitored”.
- Instances where it was difficult to reconcile the fund’s proposed investments with ESG-related statements. For example, one “sustainable investment” fund held two ‘high-carbon emissions’ energy companies in its top-10 holdings, and there was no obvious context or rationale behind it (e.g. “a stewardship approach that supports companies moving towards a orderly transition to net zero”).

The FCA summarised that, in its view, it was not seeing “sufficient, clear information explaining [a fund’s] chosen strategy and how this relate[d] to the assets selected for the fund”.

The Guiding Principles

The FCA notes that there are already rules in the FCA Handbook (the “Handbook”) which are relevant to the making of disclosures, including Principle 7 of the FCA’s Principles for Businesses,[1] requiring that communications must be “clear, fair and not misleading”. These Guiding Principles are in addition to those rules in the Handbook.

As an “Overarching Principle” for the Guiding Principles the FCA has said that firms should be guided by the principle of consistency. In particular, the “fund’s focus on ESG/sustainability should be reflected consistently in its name, stated objectives, its documented investment policy and strategy, and its holdings”. The other principles might be viewed as facets of the “consistency” principle.

a. Principle 1: The design of responsible or sustainable investment funds and disclosure of key design elements in fund documentation

Under this Principle the FCA states that references to ESG/sustainability in relation to the fund should “fairly reflect the materiality” of ESG/sustainability to the fund’s objectives/investment policy and strategy. In particular, the FCA lists certain “key considerations” where this Principle should be considered, namely:

- **Fund name**: It is already a general rule that fund names should not be misleading. In particular, however, the FCA notes that using ‘ESG’, ‘green’, ‘sustainable’, ‘responsible’, ‘ethical’, ‘impact’ and any related terms are likely now be viewed as misleading if the fund does not pursue ESG/sustainability substantively and materially in its objectives, policies and strategy.

  - The inclusion of “impact” in this list is the subject of particular commentary, as the FCA “considers that a fund that uses the word ‘impact’ in its name in the context of ESG/sustainability outcomes should only do so if it is seeking a non-financial (real world) impact, and if that impact is being measured or monitored”.

- **Investment objectives and policy**: Where the fund claims to pursue ESG/sustainability characteristics, this should be indicated—and therefore followed—as part of the fund’s investment objectives and policy in the fund documentation. The FCA has stated that the fund should be specific about what it means when it says that it pursues ESG/sustainability, describe the aims and set out how this is monitored, including by reference to “real world” impact. Where firms rely on third party data in assessing a security’s ESG/sustainability characteristics, this should be disclosed in the prospectus. If the fund holds any securities which might not be “expected” of a fund with an ESG/sustainability promoting purpose, the prospectus should disclose and explain the reason why such securities are held.

- **Investment strategy**: Where the fund claims to pursue ESG/sustainability characteristics, the FCA expects details about the strategy followed to pursue these features in the fund documentation, including any limitations/thresholds relating to particular types of investment, any screening criteria used, specific ESG objectives pursued, the application of benchmarks or indices and the stewardship approach of the fund.

  - In particular, the FCA has noted that where a fund integrates ESG considerations into mainstream investment processes, this should not mean that “prominent ESG claims” are made in the fund’s name/documentation, or that ESG is positioned as a key part of the fund’s offering.

  - The FCA has also said that sufficient information should be provided in the documentation to differentiate between funds of the following (non-exhaustive) varieties: funds that avoid exposure to certain types of investment; funds that apply a positive screen to promote particular sustainability characteristics/themes; and funds that pursue a positive impact (e.g. through direct investment in sustainable projects or influencing change through active investors stewardship).

- **Stewardship approach**: Under the Shareholder Rights Directive,[2] firms are either required to have shareholder engagement policies or explain why they do not do so. Where a firm’s investment strategy uses investor stewardship to promote ESG/sustainability features, the FCA expects that a firm will have an engagement policy setting this out.

b. Principle 2: The delivery of ESG investment funds and ongoing monitoring of holdings

In accordance with this Principle, the resources used by a firm in pursuit of the fund’s stated ESG objectives should be appropriate, and the manner the investment strategy is implemented should be consistent with its disclosed objectives on an ongoing basis.

- **Resources to support delivery**: The ESG aims must be reasonably capable of being achieved, given the resources applied. The resources should be considered broadly, including investment professionals with appropriate skills and experience, technological inputs and ESG/sustainability-specific research, data and analytic tools.

- **Data, research and analytic tools**: The firm should employ appropriate resources to oversee the use of research, data and analytic tools, including conducting due diligence on any data relied upon to be confident that the firm is able to validate any ESG/sustainability claims that it makes.
- **Holdings**: The firm should take into account whether a reasonable investor would consider that the fund's actual holdings reflect any ESG/sustainability characteristics, themes or outcomes that have been disclosed or any claims made. Where the holdings might appear contradictory to the fund's presentation of ESG/sustainability features, the firm should consider explaining this apparent inconsistency.

c. Principle 3: Pre-contractual and ongoing periodic disclosures on responsible or sustainable investment funds should be easily available to consumers and contain information that helps them make investment decisions

This Principle is of greatest importance to funds marketed to retail clients, as it is especially concerned with presenting information on ESG/sustainability characteristics in a suitable and comprehensive fashion. It remains of significance to wholesale funds, however, that the disclosures should be comprehensible to the appropriate audience, particularly where certain terminology surrounding ESG/sustainability remains comparatively specialist.

- **Easy availability**: Firms should take appropriate steps to ensure that investors have suitable access to ESG/sustainability-related information. This may be especially important where the firm relies on third-party data or analytical tools, in which cases descriptions of relevant methodologies or any limitations in the data should be provided.
- **Pre-contractual disclosures**: The ESG/sustainability factors should be made available in relevant regulatory documents and reflected in any accompanying marketing materials in a clear, fair and not misleading way.
- **Ongoing performance reporting**: Firms should take appropriate steps to make information available on how well the fund is meeting its stated objectives on an ongoing basis. This may include information about whether the fund is meeting key performance indicators, the progress towards non-financial (real world) outcomes, and details about the firm's stewardship.

[1] PRIN 2.1 https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html, "A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading".

[2] As implemented in COBS 2.2B.

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