Greenwashing and the misapplication of articles 8 and 9 of the Sustainable Finance Disclosure Regulation

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Abstract

Greenwashing refers to the practice of presenting financial products, or more in general investments, as if they had environmental or green or ESG characteristics when in fact they don't. It is a case of mis-representation potentially leading to mis-selling of financial products which could harm those investors looking for sustainable or green investment opportunities. The complexity of the new European legal regime and the misuse of some provisions might end up giving rise to greenwashing practices despite the declared intention stated in the framework to contrast them.
Greenwashing can be effectively tackled through closer coordination between ESMA and the national competent authorities, more efforts in terms of regulatory harmonisation among member states and the introduction of a clearer and possibly more demanding set of rules on the qualification of green and/or sustainable financial products.

Keywords: greenwashing, sustainable finance, taxonomy, green finance, environmental sustainability, environmental factors, ESG

1. Introduction

Greenwashing is a term increasingly used in finance and financial regulation to mainly refer to the practice of presenting financial products, or more in general investments, as if they had environmental or green or ESG characteristics when in fact they don't.[1] It is, in other words, a case of mis-representation potentially leading to mis-selling of financial products which could harm those investors looking for environmental or green investment opportunities.
The European framework refers to greenwashing several times and one of its main goals is to prevent such practices from occurring. However, the complexity of the new legal regime and the misuse of some provisions (primarily articles 8 and 9 of the Sustainable Finance Disclosure Regulation) might end up giving rise to greenwashing practices as opposed to contrasting them. The European Commission in its 2021 Strategy on Sustainable Finance expressed concerns about greenwashing.[2] On these grounds, in October 2021 the European Commission decided that a specific mandate to fulfil the Strategy's action relating to greenwashing was to be addressed to the EBA, EIOPA and ESMA. On the basis of such mandate, the ESAs have been asked to work on the following main areas: 1) definition of the role of NCAs on greenwashing issues, 2) identification of greenwashing practices in the market, and, 3) effectiveness of supervision in addressing greenwashing.
In exploring these issues, this paper analyses the European legal framework on sustainable finance with a view to identifying and discussing the main provisions that have an impact on greenwashing. The new initiatives undertaken by the European Commission and ESMA are

[1] On ESG factors see N. Eccles – S. Viviers, The Origins and Meanings of Names Describing Investment Practices that Integrate a Consideration of ESG Issues in the Academic Literature, in Journal of Business Ethics, 2011, 104, 389-402; E. Barman, Doing Well by Doing Good: A Comparative Analysis of ESG Standards for Responsible Investment, in Strategic Management, 2018, 38, 289-311; United Nations Global Compact, Who cares wins: Connecting financial markets to a changing world, New York, United Nations Global Compact Office, 2004, *passim*.
[2] See European Commission, Strategy for financing the transition to a sustainable economy, 6 July 2021, available at https://ec.europa.eu/info/publications/210706-sustainable-finance-strategy_it.

also investigated. Some critical remarks and policy considerations are advanced along with ideas for reform proposals.
This paper is divided into 12 paragraphs as follows. After this introduction, paragraph 2 deals with greenwashing in general terms, focusing on the European legal framework. Paragraph 3 discusses greenwashing in the context of the Taxonomy framework, while paragraph 4 investigates greenwashing in the context of the SFDR framework. Paragraph 5 analyses the vague and extremely broad definition of sustainable investment under the SFDR. Paragraph 6 looks at the distinction between financial products promoting environmental and/or social characteristics and financial products with sustainable investment as objective. Paragraph 7 deals with the misuse of articles 8 and 9 of SFDR. Paragraph 8 investigates some regulatory divergences among member states. Paragraph 9 discusses the ESMA's understanding of greenwashing. Paragraph 10 describes the ongoing work of ESMA on greenwashing. Paragraph 11 makes some policy considerations and advances ideas for reform proposals. Paragraph 12 concludes.

2. Greenwashing in the European legal framework

The European legal framework refers to greenwashing several times.
Recital 11 of the Taxonomy Regulation describes greenwashing as 'the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met'.[3] Similarly, Recital 16 of the Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 defines greenwashing as 'the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards'.[4]
Importantly both the Taxonomy Regulation[5] and the Sustainable Finance Disclosure Regulation[6] are seen as tools that should be able to tackle greenwashing practices.[7] Yet, despite their laudable intentions, some provisions are drafted in a such a way that they might unintentionally open up the way to greenwashing practices.

[3] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
[4] Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre- contractual documents, on websites and in periodic reports.
[5] On the Taxonomy Regulation see C. Gortsos, The Taxonomy Regulation: More Important Than Just as an Element of the Capital Markets Union, European Banking Institute Working Paper Series 2020 n. 80, *passim*; F Schütze - J Stede, The EU sustainable finance taxonomy and its contribution to climate neutrality, in Journal of Sustainable Finance & Investment, 2021, *passim*.
[6] For a legal analysis of the SFDR see D. Busch, Sustainability Disclosure in the EU Financial Sector, European Banking Institute Working Paper Series 2020 n. 70, *passim*.
[7] See European Commission, FAQ: What is the EU Taxonomy and how will it work in practice?, where it is stated that the Taxonomy 'will support companies in their efforts to plan and finance their transition, help mitigate market fragmentation, protect against greenwashing and accelerate financing of those projects that are already sustainable and those in transition, to deliver on the objectives of the European Green Deal'; see also ESAs, Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088), where it is noted that 'like Article 9 of Regulation (EU) 2019/2088, Article 8 of that Regulation addresses a potential issue of greenwashing by financial products, i.e. conveying a false impression, or providing misleading information about how a financial product is performing in terms of ESG sustainability'.

3. Greenwashing and the Taxonomy Regulation

On the one hand, the Taxonomy Regulation and the Commission Delegated Acts on climate[8] and on natural gas and nuclear energy[9] have introduced a common language as well as environmental performance thresholds (so-called technical screening criteria) on the basis of which environmentally sustainable economic activities will be identified.[10] Investments funding such activities will be in turn regarded as environmentally sustainable.[11] Over time, financial products with underlying environmentally sustainable investments will be given a 'sustainable' label. In this respect, the Taxonomy framework is expected to help tackle greenwashing in that financial products will need to make investments meeting precise and pre-defined thresholds to be labelled as sustainable. Clarity in this area is crucial also in light of the freedom to passport financial services and products within the single market through the so-called European passport.[12] In the absence of a harmonised classification system such freedom to operate on a cross-border basis could be abused through regulatory arbitrage,[13] which would increase the risk of greenwashing.[14]

Against this background, the main drawbacks are that the legislation on the use of such labels anchored to the Taxonomy criteria is not yet available and the thresholds to qualify economic activities and investments as sustainable under the Taxonomy framework are so demanding that at least initially only a limited number of financial products will be able to obtain such labels. To face this issue, somewhere else we have advocated in favour of an extension of the taxonomy system with a view to including even environmentally sensitive economic activities that however do not meet yet the Taxonomy technical screening criteria.[15] Such an extension would expand the list of environmentally sustainable economic activities and accordingly the

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[8] Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives.

[9] Commission Delegated Regulation (EU) 2022/1214 of 9 March 2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities.

[10] See M. Bodellini – D. Singh, Sustainability and finance: utopian oxymoron or achievable companionship?, in Law and Economics Yearly Review, 2021, *passim*.

[11] In literature, sustainable investment is a term which is often used with a broad meaning to encompass also impact investing and responsible investing, see H. Liang – L. Renneboog, Corporate Social Responsibility and Sustainable Finance: A Review of the Literature, European Corporate Governance Institute, Finance Working Paper n. 701/2020, *passim*.

[12] See M. Bodellini, La gestione collettiva del risparmio davanti alla sfida della sostenibilità tra ambiguità normative e difficoltà applicative, in Rivista di Diritto Bancario, 2022, III, 599-630; on the functioning of the European passport see M. Bodellini, Does it still make sense, from the E.U. perspective, to distinguish between UCITS and non-UCITS schemes?, in Capital Markets Law Journal, 2016, 4, p. 535.

[13] On regulatory arbitrage against the background of the provision of financial products in the European single market, see M. Bodellini, The E.U. regulation on marketing of alternative investment funds: another step towards integration of the E.U. financial market, in Business Law Review, 2016, 6, p. 208 – 219; M Bodellini, The marketing of hedge funds in the U.K.: did the system maintain its attractiveness after the transposition of the AIFMD?, in Business Law Review, 2016, 5, p. 162 – 172; M. Bodellini and R. Olivares-Caminal, The impact of Brexit on the UK alternative investment fund industry, in Law and Economics Yearly Review, 2017, 1, 79 – 103.

[14] See T. Wahida Shahan, Green Washing: An Alarming Issue, in ASA University Review, 2013, 7, 1, 81-88; D. Schmuck – E. J. Matthes, Misleading Consumers with Green Advertising? An Affect–Reason–Involvement Account of Greenwashing Effects in Environmental Advertising, in Journal of Advertising, 2018, 47, 127-145.

[15] See D.A. Zetzsche, M. Bodellini and R. Consiglio, Towards A New European Social Taxonomy: A Counterproposal Based On A Three-Step Approach, University of Luxembourg, Working Paper, 2022.

pool of sustainable investments would increase as well. To make the system consistent, a different grade should be given to financial products on the basis of the environmental performance of the financed underlying economic activities.[16]

4. Greenwashing and the Sustainable Finance Disclosure Regulation

On the other hand, in a predominantly disclosure-based system, the SFDR plays a pivotal function by spelling out the disclosure obligations that financial service providers must fulfil depending on the activities they carry out.[17] The SFDR lays down harmonised rules for financial market participants and financial advisers on transparency with regard to: a) the integration of sustainability risks in their processes,[18] b) the consideration of adverse sustainability impacts in their processes, and, c) the provision of sustainability-related information with respect to financial products.[19] The rationale behind the new SFDR rules is twofold. Indeed, they aim, on one side, to provide end-investors with disclosure and transparency on the sustainability risks potentially affecting their investments, and on the other side, to ensure that financial market participants and financial advisers pay attention to the (potentially negative) impact of their investment decisions on environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.[20] In other words, there is a double dimension of sustainability that matters for the purposes of the SFDR. The first dimension moves from outside to inside (outside-in) and relates to the impact of environmental and social issues on investments through the creation of sustainability risks. The second dimension moves from inside to outside (inside-out) and concerns the potentially negative impact of investment decisions on sustainability factors, such as environmental, social, employees, human rights and corruption-related matters.[21] This double dimension,

[16] The possibility to extend the environmental taxonomy has been discussed also by the Platform on Sustainable Finance, see Platform on Sustainable Finance, The Extended Environmental Taxonomy: Final Report on Taxonomy extension options supporting a sustainable transition, March 2022.

[17] Elsewhere we have defined the European framework as a 'disclosure-based system' yet raising some doubts about its effectiveness and ability to deliver on its goals, see M. Bodellini – D. Singh, Sustainability and finance: utopian oxymoron or achievable companionship?, in Law and Economics Yearly Review, 2021, *passim*.

[18] It is worth noting that the SFDR treats sustainability risks as a new and distinct category of risk. Such a legislative choice has raised criticism among market participants, see European Fund and Asset Management Association**,** EFAMA's Response to the Commission's Drafts Amendments Integrating Sustainability Considerations into UCITS and AIFMD, 6 July 2020, available at https://service.betterregulation.com/sites/default/files/20-4040_EC%20Better%20Regulation%20CP%20ESG%20UCITS%20AIFMD%20Integration.pdf, where it is said that 'EFAMA fully supports the integration of sustainability risks as part of risk management policy at fund level, but we believe that from a risk management perspective there is no reason to single out sustainability risks vis a vis all the other types of risks and introduces an artificial ranking amongst those different risks. In addition, and as already recognised by a number of public authorities, we would also like to see the possibility for sustainability risks to be assessed also on a qualitative basis … Having sustainability risks in such general provisions, seems to imply a different weighting for sustainability risk vis a vis all the other types of risks and introduces an artificial ranking amongst those different risks. Furthermore SFDR, which requires fund managers to inform how they assess sustainability risks, already tackles significant regulatory changes to be made in organisation, resources, management and due diligence requirements within UCITS & AIFMD management companies. Singling out sustainability risks here is therefore not only inappropriate from a risk management perspective, it is also unnecessary from a regulatory policy development'.

[19] See M. Bodellini, La gestione collettiva del risparmio davanti alla sfida della sostenibilità tra ambiguità normative e difficoltà applicative, in Rivista di Diritto Bancario, 2022, III, 599-630.

[20] On sustainability risks and sustainability factors see M. Siri - S. Zhu, Will the Eu Commission Successfully Integrate Sustainability Risks and Factors in the Investor Protection Regime? A Research Agenda, in Sustainability, 2019, 11, 6292.

[21] See D.A. Zetzsche, M. Bodellini and R. Consiglio, The EU Sustainable Finance Framework in Light of International Standards, in Journal of International Economic Law, 2022, 4, 659-679.

which has been defined as double materiality, features the European legal framework, thereby making it more ambitious as a result of requesting financial service providers to also consider the impact of their investments on environmental and social factors.[22]

5. Sustainable investment under the SFDR: a vague and extremely broad definition

The SFDR provides also a broad definition of 'sustainable investment' referring to two different sub-categories, namely: 1) environmentally sustainable investments, which are investments 'in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy', and, 2) socially sustainable investments, which are investments 'in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or … in human capital or economically or socially disadvantaged communities'.[23] Though diverse in terms of content, in order to be qualified as sustainable, both types of investment need to meet some additional common requirements. Accordingly, 1) they must not significantly harm any of the above-mentioned objectives (DNSH principle), and, 2) the investee companies must follow good governance practices, by setting, in particular, sound management structures, decent employee relations, adequate staff remuneration while complying with tax laws.

Interestingly, the SFDR defines sustainable investments as the ones that try to pursue ESG goals, by keeping the three dimensions (environmental, social and governance) together. Additionally, under the SFDR, the DNSH principle is broader than the one under the Taxonomy Regulation. While the latter is limited to environmental objectives, the former also encompasses social objectives. All of these elements make the SFDR's structure different from the one of the Taxonomy Regulation, that, in fact, is primarily focused on the environmental dimension. The differences concerning the DNSH principle, in particular, are relevant since they might end up being material, as compliance with it under the SFDR would imply that, if an environmental objective is to be pursued the related activity cannot be carried out by harming social objectives.[24]

6. Financial products promoting environmental and/or social characteristics and financial products with sustainable investment as objective

On the basis of the SFDR provisions, two types of financial products, carrying a different level of sustainability, can be manufactured. These are: 1) financial products promoting environmental or social characteristics under article 8 (so-called light green financial products), and, 2) financial products with sustainable investment as objective under article 9 (so-called dark green financial products). Depending on the category under which financial products fall, different disclosure obligations apply.

As to article 8 products, disclosures should include information on the environmental and social characteristics promoted, on how they are met, and on the methodologies used to assess, measure and monitor the promoted environmental or social characteristics. If an index has been

[22] See T. Adams, L. Smalling and S. Dichter, ESG Investing Needs to Expand Its Definition of Materiality, in Stanford Social Innovation Review, 23 February 2022, ssir.org/articles/entry/esg_investing_needs_to_expand_its_definition_of_materiality#.

[23] Article 2(17) of the SFDR.

[24] See M. Bodellini – D. Singh, Sustainability and finance: utopian oxymoron or achievable companionship?, in Law and Economics Yearly Review, 2021, *passim*.

designated as a reference benchmark, information on whether and how this index is consistent with those characteristics should be disclosed as well.
As to article 9 products, if an index has been designated as a reference benchmark, information has to be disclosed on how the designated index is aligned with the pursued sustainable objective; if there is no designated index, disclosure should specify how the sustainable objective is to be attained, the overall sustainability-related impact of the financial product by means of relevant sustainability indicators, as well as the methodologies used to assess, measure and monitor the impact of the sustainable investments selected for the financial product, including data sources and screening criteria for the underlying assets.
Articles 8 and 9 of SFDR contain provisions concerning disclosure obligations that vary depending on the degree of sustainability ambitions of the financial products concerned. Focusing on disclosure, such provisions do not set out any clear and prescriptive indications concerning the environmental and social characteristics that article 8 products should promote, how such characteristics can be successfully met and the methodologies to apply to ascertain whether they have actually been met. Similarly, no clear and prescriptive indications are provided with regard to how the sustainable investment objective of article 9 products can be attained, the sustainability indicators to use to measure the impact of the underlying investments and the methodologies to apply to measure the impact of such sustainable investments. It follows that all these elements can be autonomously set and determined by financial market participants when manufacturing their financial products. Yet, allowing financial market participants to decide on their own on all these matters with no prescriptive regulatory provisions in force, is expected to cause substantial divergences among financial products as to their degree of sustainability. Against this backdrop, ESMA pointed that in asset management, 'the unequal understanding of the type of products which are subject to Articles 8 and 9 of the SFDR may lead fund managers to disclose inconsistently under these articles and effectively cause greenwashing'.[25]

7. The misuse of articles 8 and 9 of SFDR

The rationale behind the provisions under articles 8 and 9 of SFDR is to ensure transparency on the degree of sustainability (concerning both sustainability risks and the impact on sustainability factors) of the investments made by financial products to the benefit of end-investors. Despite this being the authentic goal of the SFDR, articles 8 and 9 have sometimes ended up being interpreted (and misused) as if they had introduced labels to apply to financial products based on their different degree of sustainability for marketing purposes.[26] These incorrect practices obviously result from the growing interest of end-investors for sustainable and/or green financial products which seems to have turned into a pressure on financial market participants to manufacture products with such characteristics.[27] In other words, to satisfy the

[25] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-24, 10 February 2022, ESMA30-379-1051.
[26] The rationale of these provisions has been recently discussed by ESMA, see European Securities and Markets Authority, Sustainability risks and disclosures in the area of investment management, Supervisory briefing, 31 May 2022, ESMA34-45-1427, where it is said that 'without giving the impression of a "label" to investors, an indication as to under which Article of SFDR (and if relevant, the TR) the UCITS/AIF discloses the relevant information should be mentioned in the fund documentation'.
[27] See Malta Financial Services Authority, MFSA Report on Operational and Compliance Readiness by Financial Market Participants and Financial Advisers – Sustainable Finance, 12 April 2022, where it is found that 'SFDR requires entities to classify the products or advice they offer into one of the three following categories: products promoting environmental or social characteristics; products with sustainable investment objectives; and mainstream products that do not fall within the previous two categories'; see also T. Lynn Taylor – S. Collins, Ingraining sustainability in the next era of ESG investing - New opportunities are emerging for investment

market appetite for sustainable and/or green financial products, financial market participants have sometimes misused articles 8 and 9 of SFDR as if they assigned sustainability labels to their financial products, that on this basis have been presented and sold as green and/or sustainable.

Against this backdrop, the lack of clear indications and precise thresholds in the SFDR on the characteristics that article 8 and article 9 financial products should meet, despite being motivated by the different rationale behind those provisions, has made the situation on the market even more critical. As a consequence of the broad scope of application of such provisions, the financial strategies featuring article 8 products (and to a certain extent article 9 products as well) are very different from each other.[28] Yet, even financial products with no substantial exposure to sustainability-related and/or green activities might fall under the scope of application of these provisions (particularly of article 8 of SFDR).

It is also worth noticing that immediately after the adoption of the SFDR, several financial market participants, preferring a prudent approach, avoided to qualify their products as article 8 products due to uncertainties relating to the meaning of promoting environmental and social characteristics, which in their view could have led to the risk of being involved in greenwashing practices.[29] Such approach has however changed after the clarifications provided by the European Commission that has confirmed the broad meaning of the wording promoting environmental and social characteristics.[30] As a result, a considerable number of financial products, particularly investment funds, have been re-qualified as article 8 funds, showing the attitude of financial market participants to use the reference to that provision as a marketing tool to attract investors looking for green and/or sustainable opportunities.[31]

Yet, some interpretative doubts still remain. One of such doubts relates to the so-called exclusion lists and whether investment strategies based on those lists would be enough for an investment fund to qualify under article 8 of SFDR. The European Commission has taken a position in favour of this interpretation[32] and the draft version of level 2 legislation seemed to

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managers to adapt as investor preferences evolve, in Deloitte Insights, 17 April 2022, arguing that 'The implementation of the Sustainable Finance Disclosure Regulation (SFDR) in March 2021 effectively created three fund designations (Article 6, Article 8, and Article 9) based on the level of the investment manager's incorporation of ESG characteristics in the investment decision-making process … Despite the lack of clarity surrounding the disclosures required under each designation, funds that classified themselves as either "light green" or "dark green" still represented more than half (54%) of funds that launched with an SFDR designation. These "green" fund launches follow the trend seen during 2020, when more than half of total investment fund flows in Europe were directed to sustainable funds'.

[28] See European Securities and Markets Authority, Sustainability risks and disclosures in the area of investment management, Supervisory briefing, 31 May 2022, ESMA34-45-1427 pointing that 'While there are no rules specifying minimum quantitative criteria for financial products to disclose sustainability features under SFDR, some Member States have taken the initiative of setting thresholds at national level to ensure that financial products' names with sustainability features are not misleading investors. Furthermore, national labels for sustainable financial products have been developed at national level in many Member States'.

[29] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-2024, 10 February 2022, ESMA30-379-1051.

[30] See European Commission, Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088), at 7-8, available at https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf.

[31] See T. Lynn Taylor – S. Collins, Ingraining sustainability in the next era of ESG investing - New opportunities are emerging for investment managers to adapt as investor preferences evolve, in Deloitte Insights, 17 April 2022, arguing that 'At the end of Q1 2021, assets in discretionary mandates with an ESG investment approach, Article 8, and Article 9 funds in the EU totalled US$13 trillion, representing 40% of the total assets under management'.

[32] See European Commission, Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088), at 7-8, available at https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf, where it is said that 'nothing

confirm it.[33] From a systematic perspective, nevertheless, on the basis of this reading of the legal framework, potentially every European investment fund would (or at least could) qualify under article 8 SFDR. For instance, every fund declaring that no investment in companies exploiting child labour can be made would comply with such an interpretation and thus qualify as an article 8 fund.[34] Similar issues would arise when exclusion strategies are not binding as pointed out by Recital 16 of Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022. It follows, though, that even financial products with very limited (if not inexistant) environmental and social ambitions could benefit from a label that, despite a different rationale behind its regulatory provisions, currently is perceived on the market as a guarantee of sensitivity to sustainable matters. This is clearly an unwanted consequence and in this regard ESMA has observed a mismatch 'between the emphasis placed on ESG characteristics in the

prevents financial products subject to Article 8 of Regulation (EU) 2019/2088 not to continue applying various current market practises, tools and strategies and a combination thereof such as screening, exclusion strategies, best-in-class/universe, thematic investing, certain redistribution of profits or fees'.

[33] Recital (18) of the Draft Regulatory Technical Standards of the European Supervisory Authorities (ESAs) Supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector with regard to regulatory technical standards specifying the content, methodologies and presentation of information in relation to sustainability indicators and the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, websites and periodic reports pointed that 'there are a variety of financial products with various degrees of ambition with regard to taking into account sustainability factors. Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions. The disclosures required from financial market participants making available such financial products should reflect this diversity and cover the widest possible range of approaches. Among financial products, a difference is to be made between financial products that exclusively pursue sustainable investments and all other financial products that promote environmental or social characteristics'. Interestingly, the Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022, adopting those ESAs' regulatory technical standards has not kept that recital. In the Commission Delegated Regulation, some references to exclusion lists are made in Recital 16, that without mentioning article 8 products states that 'many financial products rely on exclusion strategies based on environmental or social criteria. End investors should be provided with the information necessary to assess the effects of such criteria on investment decisions, and the effects of such exclusion strategies on the composition of the resulting portfolio. Market practice demonstrates that some exclusion strategies are showcased as effective, while in fact those exclusion strategies actually lead to the exclusion of only a limited number of investments, or are based on exclusions required by law. It is therefore necessary to address concerns about 'greenwashing', that is, in particular, the practice of gaining an unfair competitive advantage by recommending a financial product as environmentally friendly or sustainable, when in fact that financial product does not meet basic environmental or other sustainability-related standards. To prevent mis-selling and greenwashing, and to provide end investors with a better understanding of the effects of the exclusion strategies applied by certain financial products, financial market participants should confirm any commitment in terms of excluded investments, in particular as binding elements of the investment strategy, in information on asset allocation and in the information on sustainability indicators used to measure the effects of such strategies'. From a different perspective, Recital 11 provides that 'Financial market participants should therefore only disclose those criteria for the selection of underlying assets that are binding on the investment decision-making process, and not criteria that they may ignore or override at their discretion'.

[34] See EUROSIF, EU Sustainable Finance & SFDR: making the framework fit for purpose - Eurosif Policy Recommendations for Article 8 & 9 product labels, June 2022, 3, where it is pointed that 'As of 31st March 2022, 31,5% of funds available in the EU (excluding money market funds, funds of funds and feeder funds) were classified as either Article 8 SFDR funds (27,9%) or Article 9 SFDR funds (3,6%). In terms of assets under management, the two groups accounted for an even larger share of the EU market, amounting to 45,6% of the total assets under management. Article 8 SFDR products alone accounted for 40,7% of total assets under management, while Article 9 SFDR products accounted for 4,9% total assets under management. In terms of monetary value, the combined assets under management of Article 8 SFDR funds and Article 9 SFDR funds amounted to EUR 4,18 trillion, see Morningstar Direct. Data as of 31 March 2022 - Based on SFDR data collected from prospectuses on 96% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds'.

presentation of an investment product and the strategy that is actually implemented'.[35] Often, the marketing documentation emphasises the use of exclusion policies which, however, do not *per se* result in selecting a fully sustainable eligible investment universe; sometimes, an ESG integration strategy is presented but no commitment is made to use ESG considerations in the investment decision-making. According to ESMA, these practices can negatively affect both institutional investors and retail investors, insofar as they increase the risk of misinformation, mis-pricing and mis-selling.[36]

This obviously represents an issue, which is further exacerbated by the consideration that several article 8 funds (and article 9 funds as well) still have considerable exposure (which sometimes is still growing) to investee companies significantly relying on fossil fuels.[37] From the opposite perspective, the incorrect use of these provisions exposes financial market participants to the risk of being accused by end-investors of engaging in greenwashing practices when the sustainability elements embedded in the investment strategies of their financial products are very limited or, even worse, absent.[38]

8. Regulatory divergences among member states

ESMA pointed that also regulatory arbitrage can lead to greenwashing.[39] Importantly, there exist diverging applications of the rules on what constitutes a 'green' financial product across member states. On top of that some member states have introduced in their domestic legal framework provisions aimed at further defining the European rules.[40]

On these grounds, BaFin in Germany has published guidelines on sustainability risk management and consulted about the possibility of adopting provisions on sustainable investment funds.[41] Similarly, at the beginning of 2020, the French *Autorité des Marchés Financiers* (*AMF*) published a recommendation titled 'Information to be provided by collective investment schemes incorporating non-financial approaches'.[42] Such recommendation, which is applicable to every French alternative investment fund and UCITS scheme as well as to non-French UCITS schemes authorised to be marketed to retail investors in France, aims at preventing greenwashing practices through requesting that information given to investors on the consideration of ESG factors and sustainability is proportionate to the attention actually paid by the investment fund to such factors.

Yet, such guidelines and recommendations adopted at national level add the national authorities' viewpoint to the EU legal framework. The national authorities' viewpoint

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[35] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-24, 10 February 2022, ESMA30-379-1051.

[36] Id.

[37] See EUROSIF, EU Sustainable Finance & SFDR: making the framework fit for purpose - Eurosif Policy Recommendations for Article 8 & 9 product labels, June 2022, 9.

[38] Id., 3.

[39] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-24, 10 February 2022, ESMA30-379-1051.

[40] See A. Peter – N. Bonnet, Challenges and practical solutions to sustainable investing in the EU, in IFLR 1000, 30 March 2022, defining such national initiatives as 'gold-plating rules'.

[41] See BaFin, BaFin starts consultation on its Guidelines on sustainable investment funds, Press Release, 2 August 2021, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2021/pm_210722_Nachhaltigkeitsleitlinien_en.html.

[42] See Autorité des Marchés Financiers (AMF), Information to be provided by collective investment schemes incorporating non-financial approaches, AMF Position/Recommendation - DOC-2020-03, 11 March 2020, available at https://www.amf-france.org/sites/default/files/doctrine/Position/Information%20to%20be%20provided%20by%20collective%20investment%20schemes%20incorporating%20non-financial%20approaches.pdf.

nonetheless can diverge across the EU and such differences can end up making it more difficult for financial market participants to operate on a cross-border basis.[43] Furthermore, from a systematic perspective, such an approach contrasts with the intention of the EU legislator to ensure maximum harmonisation of the legal framework clearly resulting from the considerable use of regulations instead of directives.

Also, such divergences can facilitate greenwashing practices leading to investor protection challenges such as lack of comparability, transparency and even mis-selling, for instance when products with a similar or even the same name do not have the same environmental characteristics.[44] This problematic situation can be effectively tackled only through coordination and harmonisation efforts led by ESMA on the basis of closer cooperation with national competent authorities. Harmonisation is a *conditio sine qua non* for the creation of sustainability labels to be given to financial products.[45]

9. ESMA's understanding of greenwashing

On the basis of a specific mandate received from the European Commission, since 2021 ESMA has been extensively working on greenwashing. On these grounds, ESMA has drafted a very broad definition of greenwashing which refers to 'market practices, both intentional and unintentional, whereby the publicly disclosed sustainability profile of an issuer and the characteristics and/or objectives of a financial instrument or a financial product either by action or omission do not properly reflect the underlying sustainability risks and impacts associated to that issuer, financial instrument or financial product'.[46] In the view of ESMA, 'greenwashing could, therefore, be generally identified as a misrepresentation, mislabelling, mis-selling and/or mis-pricing phenomenon. However, these terms may only represent the ultimate symptoms, since the causes of greenwashing may relate to multiple aspects of the functioning of the investment value chain, sometimes affecting nodes of that chain long before a certain financial product reaches the final investor. This is the case, for example, of issuers' disclosures misrepresenting the real sustainability profile of a listed entity or the poor quality of data available to an EU investment fund on investee companies located within or outside the EU'.[47]
On these grounds, ESMA correctly underlined that greenwashing does not necessarily only take place when a product is offered to investors. Misrepresentation of the real sustainability profile of a given investment might originate even earlier on, for example when an issuer discloses sustainability-related information concerning its economic activities. Accordingly, the causes of greenwashing may result from poor issuer disclosures misrepresenting the real sustainability profile of an entity or from the poor quality of data available to an investment fund on investee companies. On the other hand, the reference to unintentional market practices

[43] See A. Peter – N. Bonnet, Challenges and practical solutions to sustainable investing in the EU, in IFLR 1000, 30 March 2022, arguing that 'although these apply only to national products distributed to domestic retail investors and often focus mainly on marketing material, fund managers looking to distribute their products in these countries must still take them into account, and must find ways to accommodate them at the risk of being shut out of the market for misalignment with local rules or client expectations. Such rules can introduce minimum sectoral exclusions, materiality thresholds for proposed ESG approaches, or minimum sustainable investment percentages, all of which can add onto the EU level rules (which themselves ought to be seen as a transparency mechanism above all else)'.

[44] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-24, 10 February 2022, ESMA30-379-1051.

[45] See D. Zetzsche – M. Bodellini, A Sustainability Crisis Makes Bad Laws — Towards Sandbox Thinking in EU Sustainable Finance Law and Regulation, Working Paper, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4147295, *passim*.

[46] See European Securities and Markets Authority, Sustainable Finance Roadmap 2022-24, 10 February 2022, ESMA30-379-1051.

[47] Id.

might pose legal issues in the event of enforcement as it could become complicated to raise sanctions and to bring claims against financial market participants on these grounds.

10. The work of ESMA on greenwashing

ESMA, along with the national competent authorities, are looking into greenwashing from a number of different perspectives. They aim at reaching consensus on a definition of greenwashing; such definition is expected to help drive the supervisory work in a coordinated and efficient manner across sectors. Developing this complex definition should be preceded by discussions on supervisory cases to gain a shared understanding of what in NCAs' perception can be regarded as greenwashing. Once a definition has been identified, consistency in its application and in the application of the inherent provisions will be key. Q&As and Guidelines in this respect will be important tools. ESMA and the national competent authorities should also see whether there are in the framework currently in force areas of inconsistency or potential gaps which would require regulatory action.[48]

On the basis of its 2022-2024 roadmap, ESMA published a supervisory briefing on 31 May 2022 clearly stating that administrative measures including enforcement, may be appropriate to consider in the following (non-exhaustive) cases, in order to combat greenwashing: a) 'legally required SFDR disclosures have not been made at all after the application of the new rules'; b) 'SFDR disclosures are viewed as severely misleading. This is particularly the case when consistency checks would highlight a situation where there is a significant discrepancy between what the fund actually invests in and what has been disclosed to investors in pre-contractual disclosure documentation'; c) 'sustainability risks have not been integrated throughout the organisation despite an appropriate period of time after entry into force of the AIFMD and UCITS amendments in this respect'; d) 'the periodic disclosure of a financial product disclosing under Article 8 or 9 SFDR does not match (or fulfil) the characteristics or objectives shown in the fund documentation'; and e) 'a financial product disclosing under Article 9 SFDR with a sustainable investment objective shows in periodic disclosure that significant proportions of investments do not comply with the sustainable investment criteria of Article 2(17) SFDR'.[49]

With a view to collecting useful information on greenwashing to be used also to draft a thorough definition, the ESAs published a Call for Evidence seeking input on potential greenwashing practices in the whole EU financial sector, including banking, insurance and financial markets.[50]

Moreover, on 18 November 2022, ESMA published a Consultation Paper on Guidelines on funds' names using ESG or sustainability-related terms.[51] Importantly, ESMA emphasised that while lately investor demand for investment funds that incorporate environmental, social and governance (ESG) factors has been growing sharply, the lack of effective application of clear criteria for sustainability, such as the ones of the Taxonomy, represents an issue. In fact,

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[48] Id.

[49] See European Securities and Markets Authority, Sustainability risks and disclosures in the area of investment management, Supervisory briefing, 31 May 2022, ESMA34-45-1427.

[50] See ESAs, ESAs Call for evidence on better understanding greenwashing, available at https://ec.europa.eu/eusurvey/runner/ESAsCfEGreenwashing2022, where it is pointed that the ESAs are interested in collecting: 'i. The views from various stakeholders on how to understand greenwashing and what the main drivers of greenwashing might be; ii. Examples of potential greenwashing practices across the EU financial sector relevant to various segments of the sustainable investment value chain and of the product lifecycle; and, iii. Any available data to help the ESAs gain a concrete sense of the scale of greenwashing and identify areas of high greenwashing risks'.

[51] See ESMA, Consultation Paper on Guidelines on funds' names using ESG or sustainability-related terms, 18 November 2022, ESMA34-472-373.

sustainability disclosures may give rise to greenwashing and this is particularly relevant when funds are named as green or socially sustainable, although sufficient sustainability standards commensurate with that name have not been met.[52] On these grounds, the ESMA consultation paper aims to develop precise Guidelines on funds' names with ESG or sustainability-related terms.[53] On these issues ESMA is currently seeking the views of external stakeholders.[54]

The starting point is obviously that the fund name is one of the most effective ways to provide investors with information about the fund in question. In other words, the fund name is the first marketing tool at the disposal of the fund manager. Against a background where market interest for ESG investments is growing, there exist incentives for asset managers to use terminology in their funds' name that can attract investors' interest. Yet, if the name does not match the real underlying strategies of the investment fund, a considerable risk of greenwashing exists. On these grounds, the ESMA Consultation Paper has proposed the introduction of quantitative thresholds for the use of ESG and sustainability-related terminology on the assumption that funds' names should not be misleading and the disclosure of sustainability characteristics should be commensurate with funds' effective characteristics. On these grounds, the use of ESG- and sustainability-related terminology in fund names should be allowed only if there is evidence that sustainability characteristics and objectives are reflected consistently in the fund's investment strategies and policy.

More precisely, the proposal advanced by ESMA is twofold. On the one hand, for funds having ESG-related words in their name, a minimum proportion of at least 80% of the underlying investments should be used to meet the environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy. On the other hand, funds having the word "sustainable" or any other term derived from the word "sustainable" in their name should allocate within the 80% of investments to "meet the characteristics/objectives" at least 50% of minimum proportion of sustainable investments as defined by Article 2(17) of SFDR.

Despite its laudable intentions, this proposal does not seem able to effectively contrast greenwashing as it refers back to the ambiguous definitions provided by the SFDR concerning environmental and social characteristics and sustainable investments. The introduction of prescriptive investment thresholds should be further explored as they can be an effective way to anchor the investment strategy to the pursued objective. However, to properly function, such thresholds cannot be determined against vague criteria as the ones of the SFDR.

11. Policy considerations and ideas for reform proposals

A clearer and possibly more demanding legal framework as to the qualification of green and/or sustainable financial products would certainly be helpful to successfully contrast greenwashing practices, while providing the market with the necessary transparency. From a *de jure condendo perspective*, a legal framework of this kind could be based on two different

[52] Id.

[53] The issue of fund names is being tackled even outside the European Union. In the US, a proposal to amend rule 35d-18 under the Investment Company Act of 1940 (also known as the "Names Rule") to expand its scope to apply to any fund name with terms that suggest, among others, investment decisions incorporating one or more ESG factors has been advanced; see SEC, SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names, Press Release 25 May 2022, available at https://www.sec.gov/news/press-release/2022-91. In the UK, the FCA is proposing to introduce restrictions on how certain sustainability-related terms – such as 'ESG', 'green' or 'sustainable' – can be used in product names and marketing for products which do not qualify for the sustainable investment labels; see FCA, FCA proposes new rules to tackle greenwashing, Press Release 25 October 2022, available at https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-tackle-greenwashing.

[54] See ESMA, Consultation Paper on Guidelines on funds' names using ESG or sustainability-related terms, 18 November 2022, ESMA34-472-373.

legislative acts: on the one hand, there would be the SFDR only governing disclosure obligations, whereas, on the other hand, there would be a new piece of legislation establishing precise rules on financial products' portfolio composition aligned with the labels (e.g. dark green and light green) to assign. Such rules on portfolio composition should introduce thresholds concerning the minimum amount of sustainable investments that dark green products are expected to make. In this respect the definition of sustainable investments under the SFDR is vague and too broad and thus cannot be used as a reference to calculate such thresholds. By contrast, the criteria set out by the Taxonomy framework would work as a reference, but they are too demanding and for quite some time it is likely that only a few economic activities could meet them.[55] As a result, for the system to work, the extension of the taxonomy framework is needed so as to include also other economic activities with a positive environmental performance, that however do not reach (yet) the technical screening criteria of environmentally sustainable economic activities.[56] The methodology used by the taxonomy is able to provide clarity. Such methodology should be used to also define additional activities with a positive environmental performance. Such activities could be the ones to be financed through the investments made by dark green financial products.

On the other hand, rules on portfolio composition of light green financial products should precisely define what promoting environmental and social characteristics means, based on the condition that such promotion cannot be understood as an empty filler that every financial market participant can autonomously fill simply by stating that investments in illegal activities cannot be made.

12. Concluding remarks

This paper has analysed the European legal framework on sustainable finance with a view to identifying and discussing the main provisions potentially leading to greenwashing. The new initiatives undertaken by the European Commission and ESMA have also been investigated and some critical remarks and policy considerations have been advanced. Particularly, a position in favour of adopting an extended taxonomy has been taken in that such extended taxonomy could act as a reference point for the determination of thresholds to use for distinguishing between financial products with different degree of sustainability ambitions.

[55] Id., where it is said that the increasing demand of ESG investments 'without the effective application of existing criteria for sustainability, such as the EU Taxonomy, has led to concerns in ESMA'.

[56] See D.A. Zetzsche, M. Bodellini and R. Consiglio, Towards A New European Social Taxonomy: A Counterproposal Based On A Three-Step Approach, University of Luxembourg, Working Paper, 2022.