Greenwashing: What's in a name?

With the FCA set to publish final labelling rules in the UK by the end of the year, Elisabeth Øverland and Emily Smith explore the key proposals and challenges involved

Since this article was written, the final rules have been published by the FCA. These can be accessed here: https://www.fca.org.uk/publications/policy-statements/ps23-16-sustainability-disclosure-requirements-investment-labels

Final rules for the introduction of a UK sustainable investments labelling regime are expected to be published shortly. The UK's Financial Conduct Authority (FCA) published its consultation paper (CP 22/20) setting out its proposals for the regime in October 2022,[1] building on its 2021 Discussion Paper on Sustainability Disclosure Requirements (SDR) and investment labels (DP 21/4).[2] The proposed new rules are consumer-centric, with the FCA aiming to protect consumers from potential harms such as 'greenwashing' (where products are misleadingly described as having sustainable characteristics), and helping them navigate an increasingly complex product market. The labelling regime will form part of the FCA's delivery of the UK Government's Roadmap to Sustainable Investing.[3]

The proposed requirements focus primarily on portfolio managers and funds based in the UK, although the FCA has been clear that it expects the scope of the labelling regime to expand over time, and specifically that consideration will be given to the applicability of the regime to overseas products marketed in the UK, which are outside the scope of the current proposals. The FCA intends to publish a separate consultation in due course on how the rules may apply to overseas funds.

Originally intended for June 2023, the FCA has delayed the publication of its corresponding policy statement (containing the final rules) a couple of times, noting it received around 240 written responses to the CP, and it is now expected to be published by the end of 2023.[4] The FCA is expected to reconsider some of its proposals in order to address stakeholder concerns, including some of the practical challenges that firms may face.

Affected firms will need to start implementation planning soon, which may include complex considerations of the interaction between the UK regime and similar rules in different jurisdictions for firms that are subject to several regimes.

Sustainable investment labels

The proposed labels distinguish between three different types of products according to their investment aims:

1. **Sustainable focus** – Products with an objective to maintain a high standard of sustainability in the profile of assets by investing to meet a credible standard of environmental or social sustainability or to align with a specified environmental or social sustainability theme.
2. **Sustainable improvers** – Products with an objective to deliver measurable improvements in the sustainability profile of assets over time, including in response to the stewardship influence of the firm.
3. **Sustainable impact** – Products with an explicit objective to achieve a positive, measurable contribution to sustainable outcomes.

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The labels are based on 'intentionality' and focus on the particular sustainability objective the product is seeking to achieve. There is no obligation to apply a label and no hierarchy between the labels, as each type of product is designed to deliver a different profile of assets and meet different consumer preferences. As they are intended to be mutually exclusive, products with a blended strategy would not be able to qualify for more than one label.

To qualify for a label, products must meet certain criteria, including five overarching principles applicable to all three labels, and specific criteria applicable to each label. The overarching principles include the need for the product to have an explicit environmental or social sustainability objective. Other principles relate to the firm's investment policy and strategy, key performance indicators (KPIs), investor stewardship, and resources and governance. One of the specific criteria for the 'Sustainable focus' label, which has been the subject of much industry commentary, is that "at least 70% of the product's assets must meet a credible standard of environmental and/or social sustainability, or align with a specific environmental and/or social sustainability theme".

Several industry responses have called for further guidance and context on this criterion. For example, how should firms calculate the 70% threshold (e.g. on a weighted basis or pass/fail approach), and why has no quantitative threshold been applied to the other labels? The FCA recognised concerns relating to the proposed criteria in an update in March[5] and confirmed that, in considering the feedback, it may refine some of the specific criteria for the labels and clarify how different products can qualify for a label (including multi-asset and blended strategies).

If a firm applies one of these labels to a product, associated product and entity disclosure requirements will apply, with some targeted at consumers and others at a broader range of stakeholders, including institutional investors. Although disclosures will also apply to products without a label, these will be more limited under the proposals.

Where a label is not applied

Where firms do not apply a label to a product, either because the product does not meet the relevant qualifying criteria or they decide not to apply a label, under the proposals firms must comply with new 'naming and marketing' rules. ►

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Firms should expect to be scrutinised on their performance, not only by financial regulators

These are aimed at reducing the risk of firms continuing to name or market products in a way that may indicate that they are sustainable, when in practice they do not qualify for a label. The FCA is proposing to prohibit firms providing in-scope products that do not qualify for a label from using sustainability-related terms in product names and marketing, including 'ESG', 'climate', 'sustainable', 'green', 'Paris-aligned', 'net zero' etc. Restrictions will also apply to products labelled 'Sustainable Focus' or 'Sustainable Improvers' by preventing use of the term 'impact' in their naming and marketing.

One difficulty with this proposal is that products that may not qualify for a label may nevertheless have sustainability-related characteristics that could be important to consumers. Responses to the CP have emphasised the importance of consumers receiving the information they need to understand the features of such products. The FCA has recognised this concern in its March update, confirming that there will be a place for such products in the overall package of measures, and it is considering its approach to marketing restrictions.

Anti-greenwashing rule

Under the proposals, a general 'anti-greenwashing' rule will apply to all regulated firms upon the publication of the FCA's policy statement. This will clarify that sustainability-related claims must be clear, fair and not misleading, and consistent with the sustainability profile of the product or service (i.e. proportionate and not exaggerated). While this reaffirms existing requirements in the FCA Handbook,[6] the FCA wants an 'explicit rule' on which to challenge firms that it considers to potentially be greenwashing, and to ensure firms understand that these requirements apply when they are making sustainability claims.[7] There appears to be general support across the industry for the proposed anti-greenwashing rule, but questions remain as to its practical application, including the impact on innovation and 'green-hushing' (firms opting to remain silent on their climate strategies).

Coherence with other international regimes

Whilst the FCA notes that it is working to maintain coherence between its proposals and similar requirements/proposals in other markets, a number of important differences will likely involve additional complexity for firms subject to several regimes. In the CP, the FCA has included mapping diagrams to help firms translate EU Sustainable Finance Disclosure Regulation (SFDR) categories and US Securities and Exchange Commission (SEC) proposals across to the proposed UK labels. However, mapping across products is not always easy. For example, an Article 8 fund (promoting, amongst other characteristics, environmental or social characteristics or a combination of them, provided that the companies in which the investments are made follow good governance practices) marketed under SFDR may fail to qualify for a label under the proposed UK regime if the fund does not have an explicit sustainability objective. Therefore, for a firm to classify an Article 8 SFDR fund under the UK labelling regime, it would have to 'level up' by specifying a sustainability objective.

This is just one example of the practical challenges firms might face in being subject to more than one regime, with the lack of interoperability likely to present challenges for investment managers applying strategies across different jurisdictions. The FCA noted in its March update that it will continue to consider how to further support compatibility with other regimes, while emphasising the need for robust UK standards.

A wider focus

The proposals reflect an increasing focus by the FCA (and other regulators internationally) on greenwashing. The regime is complex and leaves significant areas for judgment, and firms should expect to be scrutinised on their performance, not only by financial regulators (through supervisory and enforcement activity) but also by customers, NGOs, and other bodies. It is critical that the public interest in consumer protection (which is also at the heart of the FCA's new Consumer Duty) and in promoting sustainability are aligned. Whether the FCA's final rules will strike the right balance between protecting consumers and encouraging the development of sustainable investment products and services remains to be seen.

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1. CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)
2. DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)
3. Greening Finance: A Roadmap to Sustainable Investing (publishing.service.gov.uk)
4. Regulatory Initiatives Grid – Update from the co-chairs July 2023 (fca.org.uk)
5. FCA updates on its Sustainability Disclosure Requirements (SDR) and investment labels consultation | FCA
6. PRIN 2.1, Principle 7 and COBS 4.2.1 in the FCA Handbook.
7. Section 6.10, page 74: CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)