14 January 2026
ESMA36-429234738-165

Thematic notes on clear, fair & not misleading sustainability-related claims

Addressing greenwashing risks in support of sustainable investments

Second Note: ESG strategies

I. General expectations

These thematic notes are prepared for the attention of market participants with an educational objective and build on observed market practices. Using the four principles as a basis, the second note focuses on ESG strategies. Other thematic notes will follow, as judged necessary. When combined, the notes should be read as a thematic study.

Why do sustainability claims matter?

1. Sustainability information remains increasingly important to the choices of investors. Market participants have a responsibility to communicate sustainability information in line with the principle of "fair, clear, and not-misleading information". Sustainability claims are related to key aspects of the sustainability profile of an entity or a product[1].

2. Sustainability claims are made by market participants across the Sustainable Investment Value Chain (SIVC), notably by issuers, fund managers, benchmark administrators and investment service providers. Due to the complex nature of sustainability information, market participants making sustainability claims may risk that these claims are misinterpreted and that investors are misled, regardless of whether or not this is the market participant's intention.

3. In line with the work carried out by ESMA on greenwashing in which good and bad practices have been observed, this section aims to explain and clarify ESMA's expectations towards market participants when making sustainability claims, leveraging off the European Supervisory Authorities (ESAs)' common high-level understanding and the core characteristics[2] of greenwashing as stated in the ESMA Progress Report[3].

4. Market participants should acquaint themselves with the below four principles for making sustainability claims to ensure that all claims are clear, fair, and not misleading and thereby avoid the risk of greenwashing. Misleading claims can in particular take the form of cherry-picking, exaggeration, omission, vagueness, inconsistency, lack of meaningful comparisons or thresholds, misleading imagery or sounds, etc.

Four principles to follow

5. ESMA's starting point in designing these principles is the ESA's Progress Reports on Greenwashing that recognised misleading sustainability claims being a concern from an investor protection perspective, whether they are specifically covered by the EU sustainable finance rulebook or not. Certain EU legal

[1] The terms "products" is meant to cover financial products and services.
[2] (1) has a misleading component, (2) can occur at product/service level or at entity level, (3) can occur and spread intentionally or unintentionally, (4) can occur at different stages of the product lifecycle, (5) can occur in or out of the current regulatory framework, (6) the source can be the entity in question or a third party, (7) undermines trust in undertakings/markets and (8) may or may not result in immediate damage to consumers or investors.
[3] ESMA30-1668416927-2498 Progress Report on Greenwashing

texts go further in defining the meaning of 'clear, fair and not misleading information'[4]. The four principles are in line with those set out by the 2024 EIOPA Opinion and by the EBA Final report on greenwashing[5].

6. The principles do not create new disclosure requirements but aim to remind market participants about their responsibility to make claims only to the extent that they are clear, fair and not misleading. These principles and the following guidance included in these notes apply to non-regulatory oral and written communications, referred to as 'communications'. For the purpose of these thematic notes, regulatory information is understood as that required by specific disclosure standards (e.g. fund or bond prospectuses, management reports, funds' KIDs, benchmark statements), while non-regulatory information covers all other types of communications such as marketing materials and voluntary reporting. Communications aimed at retail investors may vary in length and may need to rely on the use of layering which is further explained below[6].

FIGURE 1: FOUR PRINCIPLES TO FOLLOW

1) Accurate

- Sustainability claims should fairly and **accurately** represent the entity's sustainability profile, and/or that of its financial products. This should be done without exaggeration and **consistently** across all communications while avoiding falsehoods.
- Claims should be precise and be based on all relevant positive and negative aspects. **Omission and cherry-picking** should be avoided. Claims should steer clear of **vagueness** and excessive references to irrelevant or non-binding information.
- Market participants should make sure that the **ESG terminology and non-textual imagery or sounds** used are **consistent** with the sustainability profile of the entity or product and do not overshadow the other contents.

2) Accessible

- Sustainability claims should be based on information that is **easy to access** and easy to browse through by readers[7] and at an appropriate level of detail so they are understandable. Moreover, claims should not be **oversimplistic** but should be easy to understand.
- Sometimes more explanation is desirable beyond the space provided, or when the aim is not to overwhelm the reader with information. This is particularly important in the case of short marketing materials aimed at retail investors. Further substantiation can then be presented to the reader in **layers** in the case of documents distributed in electronic format, ensuring substantiation is easy to find.

3) Substantiated

- Sustainability claims should be substantiated with **clear and credible** reasoning, facts and processes.
- Substantiation should be based on **methodologies** (including **comparisons, thresholds or underlying assumptions**) that are fair, proportionate and meaningful. Limitations of information, data and metrics used in a claim should be made available. Comparisons should make clear what is being compared, how the comparison is made and, if possible, compare "like with like".

4) Up to date

- Sustainability claims should be based on information that is **up to date** with any material change to be disclosed in a timely manner.
- The clear indication of the analysis' date and perimeter could be useful for this purpose.

[4] For further details, see Annex 2 of the ESMA36-287652198-2699 Final Report on Greenwashing.
[5] EIOPA-BoS-24-160- Opinion on sustainability claims and greenwashing & Report on greenwashing monitoring and supervision.pdf The principles match the other ESA's principles with which they share a common trait: while each principle targets different aspects, the principles can overlap due to their complementary nature.
[6] More information on the importance of layering is present in the ESMA Opinion on the sustainable finance framework.
[7] Such as retail investors, institutional investors, supervisory authorities and other market participants.

II. Sustainability claims on ESG Strategies

Reasoning

1. References to ESG strategies, notably to ESG integration and ESG exclusions are often made by market participants and widely referenced in marketing communications aimed at retail investors. This note focuses on the way these two types of ESG strategies are described, communicated to investors.

2. Various ESG strategies serve as building blocks or standalone choices in the design of the overall ESG approach used by funds, benchmarks and other investment products that have similar characteristics to funds (e.g. discretionary mandates and certain sustainable Exchange-traded products included in some Euro Medium Term Notes (EMTNs)). Claims about ESG integration and ESG exclusions concern fund managers, benchmark administrators, issuers and investment service providers.

3. Terms like negative and positive screening, best-in-class selection, thematic and impact investing are indicative of a broad market understanding of sometimes overlapping ESG strategies. It is observed that ESG integration and ESG exclusions are widely considered as less ambitious among these strategies and can mean different things to different market participants and imply different levels of ambition. For this reason, ESG integration and ESG exclusions need to be explained in clear language by market participants. Otherwise, they can be misleading. For example, sometimes ESG integration is used as an umbrella term for other ESG strategies.

4. Market participants are expected to communicate in a clear, fair and not misleading manner to investors on the way they define ESG integration and ESG exclusions and the elements they apply under such strategies. This note builds on a collection of definitions most used by the market[8], recognising their differences.

5. **ESG integration:** strategy generally aimed at improving risk-adjusted returns by factoring in material ESG risks and opportunities. Market participants have different ways of doing ESG integration. At a high level, there may be binding or non-binding consideration of one or more ESG factors that may or may not be instrumental in deciding to include or exclude an investment. ESG factors include risks and opportunities that may or may not be material for the investments in question, whether this be based on financial (or single) materiality or on an assessment of sustainability impact in the real economy (double materiality).

6. **ESG exclusions:** strategy commonly aimed at avoiding or minimising exposures that are prone to risks and/or at aligning the portfolio with specific values or norms. Market participants have different ways of implementing ESG exclusions, usually via a consistent application of filters to a universe of securities, issuers, investments, sectors, regions, business practices and/or other financial instruments to rule them out. Market participants seem to use a mix of one or several types of ESG screening techniques[9] based on ESG criteria for when investments are not permitted in a portfolio.

7. One of the key differences between the two strategies is that ESG exclusions tends to focus on holdings that are prohibited, while ESG integration does not mean a security/asset/sector will be excluded from

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[8] This was done by studying real examples of claims, as well as via a desk-based review of several reports such as those by the CFA Institute (How to Build a Better ESG Fund Classification System | RPC) Eurosif, UNPRI, the Platform on Sustainable Finance, etc.
[9] (i) exclusions (using desirable and undesirable ESG criteria), (ii) negative screening (using only undesirable ESG criteria) and (iii) norms-based screening (based on compliance with widely recognised ESG standards or norms).

the portfolio automatically, but that the attractiveness of holding certain securities, assets, sectors will be ascertained by scoring them on ESG factors.[10]

Observed market practices when communicating on ESG integration

8. There seems to be a consensus about the step or activity of the relevant investment process where this strategy is used: ESG information is applied namely in the investment analysis and decision-making/ portfolio construction steps. These include security selection (analysis at the 'bottom-up level'), weighting of securities, and defining 'top-down' asset allocation.

9. Observed points of difference regarding market practices on ESG integration:

   1) Binding or non-binding part of the product's ESG approach[11]. In some cases, ESG integration can be a non-binding, optional aspect of the product's strategy that may be conducted on an ad-hoc basis or only for some of the portfolio holdings. In other cases, it can be binding and applied across the entire portfolio, or for a part of it (e.g. certain asset classes).

   2) Any material change in ESG factors may or may not trigger a need for action. For some products, the integration of financially material ESG factors into company analysis is not only binding, but it creates a need for action for those market participants managing that portfolio. This either triggers a portfolio construction (for benchmarks) or an investment decision or an explanation by the portfolio managers. On the other hand, for other products, a similar material change in ESG factors may not trigger any need for action. Usually, ESG integration is focused on ESG factors that are financially material (i.e. single materiality).

   3) ESG factors may or may not play a key role in portfolio construction as they may or may not be treated with the same level of importance as key material financial information. At the 'bottom-up level' this means the product focuses on one or more ESG factors by using them as a significant or main consideration in selecting securities. At the 'top-down level', this entails buying, selling or adjusting the weights of certain asset classes, sectors, regions based on material ESG factors. In other cases, ESG factors may be only an adjacent consideration.

   4) ESG factors may or may not be integrated in the financial analysis for each security/instrument/ asset class/ sector /country to which ESG integration is applied. In top-down asset allocation, this can be done via scenario analysis, sensitivity analysis, and benchmark-relative weighting. For equity analysis, techniques include adjustments to forecasted financials, to valuation model assumptions (e.g. weighted average cost of capital), and the development of valuation multiples.

   5) Actual impact on portfolio composition: Depending on the products, ESG integration may or may not have a notable impact on the portfolio holdings and weights of the product compared to an otherwise identical strategy that doesn't do ESG integration. In the last few years, market participants have created ESG versions of their flagship products by replicating an investment strategy with an ESG integration or ESG exclusions add-on. Depending on the level of ambition with which the above characteristics are addressed, significantly different portfolios for the non-ESG and ESG products or very similar ones are observed. The overlap of the two portfolios is used to measure the impact of the ESG strategy on the portfolio composition. In some cases, the two portfolios may share 80%-90% of holdings and have a very similar risk/return profile. Another

[10] The focus on what is prohibited is what sets ESG exclusions apart from other strategies like positive screening or best-in-universe and best-in-class (based on ESG criteria that are desirable/ desirable relative to peers). These best-in-universe and best-in-class strategies are broadly considered similar in terms of process to exclusions, thus many of the do's and don'ts for ESG exclusions may also be relevant for them.

[11] In line with the more formal disclosure already required under SFDR about the binding elements of the investment strategy used to select the investments to attain the characteristics or objectives of the product.

way to measure the impact is via the tracking error relative to the relevant non-ESG benchmark. In some cases, the implementation of the ESG strategy does not lead to a substantially higher tracking error, indicative of a low impact on portfolio composition.

Observed market practices when communicating on ESG exclusions

10. Similar to ESG integration, there seems to be a consensus among market participants about the step or activity of the relevant investment process where this strategy is used, namely the investment analysis and decision-making/ portfolio construction steps.

11. Observed points of difference among market participants regarding their practices on ESG exclusions:

    1) Relying on absolute or relative thresholds used for the exclusions that can be more or less ambitious

    2) Relying or not on a materiality assessment in defining the ESG criteria or factors on which the exclusion rules or screenings are based. In some cases, these rules may concern ESG factors of little relevance to the investable universe and possibly with little impact on reducing or shaping it[12]. In other cases, ESG exclusion strategies may be based on a materiality assessment and select ESG criteria in connection with the relevant ESG risks and opportunities for a given investment universe.

    3) Actual impact on portfolio composition: the application of the exclusion criteria may or may not have a notable impact on reducing the initial investment universe compared to an otherwise identical strategy that doesn't apply ESG exclusions. Not all products using ESG exclusions note a big reduction of the investable universe and/or final portfolio composition relative to an identical strategy that does not use these ESG exclusions. Similarly, not all products note an increase in tracking error. This is due to the materiality aspects explained above, as well as to the thresholds linked to the ESG criteria which can be more or less ambitious.

12. These divergent market practices regarding ESG integration and ESG exclusions are often not well explained by market participants, thus creating a risk of claims being misinterpreted and investors being misled in the absence of sufficient transparency. For this reason, the practical do's and don'ts and examples that follow aim to provide useful guidance both to investors and to the market participants making these claims.

[12] e.g. firmwide exclusions regarding tobacco that may not be material for a clean energy benchmark leading to few or no relevant securities being prohibited.

Claims about ESG integration

Do's

- When using the term "ESG integration", do make clear what is meant by it the first time it is used in the communication. Use plain language to accurately describe how ESG factors are considered in the portfolio construction process and try to use illustrative examples to clarify abstract terms.
- Be clear about: i) whether ESG integration is a binding or non-binding aspect of the product's approach, ii) whether ESG factors trigger portfolio decisions and if so, if they play a key role in the portfolio construction process or not, iii) the extent to which they are used in the financial analysis of holdings, iv) their impact on portfolio composition.
- Clarify at which level ESG integration is done (e.g. at the level of security selection, security weighing, asset allocation).
- Be transparent about any differences in the level of ambition with which ESG integration is done for various asset classes, sectors, etc. and at each step of the process.
- Be clear about whether the strategy adopts a single or a double materiality approach. Moreover, clarify whether this entails the sole consideration of risks (or also of opportunities).

Don'ts

- Don't use the term "ESG integration" as an umbrella term to describe a variety of ESG strategies such as exclusions, best in class, etc.
- Don't make entity-level claims such as "X% of the assets under management are ESG integrated" or "ESG integration is used in Y% of the discretionary portfolios managed" without clarifying whether this includes only products applying ESG integration and/or other products doing other ESG strategies.
- For products that have an ESG benchmark, don't claim they are doing ESG integration if neither the product's strategy nor that of the benchmark contain any of the elements associated with this strategy mentioned in this note.
- Don't use ESG integration as the basis for emphasising the superior sustainability profile of a product, unless this is supported by the level of ambition in relation to i) a key role that ESG factors play in the portfolio construction process, ii) the extent to which these ESG factors are integrated in financial analysis of holdings and/ or iii) their actual impact on portfolio composition.

Example 1
Good practices

An investment firm that offers discretionary portfolio management services manages several bond accounts investing in corporate and government issuers. Every quarter, an update is sent to its clients in which it includes a description of its ESG integration strategy.

- ✓ It clarifies it applies ESG integration only at the security selection part of its process, adding "Our rationale for owning credits where we observe credit-material ESG challenges is twofold. We see the issuer moving in the right direction to reduce these risks and/or we feel that spreads have sufficiently compensated us for the ESG risks."
- ✓ It explains its ESG integration does not apply to some frontier and emerging bond issuers.
- ✓ It clearly states that it only integrates ESG information in its valuation models for issuers for which it has external ESG qualitative research.
- ✓ It points out that the integration of ESG factors does not lead to exclusions, giving as example a historical holding of a utility company found to be significantly undervalued in light of its environmental risks relative to peers and bought by the fund.
- ✓ It provides a link on the materiality analysis carried out in order to select the most relevant ESG factors included in the ESG integration strategy.

Example 2
Poor practices

Fund manager X offers a multi asset ESG portfolio that holds listed equities, corporate bonds and mortgage-backed securities (MBS). It also manages discretionary portfolios for retail and institutional clients. For listed equities it applies best in universe approach, for bonds a best-in-class approach, and for MBS it does ESG integration. The fund was launched recently and replicates the strategy of a similar fund managed by the same team that does not consider ESG factors.

- × In it its brochure the fund is described as "ESG integrated", without any explanation about what that means and without mentioning that the fund's ESG approach varies for the various asset classes.
- × In the marketing brochure, the fund manager displays this fund alongside the non-ESG version of it claiming "the ESG fund is substantially different from the flagship non-ESG fund". This is inconsistent with the 90% portfolio overlap between the two funds.
- × A retail investor expresses interest in having a discretionary portfolio managed that would replicate the ESG multi-asset strategy. The investor wants to add a bespoke ESG exclusions policy which would rule out all companies doing animal testing. X fails to notify the potential client that this is not a material factor for the given investment universe and that it will not lead to a meaningful reduction of the permissible securities.

Claims about ESG exclusions

Do's

- Describe in plain language the process, the ESG criteria and thresholds used to implement ESG exclusions.
- Clarify whether ESG exclusions are defined in absolute terms or based on thresholds that apply to all the criteria, or some of them.
- Be transparent about whether the ESG exclusions strategy relies on a materiality assessment, and if so, whether this is single or double materiality.
- Be clear about the level of impact of the exclusions on the investable universe and/or on the final portfolio composition, especially if these are negligible.
- For claims about a product's use of ESG exclusions, clarify if the exclusions are defined following a firm-wide policy and/or whether if they are tailor-made to the product's investment universe.

Don'ts

- Don't claim to adopt an ESG exclusions strategy if the exclusion rules are not based on defined criteria and applied consistently.
- Don't use ESG exclusions as the basis for emphasising the superior sustainability profile of products relative to comparable peers, unless this is supported by the level of ambition of the product in relation to i) the materiality of the exclusion criteria, ii) the ambition of the thresholds used for the criteria, and/ or iii) the actual impact of the exclusions on the reduction of investable universe or on portfolio composition.

Example 3
Good practices

A semi-passive global equity fund tracks an ESG benchmark which applies several ESG strategies: first, it excludes companies involved in human rights violations and CO2-intensive industries, second it applies ESG integration at the security selection level. The fund's strategy allows it to invest in companies not held by the benchmark. Across its marketing documents, the fund manager explains that:

- ✓ Human rights violations are measured via a controversy score, clarifying that only companies with very severe human rights violations are excluded.
- ✓ For the off-benchmark companies, instead of the benchmark's criteria for exclusions and ESG integration, it applies a series of different exclusions also used for some of its other funds that are not based on a materiality assessment and that may or may not be material for all the off-benchmark holdings.
- ✓ It clarifies that for these off-benchmark companies "The manager may not assess ESG factors and, when it does, not every ESG factor may be identified or evaluated ".

Example 4
Poor practices

A firm issues a "green" EMTN whose coupon tracks an ESG benchmark composed of emerging market equities. The benchmark has exclusions for fossil fuel developers, as to the development of new oil and gas fields and/or coal mines. On the firm's website, there is a prominently displayed claim "thanks to the benchmark's advanced and above-average ESG exclusion methodology, the EMTN offers zero exposure to fossil fuel developers". The benchmark's factsheet states "when a company is found to violate our exclusion filters, we take immediate action "

- × The two criteria used to implement the fossil fuel exclusion are 1) a peer relative environmental score which gives a negligible weight to fossil fuels and 2) an exclusion using a revenue threshold of Y% from unconventional oil and gas. Both criteria do not prevent the benchmark from holding A, the second largest oil developer in the region.
- × According to the exclusion methodology, fossil fuel developers not meeting the exclusion criteria are permitted if their weight is below 5%, which allows the benchmark to currently hold 4% of company A.

Additional examples for both ESG strategies

Example 5
Good practices

An investment firm offering portfolio management and investment advice services has a brochure for potential clients describing its ESG integration strategy for its discretionarily managed accounts. In the brochure:

- ✓ It clarifies that by ESG integration it means the consideration of relevant financially material ESG risks only.
- ✓ It notes that ESG integration may increase the tracking error of a portfolio relative to a benchmark by 1% to 2%.
- ✓ It explains that in multi-asset portfolios, ESG factors are key investment considerations for equity and bond selection but not for the other asset classes where ESG integration is not applied.

The firm manages a discretionary portfolio for a client Y who expresses various exclusion-related preferences: no more than 5% exposure to alcohol and no tolerance for any exposure to palm oil. When a new green bond is issued by an infrastructure company, the investment team look into the exposure of the issuer's projects and underlying suppliers to palm oil. They notice the main food contractor for one of the financed projects is a company for which more than 20% of their revenues come from palm oil. This is allowed as per the green bond framework of the infrastructure company, which requires all suppliers have no more than 40% exposure to palm oil.

- ✓ Based on this in-depth analysis, the bond is tagged as ineligible given the client's palm oil preferences.
- ✓ For the other ESG integrated portfolios managed by the team, the palm-oil exposure is considered a material ESG risk and integrated in the bond's discounted cash-flow valuation model.

Example 6
Poor practices

An online platform aimed at retail investors has its own internal classifications of products that have an ESG exclusions and ESG integration strategy. These include "low-carbon" ETFs and EMTNs that track benchmarks tagged as "low-carbon" by the platform. The low-carbon classification is given only to benchmarks with exclusions to fossil fuels whose exposures to these sectors are "monitored on an ongoing basis", The platform's website claims that ""ESG is an integral part of our platform's DNA, for every 100 EUR invested in a low-carbon product, we will plant a tree".

- × The platform has a very long and difficult to understand document about its exclusions analysis for the low-carbon products which includes irrelevant information about the trees planted yearly.
- × The document fails to clarify that the thresholds applied in the analysis of ESG benchmarks that qualify as "low-carbon" are not very ambitious. Indeed, the fossil fuel exclusions thresholds applied by the benchmarks can be up to 40% higher than the thresholds used in the PAB/CTB exclusions.
- × The platform is not transparent about the outdated nature of the benchmark holdings used in the analysis (12 months old) of the ETFs and EMTNs, nor about the frequency with which the analysis is performed which is only on a yearly basis.
- × The process for adding a product tracking a new, not yet analysed ESG benchmark to the platform and labelling it as "low carbon" allows for the actual analysis to be conducted ex-post, up to 6 months after this classification is given. This information is difficult to find in their methodology document.