

Deutsche Börse Group's response on the ESAs Call for Evidence on better understanding greenwashing

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Re: ESAs Call for Evidence on better understanding greenwashing

Deutsche Börse Group (DBG) appreciates the opportunity to provide comments on the ESAs Call for Evidence (CfE) on better understanding greenwashing.

The problem of greenwashing is fast climbing the policy and regulatory agenda. Apart from the consumer protection implications that greenwashing may entail, the issue also casts doubt on whether financial markets are genuinely responding to the changing profile of client preferences for sustainable investment. Greenwashing can undermine consumer trust and create the conditions for unfair competition and free-riding behaviours. This distortion of market integrity may even undermine broader sustainable finance policy objectives and public policy goals such as the European Green Deal.

Therefore, DBG welcomes that regulators not only in the EU but globally, are paying attention and focusing on retail investor protection as well as mis-selling of ESG products. We believe that misconduct, manipulation or deception – whether in connection with sustainability claims or securities frauds generally – should be matched by robust enforcement of laws.

Given the fact that greenwashing is a complex phenomenon which can involve or impact a multitude of financial market participants and potentially affects all sectors in the sustainable value chain, we hope that by providing a multidimensional view along our own unique value chain – covering several parts of the sustainable investment value chain – we can contribute positively to the fact-finding nature of this CfE. We would like to note that we use the term “greenwashing” broadly to include sustainability-related claims relating to all aspects of the ESG spectrum (i.e., environmental, social and governance dimensions).

Addressing rising concerns about greenwashing is key to our business, to ensure trust in sustainable finance and the broader capital markets. Trust is essential for functioning markets, fostering growth and sustainable economies. At DBG, we provide fair, transparent, reliable and stable infrastructures that ensure safe and efficient markets around the globe.

DBG generally shares and supports the ESAs understanding of greenwashing

What has come to be a widespread and accepted term – “greenwashing” – lacks a formal definition. DBG welcomes the efforts undertaken by the ESAs to provide more clarity and, as a consequence, tackle the issue of greenwashing on that basis.

DBG therefore supports the ESAs understanding but would like to note some comments, namely:

- We would like to stress the importance of full and fair corporate ESG disclosure as a requisite to a strong ecosystem on which investors can rely for timely, relevant and reliable information that collectively presents a clear picture of a company’s business or financial condition. Asset owners, asset managers, benchmark administrators, ESG research and ratings firms, and the markets rely on companies and auditors to ensure that these reports are accurate. This serves as the foundation for investor confidence.
- Arguably, information more prone to greenwashing risks is generally “soft information”, such as forward-looking statements. Such information is generally based on subjective analysis and can include corporate projections, intentions and opinions. Soft information can be as valuable to investors as “hard” information, such as quarterly or historical data or reports. The use of cautionary language in accompanying disclosure, especially with regard to forward-looking statements, would encourage greater disclosure of “soft” information and provide investors access to information that may be important to their assessment of a company. The dynamic would preclude the risk of greenwashing from unnecessarily “scaling back” the scope of information available to the market.

- Even if formed in good faith and on the most complete information available, opinions, such as forward-looking statements or projections, may turn out to be wrong when the facts materialise at a future date. In hindsight, the original claims/opinions could be falsely deemed greenwashing. This creates a reporting risk for market actors and may incentivise market actors to “scale” back the scope of their reporting or the range of products or services they offer to investors (or other clients).
- Considering that much of modern-day corporate value is derived from “intangibles” and that ESG reporting is prone to forward-looking claims, opinions and analysis, the regulatory framework should encourage detailed and fulsome reporting while being clear about regulatory expectations – as well as enforcement and liability risk. By encouraging the accompanying use of cautionary language with disclosure, e.g., forward-looking statements or product descriptions, the ESAs would incentivise further provision of “soft” information and preclude the risk of greenwashing from unnecessarily scaling back the scope of information or range of analytical tools and investment choices available in the market.
- As independent providers of research, data and analytics, ESG research providers support investors in grasping a volume of information and empowering them to understand the companies in which they are invested, including in identifying and assessing claims that may be described as “greenwashing”. They undertake objective evaluations and function as a “filter” in the information value chain. The methodology of our subsidiary ISS ESG, the sustainable investment arm of Institutional Shareholder Services (ISS), for instance can be understood to function as a “filter” to greenwashing risk. Furthermore, Qontigo, our benchmark administrator with its STOXX and DAX indices, has control mechanisms in place to check the accuracy of the ESG (as well as the non-ESG) data used, thereby representing another possible “filter”.
- Speaking of “filters”, we like to note that the three proposed categories which focus on the roles market participants may play in proliferating “greenwashing” could be misleading. It is also true that market participants – and their various internal functions, such as an audit committee or portfolio managers, or policies and procedures at the entity level, such as quality assurance processes at e.g. ESG research providers – can be a “filter” to “greenwashing.” The “filter” allows market actors to identify potential greenwashing or relevant risk factors; and eliminate such claims, where possible, or shed light on them.

A premature definition of greenwashing does not solve the issue

Having said this, however, the attempt to clearly define greenwashing might be premature in our view. While we understand that the ESAs target a broad definition of greenwashing to mitigate risks and increase trust in and reliance on sustainable finance and related communications as well as product offerings, it should be considered that a (too) broad definition of greenwashing will increase liability risks and will most likely lead to fewer ESG products in order to mitigate reputational and liability risks in this context. This in turn will most likely limit the capital available to invest in the sustainable transformation of the European economy and beyond.

The EU sustainable finance disclosure regime should prove its effectiveness

As noted in ESMA’s Sustainable Finance Roadmap, in an ideal scenario, the ESAs and NCAs would tackle greenwashing based on a complete and fully applicable legislative regime setting the boundaries of the type of market behaviour and practices that are and are not permissible.

Indeed, greenwashing needs to be addressed without delay, even if all the legislative steps are not fully in force yet. But before clearly defining greenwashing, we would encourage the existing regulatory framework to be completed and demonstrate its effectiveness. In the meantime, the ESAs and NCAs can already make full use of their existing legal mandates and powers to ensure that investors and consumers are protected against fraudulent sustainability claims. This must be an evolving process, in parallel with the market developments since the perception of sustainable investment is also still evolving.

We expect many of the current shortcomings to be resolved or addressed with the EU's sustainable finance regulation becoming fully operational and with upcoming files such as the Corporate Sustainability Reporting Directive (CSRD), coming gradually into force. The latter mentioned file, in conjunction with the envisaged European Sustainability Reporting Standards (ESRS), is a particularly good example of how to effectively counter greenwashing since corporate ESG reporting is often the beginning of the sustainable investment value chain. Timeliness of reporting and consistency over time, relevance and completeness, clarity and conciseness, as well as objectivity, reliability and understandability will likely improve the situation in the whole value chain as a result.

Nevertheless, in addition to assessing the impact of the regulatory framework currently being implemented, some parts of it might need to be reviewed. As is widely recognised, the Sustainable Finance Disclosure Regulation (SFDR) was initially not intended to provide sustainability labels or criteria for marketing claims related to sustainability. However, industry practice has developed to categorise products into Article 8 or Article 9 as "light green" and "dark green" product labels, respectively, and to use these regulatory categories as a marketing claim.

DBG observes that legal uncertainty, confusion and different approaches of market participants lead to a significant risk of misunderstanding and misuse of the SFDR provisions. SFDR seems to be not fit for purpose to mitigate greenwashing risks. What is clear, though, is that this is still an area with a high degree of regulatory uncertainty and a review of the SFDR would be an opportunity to provide much-needed and welcome clarity.

Currently, it seems to be not entirely possible to have regulatory oversight and enforcement against misleading sustainability claims if financial institutions are in compliance with a (albeit deficient) regulatory framework. Or alternatively, it is not possible to have regulatory oversight and enforcement against misleading environmental impact claims where the regulatory framework is not sophisticated or detailed enough to enable it.

In addition, a clear distinction is needed between what is greenwashing and what is non-compliance with regulation. Not every non-compliance with new disclosure rules can be seen as an act of even unintentional greenwashing. It has to be considered that the ESG disclosure frameworks and the related guidance are still not finalised. Market participants, however, cannot be held responsible for unclear reporting rules. Their willingness to share sustainability information and their intention to comply with new reporting obligations should be acknowledged and welcomed. The opposite would result in reluctance to report more on sustainability than absolutely legally necessary and would, as mentioned earlier, decrease the level of "soft" but informative disclosure available for investors. This would unintentionally contradict the European legislators' intentions and lead to a decrease of supply of ESG data and qualitative disclosure, needed for the economic transition and for wider information purposes of investors and further stakeholders.

Beyond the EU level: national and global provisions as well as market standards are further increasing the complexity

All the issues identified at the EU level are compounded by a variability of approaches at the Member State level. National rules applicable to sustainability claims show a lack of harmonisation not only in the content of the rules but also in their core logic, creating legal uncertainty for market participants and unequal levels of protection for retail investors in Europe. Notably, there are diverging applications of the rules on what constitutes a sustainable financial product across the Union. This could lead 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 naming convention do not share the same underlying characteristics.

Further problems for effective governance of sustainability claims are apparent when analysing regulatory oversight and enforcement. This applies not only to financial products, but also to the variable oversight practice and culture in different Member States which leads to different quality of ESG data and a missing level playing field in the EU in, for instance, corporate reporting and related assurance processes. Regulatory and supervisory arbitrage linked to

the fast-evolving legislative framework may aggravate greenwashing risks to investors in the EU and beyond. This is of particular concern from a supervisory convergence perspective.

Moreover, the list of sustainable investment frameworks (regulatory and market standards/labels) guiding product development in the field of ESG products is long and keeps growing. Implications for product design are often conflicting as a result. For instance, specific thresholds for baseline exclusions and portfolio construction criteria that are embedded and binding leads to a situation where it is actually not feasible to design a cross-border ESG index in the EU.

On the other hand, outside the EU, globalised ESG markets are facing regulatory fragmentation, because of the diverging regulatory approach between jurisdictions, posing a challenge for global financial market participants operating across markets and raising issues regarding potential greenwashing. This reality, coupled with the associated legal, financial, and reputational risks, creates an additional challenge for EU-based market participants.

EU sustainability standards should ideally fully compatible with global sustainability reporting standards, as investors operating in the EU should be able to reconcile, at least to some extent, the sustainability disclosures of investee entities operating outside the EU. In this regard, international cooperation within IOSCO and with the International Sustainability Standards Board (ISSB) is essential to ensure that the EU reporting regime is adequate to meet the information needs of investors that operate at global level. Such compatibility will also benefit the competitiveness of EU capital markets and EU companies. Having in mind that varying sustainability topics are in scope in different jurisdictions as well as various understandings of what can and must be seen as financially and sustainably material, makes the situation even more complex and can lead to diverging quality of ESG data as the backbone of the sustainable investment value chain.

(Sustainable) financial literacy and suitability assessments can be safeguards

Greenwashing shall not be set equal to misunderstanding for instance by the retail investor. The mitigation of greenwashing must go along with increased financial literacy, which can have several benefits such as helping retail investors to improve their understanding of ESG risks, impacts and investment strategies of financial products as well as creating realistic expectations about ESG risk and performance. Furthermore, it will help retail investors increase their participation in (sustainable) financial markets and make investment decisions that are in line with their investment needs, objectives, risk tolerances, and sustainability preferences.

Greenwashing risks can also arise with regard to how conduct of business rules such as suitability assessment as well as product governance and information requirements are applied when selling ESG products. However, unintentional greenwashing might be one of the most likely outcomes, given that the concept of sustainability preferences under MiFID II/IDD is not defined as a simple reference as for the product categories under SFDR. In general, we believe that the concept of sustainability preferences in conjunction with transparency requirements (SFDR, EU Taxonomy Regulation) can be a safeguard against greenwashing if policy coherence would be provided.

A better understanding of ESG approaches can help fight greenwashing – and mobilise capital for the transition

As ESG investing continues to take hold, a wide array of new products and services is becoming available in the market. In our experience, the demand for services and products that are even more individually tailored and better suited to increasingly complex requirements is increasing, leading however to new challenges around ensuring that the products are not contributing to greenwashing risks.

Most notably, there is a lack of consistency around the use of sustainability-related terminology, which increases the potential for investor confusion around sustainability-related products, contributing to greenwashing. DBG is convinced that market participants should consider coalescing around a set of globally consistent sustainability-

related terms. The issue of terminology is distinct from the issue of labelling and classification, as terminology covers broader concepts beyond product types, such as ESG approaches (e.g. ESG integration, negative screening, best-in-class) and definitions of commonly used sustainability-related terms such as “green”. While there are existing initiatives in the EU addressing the issue of what is “sustainable” or “green”, for example the EU Taxonomy, there is a particular need for the development of common terms and definitions for ESG approaches. These ESG approaches or sustainable investment strategies are often not well-understood and it seems like ESG is sometimes considered as an own asset class instead of an investment strategy. The development of common terms and definitions for ESG approaches, while providing enough flexibility for market innovation, could also lead to more clarity on subcategories of greenwashing such as impactwashing or timewashing as well as more clarity on how to close gaps – for example, if SDG alignment can be used to account for sustainability objectives (currently) not covered by the EU Taxonomy.

In this context, sustainable investing also means impact and we would like to emphasise that especially the “least green” sectors or companies will need the highest investments for their transformation. Most regulation and labels define the sustainability profiles of funds using the current (rather than the expected) sustainability performance of the underlying companies. This could lead to the exclusion of companies that offer great potential to contribute to sustainability transition, while also severely restricting the eligible investment universe. We are convinced that it is important, to be able to make use of forward-looking, ESG performance-orientated strategies without risking being accused of fostering greenwashing while applying such strategies.

Using capital allocation to drive sustainability transition should involve actively incentivising companies to become eligible for an investment universe. Otherwise, we expect a slow-down of the mainstreaming of sustainable investments; a potential misallocation of sustainable investment funds; increased costs for fund issuers and (retail) investors; the exclusion of some systemically important companies that could be the most impactful in terms of their transition potential; as well as a potential softening of the influence investors could have on the companies’ operations, management, products and services. All the mentioned points are also not in line with investor protection and the attempt to address greenwashing risks. Brown assets going private would not serve the objectives of the EU Capital Markets Union, nor help to reach sustainability goals or meet transparency expectations (i.e. prone to greenwashing).

For further information, please refer to our input within the survey. DBG hopes that these elaborations are helpful for the process moving forward and remains at your disposal for further explanations and discussions.