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Greenwashing is no longer just a PR problem - it's also becoming legal one

White paper on ESG fraud

Regulators are starting to clamp down on greenwashing. Until recently, there was very little oversight of how ESG funds are marketed, but in May 2022, the SEC fined BNY Mellon Investment Adviser US$1.5m for "misstatements and omissions" with regard to the ESG standards of some of its mutual funds[1] Then, in November 2022, the SEC fined Goldman Sachs US$4m[2] for not "following its policies and procedures involving ESG investments". Those fines were small, but the risks to financial services firms are growing – and not just in the US. In Europe, DWS – the asset management arm of Deutsche Bank – was accused in 2022 of mis-selling some financial products as sustainable. In March 2023, DWS settled the case by signing a 'cease and desist' order on advertising the fund. The same consumer group that took DWS to court also won a greenwashing case against Commerzbank in February this year. As the legal precedents increase, so will the pressure on firms.

But what exactly is greenwashing? There is currently no legal definition of greenwashing in England and Wales. The European Securities and Markets Authority is consulting on 'a more granular understanding'[3] of greenwashing but the final report won't be due until May 2024.

That fuzzy legal backdrop is part of the reason why so many funds are marketing 'green' securities that are not always as sustainable as investors assume. But, despite the lack of clarity on what greenwashing is, there is a clear bottom line for boards.

Putting too positive a spin on a firm's ESG standards has long been a PR problem. Soon it will be a legal problem: fraud.

Greenwashing isn't defined, but fraud is.
According to the Oxford English Dictionary, fraud is 'any wrongful or criminal deception intended to result in financial or personal gain'. Committing fraud is usually a criminal offence. That is, it can mean a custodial sentence for those held responsible, and significant fines for, and reputational damage to, their firm.

In the UK, fraud includes:

- neglecting to disclose information though you had a duty to do so
- knowingly making an untrue or misleading representation for gain, or to cause others loss.

ESG fraud risks are many and varied. Firms will need to provide details of their environmental, social and governance performance. If a firm materially mis-represents any ESG data, it could find itself in trouble. So, if, for example, its standards of consumer protection fall short, or it is found to have mis-sold products as ESG-standard compliant when they were not, the board could face serious consequences.

This paper outlines what bank boards need to consider when it comes to avoiding ESG fraud, and why.

Financial institutions are on the front line

Financial institutions fund the business activities that contribute to the climate emergency. At the same time, the world relies on them to fund the activities that will mitigate the climate emergency. That is why they face "unique and complex"[4] exposure to potential climate change litigation.

1 SEC (2022) 'SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations'. Available at: https://www.sec.gov/news/press-release/2022-86.

2 SEC (2022) 'SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments' Available at: SEC.gov | SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments

3 EBA (2022) 'ESAs launch joint Call for Evidence on greenwashing' Available at: https://www.eba.europa.eu/esas-launch-joint-call-evidence-greenwashing.

4 Solana, J (2020) 'Climate change litigation as financial risk'. Green Finance, 2(4), pp. 344-372 Available at: www.aimspress.com/article/doi/10.3934/GF.2020019.

Financial services firms have limited greenhouse gas emissions of their own. But they are increasingly being held responsible for financing and promoting projects and sectors that cause climate change. All this activity is accounted for under their Scope 3 CO2e reporting.

The challenge for financial services firms is that they have only limited data on what is happening in their wider supply chain. They will have to rely on third-party data to fill the gaps. Will they know the methodology behind that data? Will they be able to verify the data, its completeness, and the conclusions reached? Regulators are likely to ask all of those questions and more.

What the law already requires on ESG, and what's coming

Article 2 of the Paris Agreement on Climate Change has a goal of: "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development".

Many countries, including the UK, have put in place legally binding greenhouse gas emission targets at the national level. And the courts are increasingly being used "to clarify the legal obligations of both public and private financial institutions for their 'portfolio emissions'", according to the June report, *Global trends in climate change litigation*, by the LSE's Grantham Institute.[5]

Even when such cases are dismissed, such as *Ewan McGaughey v. the Universities Superannuation Trust Limited*, they can set precedents. Lawyers point out that the judge in that case asked for "detailed evidence about how the directors had exercised their discretion". Future litigation is likely to refer to that approach. [6]

The *Ewan McGaughey v. the Universities Superannuation Trust Limited* focused on the personal responsibility of the managers. But, as the LSE's report points out, the litigation strategies in regard to climate change can be many and often overlap.

But it's not just the courts, regulators are also imposing new rules. In the EU, the European Council adopted the Corporate Sustainability Reporting Directive (CSRD) at the end of November 2022. The CSRD will apply to all large companies (ie those with more than 250 employees, net sales of €40m or more, or a balance sheet of over €20m) and to all firms listed in the EU unless they are micro-organisations. The CSRD aims to put sustainability reporting on a par with financial reporting. Companies will have to meet the 'double materiality' standards – that is report on how what they do affects sustainability and also on how sustainability affects them.

That follows the Sustainable Finance Disclosure Regulation (SFDR) that came into force in March 2021 with the aim of boosting transparency in the market for sustainable investment products and preventing greenwashing. The SFDR rules apply to a wide range of ESG metrics at both the firm and the financial product level.

Overall, the legal risks for the boards of financial institutions are two-fold. First, they can find themselves in the dock, as defendants of greenwashing claims against them. Second, they can be caught in the cross-fire when clients are sued for greenwashing.

Climate-related risks are material, and therefore need to be adequately disclosed and managed but it can be hard to know the full risk of a portfolio or asset base. Both regulators and investors increasingly want full disclosure of climate-related business risks. Directors who 'greenwash' could be found in breach of their fiduciary duties. They could, for example, be accused of failing to act prudently, and with the care, skill and diligence of a reasonable person, if they don't disclose all the financial risks associated with climate change that their firm faces, or could generate.

Regulators and standard-setters want to see trust in the system

If the global economy is to deliver good environmental, social and governance practices, investors need to know which assets really are green, sustainable and well-governed. Authorities are concerned that the prevalence of misleading statements will undermine investment in ESG.

ESG is a very broad field and, within that, greenwashing – presenting a firm's activities as much more environmentally friendly than they actually are – is common. It can also be surprisingly unabashed. The oil company BP Global, for example, halted an advertising campaign for its low carbon energy products in 2020 after lawyers for ClientEarth complained that the ad was misleading. As one might expect from an oil company, around 96% of BP's output is not low carbon.

But what regulators really care about is trust in the system. Nikhil Rahti, the CEO of the UK's Financial Services Authority, made that clear in November 2021 when he said: "The financial sector can only support the transition effectively if consumers can trust firms to deliver on their promises. Recently, we've seen growing scepticism about some companies' and financial firms' 'green' claims. We can't let this greenwashing persist and risk the flow of much-needed capital to help secure our futures."

The regulatory focus makes greenwashing a legal risk

5 LSE (2022) 'Global trends in climate change litigation: 2022 snapshot'. Available at: www.lse.ac.uk/granthaminstitute/publication/global-trends-in-climate-change-litigation-2022.

6 TaylorWessing (2022), 'Disputes Quick Read: Climate change litigation update – McGaughey v Universities Superannuation Scheme Limited'. Available at: www.taylorwessing.com/en/insights-and-events/insights/2022/05/dqr-climate-change-litigation-update-mcgaughey-v-universities-superannuation-scheme-limited.

Until recently green reporting was often a PR issue and 'a work in progress'. That was partly because it was a 'nice to have', rather than an imperative, and partly because it is hard to get good data. Regulators recognised the data challenge. However, regulators also recognise that allowing grey areas in reporting can result in the misallocation of funds and investor scepticism.

Once regulators set standards to ensure that investors can trust a firm's ESG reporting, investors will be able to sue for misleading reporting.

That means firms with materially misleading or incomplete green data could be guilty of fraud. The fact that green standards are still being developed and data can be lacking only increases that risk.

The pace of litigation is increasing. A report by the LSE[7], says that the cumulative number of climate change-related cases has more than doubled since 2015. The report mentions an increasing number of claims focused on financial risks, fiduciary duties, and corporate due diligence – and directly affecting banks, pension funds, asset managers, and insurers.

Boards need to take ownership of non-financial disclosures

When it comes to financial reporting, banks have clear procedures for data-gathering, for auditing and for who has ultimate responsibility for the accuracy and veracity of the accounts. When it comes to non-financials however – particularly under the upcoming CSDR rules – the shape of the assurance process is still unclear.

Boards that get the level of ESG disclosure wrong, or that do not have a suitable audit trail, run the risk of making a material misstatement on ESG factors.

The problem can't be solved by leaning on external auditors. The data and controls that they rely on in financial reporting have yet to be built for non-financial disclosures. The hope is that the new standards will bring consistency and transparency. But, for the time being, many boards are flying blind. That is both a reputational and legal risk.

What to do now

Boards need to inform themselves about the changing ESG risk landscape and to discuss best practice.

If you want to discuss tackling ESG Fraud further, **feel free to contact the lead author of the paper, Emmanuel Rondeau:** erondeau@libf.ac.uk.

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(Edited by ***Ouida Taaffe,*** *editor of* Financial World, *the magazine of The London Institute of Banking & Finance.)*

7 LSE (2022) 'Global trends in climate change litigation: 2022 snapshot'.
Available at: www.lse.ac.uk/granthaminstitute/publication/global-trends-in-climate-change-litigation-2022.