Literature review on the legislation on environmental claims

Literature review on the emergence of the legislation on environmental claims in the 20th century, regarding common consumer goods and study of the current dynamic of environmental claims and their regulation for financial products.

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About 2° Investing Initiatives

The 2° Investing Initiative (2DII) is an independent, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals.

Globally focused with offices in Paris, New York, Berlin, London, and Brussels, 2DII coordinates some of the world's largest research projects on sustainable finance. Its team of finance, climate, and risk experts develop research, tools, and policy insights to help financial institutions and regulators hasten and adapt to the energy transition.

In order to ensure its independence and the intellectual integrity of its work, 2DII has a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, governments, and NGOs.

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Horizon 2020 is the funding instrument for implementing the Innovation Union, an initiative to secure Europe's global competitiveness.

Through H2020, nearly €80 billion in funding is available over a 7-year period (2014 to 2020) - in addition to the private investment it aims to attract. The EU Commission expects more breakthroughs, discoveries and world firsts by bringing great ideas from the lab to the market.

Executive summary

During the 20th century, the question of the effects of our consumption on the environment became a real concern in Europe. With the exponentially increase of consumer products consumers have been increasingly exposed to advertisements that used the words 'ecological', 'green' or 'nature friendly' as unique selling points.

It became clear that the use of marketing claims must be regulated to protect consumers from misleading environmental claims. In the 80's, European regulators created as reaction different regulations dealing with misleading advertising, taking into consideration the specificity of environmental claims and underlying products and their environmental impact, but also the emergence of self-declared standards in order to protect the consumer in their product choices. However, while new rules, standards and methodologies were developed to evaluate the environmental impact of consumer products, they were missing for financial products.

The sustainable retail market is still in its infancy, and its potential is far from being exhausted. 60-70% of European retail investors are interested in environmental finance products, 40% of them have environmental impact as one of their objectives and especially this group of retail investors is more willing to accept losses in their returns for having an impact. In parallel, a fast-growing number of financial products is coming to the market with misleading environmental marketing impact claims, exploiting the market demand for environmental impact products in an unregulated market. Therefore, the necessity for regulating environmental marketing claims in the financial retail sector is as important as it was for marketing claims in the consumer product sector in the 80's.

This literature review reveals that the new EU regulations for financial retail products will not solve the issue. While they require that some investments exhibit investee company impact, there is no requirement for a financial institution to demonstrate a causal relation between the purchase of the financial product and the environmental impact.

The same holds true for the applicability of the Unfair Consumer Protection Directive (UCPD). The barrier to effective regulation of impact claims relates to the definition of impact itself. Under the current regulatory framework, there is no legal definition of "impact". Consequently, it may be difficult to argue that a financial institution has made a misleading/prohibited impact claim about a financial product under the UCPD where the financial institution can demonstrate that the product exhibits some investee company impact, even where it cannot attribute any of this impact to the investment in the product itself.

Given the large demand for real environmental impact by investors and in the context of lack of adequate product offering as well as misleading market practices, there is a real need for integrating impact in the regulatory EU framework. Only then investors may benefit from a real protection against environmental impact claims of financial products. Such developments should happen before investors are discouraged from investing in sustainable product due to scandals related to greenwashing and prevent market failure.

Chapter 1

Emergence of the legislation on environmental claims in the 20th century

Whether it is for our own good feeling or our real conviction, trying to do the best (or “less bad”) to the planet appears to be a decision-making element in the choice of our products and has become a more and more decisive argument in the marketing campaigns of the consumer goods sector.

But how can consumers be sure that the environmental claims which influence their choice for a product are true and not misleading?

We can observe since the beginning of the 80's the emergence of a legislation dealing with misleading advertising, taking into consideration over the years the specificity of environmental claims (1) but also the emergence of self-declared standards (2) in order to protect the consumer in their product choices (3).

1.The emergence of European legislation in the 80’

The first step towards protecting consumers from misleading claims was taken on 10 September 1984 with the adoption of European Directive 84/450[1] relating to the laws, regulations and administrative provisions of the Member States concerning misleading advertising in order to "protect consumers and persons exercising a commercial, industrial, craft or liberal activity as well as the interests of the general public against misleading advertising and its unfair consequences".

On October 6, 1997, a new directive of the European Parliament (n° 9755) reinforces directive 84/450 on misleading advertising to allow comparative tests between brands but it is with Directive 2005/29/EC[2] of the European Parliament and of the Council of 11 May 2005 on Unfair Commercial Practices that the legislation on environmental claims took a new step in the protection and information of consumers. In fact, this last directive requires that the marketing arguments used during the sale of a product must be transparent and not misleading and requires them to be defined in a "clear, precise, precise and unequivocal" way (Articles 6 and 7). On 2016, a new guidance document whom goal is to facilitate the proper application of Directive 2005/29/EC regarding UCPD is published[3].

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[1] European Commission, 1984. Council Directive 84/450/EEC of 10 September 1984 relating to the approximation of the laws, regulations and administrative provisions of the Member States concerning misleading advertising
[2] European Commission, 2005. Directive 2005/29/CE of the European Parliament and of the Council of 11 May 2005
[3] European Commission, 2016, Guidance on the implementation/application of Directive 2005/29/EC on Unfair commercial practices

In 2012, the European Commission launched a Multi-stakeholder Dialogue on Environmental Claims (MDEC) with representatives of national authorities, European business organizations, consumer associations, environmental NGOs and academics, with the purpose to provide a better understanding of the use of environmental claims. MDEC publish in 2016 principles to support Directive 2005/29/EC called "Compliance Criteria on Environmental Claims" [4]. Supporting compliance with the legislation considers following aspects of the communication: content of the claim, clear and accurate presentation and claim substantiation and documentation.

On November 27, 2019, Directive 2005/29/EC is amended by Directive (EU) 2019/2161 on better enforcement and modernization of EU rules on consumer protection and unfair commercial practices such as misleading advertising[5] before the European Commission adopted in 2021 a new Unfair Commercial Practices Directive (UCPD) to facilitate the proper implementation of Directive 2019/2161, which was scheduled to enter into force on May 28, 2022. Environmental claims and planned obsolescence are one of the main topics concerned by UCPD guide.

In parallel with these advances, several European countries are publishing their environmental claims guides, as Denmark[6], France[7][8][9], the Netherlands[10], the Czech Republic, the United Kingdom[11], and the United States[12] outside the European Union.

The “environmental claims” subject is now fundamental, and the European Commission published in 2014 "Consumer Market Study on Environmental Claims for Non-Food Products"[13], a comprehensive study the following main findings:

- 76% of all products evaluated in stores had an environmental claim, i.e. a message or suggestion, on the product or packaging presenting some environmental benefits
- Most environmental claims take the form of a logo, text, but also more implicit environmental claims (such as
 implicit environmental claims (such as images and colors)
- Consumers have a low level of understanding of environmental claims.
- Nearly 60% of respondents say they prefer to buy a product with an environmental label.
- Half of consumers also specifically look for environmental information on the packaging when purchasing a product.
- Consumers do not distinguish between uncertified claims (self-declared) and certified information.

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[4] Multi-stakeholder Dialogue on Environmental Claims, 2016, Compliance Criteria on Environmental Claims – Multi-stakeholder advice to support the implementation/application of the UCPD 2005/29/EC
[5] European Commission, 2019. Directive (EU) 2019/2161 of the European Parliament and of the Council of 27 November 2019.
[6] Danish Consumer Oymbudsman, 2005, New Nordic Guideline: Ethical and Environmental Marketing Claims
[7] French Ministry of Ecology Sustainable Development Transports and Housing, 2012. A Practical Guide to environmental claims for traders and consumers
[8] ADEME, 2012, Guide anti greenwashing
[9] Centre National de la Consommation, 2019, Mise à jour du guide pratique des allégations environnementales
[10] The Netherlands Authority for Consumers and Markets, 2021, Guidelines Sustainability claims.
[11] Competition & Market Authority, 2021, Making environmental claims on goods and services.
[12] Federal Trade Commission, 2012, Guides for the use of Environmental Marketing Claims.
[13] European Commission, 2014, Study on environmental Claims for Non-Food Products

This last point underlines the lack of knowledge of the consumers of applicable labels, rules, and regulations, such as relevant ISO standards.

2.The emergence of the ISO standards and environmental labels

As we have seen, since the 1980s, the strengthening of environmental legislation has led industries to gradually equip themselves with environmental management systems. These are defined as the management methods of an entity (company, service...) aiming to consider the environmental impact of its activities, to evaluate this impact and to reduce it.

Initial discussions at the Rio Summit (1992) revealed the need to establish international consensual and voluntary standards and to "recognize environmental management as one of the priorities of companies" as well as the desire to "adopt codes of best environmental practices".

Considering the multiplicity of standards (sometimes contradictory) and the cost that all these standards could entail for companies, the ISO standard was explicitly cited as the reference during the Uruguay Round (1994).

Thus, the first version of ISO 14001 was published in September 1996 before being supplemented several times in 2004 (to make it clearer and compatible with the ISO 9000 quality standards) and then in 2015 (strengthening the role of management, structuring environmental aspects from a life cycle perspective). This last update is increasingly strict and requires organizations wishing to benefit from it to provide concrete results on their environmental impact.

Below is a presentation of three ISO standards that are essential to understanding misleading claims for consumer products.

ISO 14001 STANDARD

The ISO 14001 standard is part of the sustainable development framework and main goal is to satisfy environmental management. It concerns all type of organizations of goods or services.
It represents today eighteen requirements divided into six chapters as follows:

- general requirements
- environmental policy
- planning
- implementation of actions to satisfy the environmental policy.
- controls and corrective actions.
- management review.

The contribution of this standard considering environmental policy and controls, offers the consumer a certification against misleading claims that could be made by a non-certified brand.

ISO 14021 STANDARD

ISO 14021 specifies "requirements for self-declared environmental claims, including product-related statements, symbols and graphics. It also describes selected terms commonly used in environmental claims and specifies their use."

This standard is intended for environmental claims on products that meet legal requirements for environmental information, claims or labelling and any other regulatory requirements[14]. The declarations are made under the sole and complete responsibility of the companies (self-declaration).

It sets out general requirements for any environmental claim, aiming to reduce the confusion faced by consumers and giving requirements on 12 aspects such as waste reduction, reduced energy consumption or recycling of the consumer products involved.

The European Commission supported this standard as a reference through a publication in 2000 ("Guidelines for marketing and assessing environmental claims")[15], just as the OECD who published on March 2011 "Environmental Claims: Findings and conclusions of the OECD Committee on Consumer Policy"[16] using the definitions of ISO 14024/14021/14025 for their presentation.

ISO 14040 STANDARD

In a finite world where resources cannot be renewed as quickly as they are consumed, recycling has become a central issue for consumers. ISO 14040 focuses on the Life Cycle Assessment of a product.

In fact, ISO 14040:2006[17] was the first standard which specified the principles and framework for conducting life cycle assessments of a product including:
- definition of the objectives and scope of the life cycle assessment
- the inventory phase of the life cycle assessment
- the life cycle impact assessment phase
- the life cycle interpretation phase
- communication and critical review of the life cycle assessment
- limitations of life cycle assessment
- the relationship between the phases of the life cycle assessment
- conditions for the use of value choices and optional elements

All these specifications make it possible to control the various aspects of product quality and aim to better protect the consumer. Thanks to ISO certifications, consumers benefit from the endorsement of an international standard on their purchases of consumer goods and services and can consume with greater transparency the products they consider suitable for their consumption and environmental preferences.

[14] ISO - ISO 14021, 2016, Environmental labels and declarations — Self-declared environmental claims (Type II environmental labelling)
[15] European Commission, 2000, Guidelines for the Assessment of Environmental Claims
[16] OECD, 2011. Environmental Claims.
[17] ISO - ISO 1404, 2006, Environmental management - Life cycle assessment - Principles and framework

Environmental labels[18] were originally introduced in 1994 for a few household appliances (especially refrigerators, freezers, washing machines, dishwashers), but they were extended in 2004 to broader consumer goods such as televisions, lamps, housing, cars, pneumatic vehicles. These energy labels provide the consumer with objective information that can support or contradict the environmental claims made by the product supplier. EU legislation on energy labelling and eco-design aims to improve the energy efficiency of products on the European market.

It provides a framework of law that aims to be as transparent as possible so that consumers have crucial information about their consumption. Eliminating the least efficient products allows the consumer to have clear and non-misleading information, particularly on the energy expenditure necessary for the operation of the product, as well as to really know to what extent it can contribute to the reduction of greenhouse gas emissions in the European Union as a whole.

The introduction of these labels is also a strong lever between the various manufacturers to offer the most efficient products.

3. A better consumer protection

In order to be as fair as possible to the consumer, European legislation and the development of ISO standards have enabled enormous progress to be made in the environmental transparency of consumer products, combining regulatory information (environmental labels, reparability index, recycling symbols) with voluntary information (environmental labels, environmental display, self-declaration).

Thus, to guide the customer of a consumer good towards a choice that would also take into consideration the environmental impact of his purchase, European regulations have been in place for several years now, acting on several aspects.

Several types of **environmental information** exist and allow consumers to find their way around when buying products. These details are affixed to the product and concerns the product, its packaging and sometimes the product/packaging combination. As stated in the advertising regulations, theses information on the packaging must comply with the same rules and must above all be accurate, verifiable, relevant, and not misleading to the consumer.

Consumers are aware that their choices have an impact, and they feel concerned about all stages of product's Life Cycle Assessment wondering how they could contribute to environment with their choices from production (did it caused pollution? what are the conditions under which my product was created?), consumption (is it good for my body?) and recycling (is my product recyclable? What will happen to the waste that its consumption will generate?)

Legislation protecting against misleading claims has made great improvements since the early 1980s, but the consumer's feeling that they are not being told the whole truth is persistent.

Environmental claims are also an important marketing tool for financial products. In this sector, considering the lack of knowledge of investors in sustainable finance, the risk of greenwashing is important. Whereas more investment from retails clients in environmental products is necessary to fight climate change, the lack of regulation of environmental impact claims could lead to increasing distrust from investors and ultimately lack of financing of the "green" economy.

[18] European Commission, 2021, About the energy label and ecodesign.

Chapter 2

Environmental claims and their regulation for financial products

In the European Union, a numbrence-specific texts have been introduced to regulate sustainable finance disclosures and claims with the end objective to combat greenwashing.

It is interesting to analyze how sector specific rules apply to different types of environmental claims. Indeed, different characteristics can be claimed by financial institutions.

A financial product can be marked with a specific label (such as ISR label, Greenfin…), in this case the criteria of the label are clearly defined but they don't include any requirements on product communication.

The industry has lately developed a practice to use certain regulatory classification of products as labels even when such classifications where not meant for this purpose initially. In this case, the criteria for regulatory classification end up equating criteria for a certain type of claim (please see below developments on the use of SFDR article 8 and 9 categories as types of labels).

We will first analyze how finance specific requirement apply to certain type of environmental claims (1). Considering environmental impact claims are really specific and involve higher risk of greenwashing (2) we will then analyze if rules exist to regulate environmental impact claims (3).

1. Application of sustainable finance specific requirements to environmental claims

There are three key legislative initiatives in the EU which focus on sustainable finance: Regulation (EU) 2019/2088 (the Sustainable Finance Disclosure Regulation, or "SFDR"), Regulation (EU) 2020/852 (the "Taxonomy Regulation"), and the proposed EU Green Bond Standard ("EUGBS")[19].

In addition, there are general provisions relating to all information, including marketing communications, addressed by an investment firm to clients or potential clients which must be "fair, clear and not misleading" both in their content and their presentation which arise under the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU ("MiFID II")[20]. For issuers who are in scope of the Prospectus Regulation 2017/1129, there is also the requirement for ESG

[19] European Commission, 2019, SFDR / European Commission, 2020, Taxonomy Regulation / European Commission, 2020, EUGBS. We do not study here the Regulation (EU) 2016/1011 (as amended) (the "Benchmark Regulation")
[20] European Commission, 2014, MiFID II

factors to be disclosed where these may have a material impact on the issuer, such as on its assets and liabilities, profits and losses, financial position or prospects.

Sustainable Finance Disclosure Regulation (SFDR)

The SFDR specifies certain disclosures which must be made by in-scope FIs. One of the principal features of SFDR is its de facto categorisation of financial products under Article 6, Article 8 and Article 9. It is important to note that SFDR was not intended to act as a categorisation mechanism or provide sustainability labels. However, industry practice has developed to categorise products falling within Article 8 or Article 9 as "light green" and "dark green" product labels, respectively.

As such, due to the way that Article 8 and Article 9 are being treated in the industry as sustainability labels (i.e. broadly, the financial services industry treats Article 8 and Article 9 products as being "sustainable"), the disclosure requirements under Article 8 and Article 9 effectively amount to requirements which must be complied with by in-scope FIs.

Article 8 – regulatory requirements

In order to claim that their financial product is "Article 8" (light green), FIs must:

a) ensure that the financial product "promotes environmental or social characteristics";
b) disclose information on how those characteristics are met; and
c) if an index has been designated as a reference benchmark, provide information on whether and how such index is consistent with the environmental or social characteristics promoted.

The European Commission clarified in its annex to Commission Decision (c(2021) 4858 final) (the "Annex") that to make an environmental claim as an Article 8 product, FIs do not need to attain a specified composition of investments or minimum investment thresholds. Similarly, Article 8 does not specify eligible investment targets, investing styles, investing tools, strategies or methodologies to be employed. The Annex states, by way of example, that Article 8 does not specify "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" which need to be used in order for an FI to claim that their product is Article 8.
The Annex also makes clear that in order to categorise a product as Article 8, a product may pursue a reduction in negative environmental externalities caused by underlying investments or may invest part of its portfolio in "sustainable investments" (as defined under SFDR).

Article 9 – regulatory requirements

In order to claim that a financial product is "Article 9" (colloquially known as dark green), FIs must:

a) ensure that the financial product has "sustainable investment" as its objective, as defined under SFDR;
b) where an index has been designated as a reference benchmark, the FI must provide information as to how the index is aligned with the sustainable investment objective as well as why and how the index differs from a broad market index; or alternatively
c) if an index has not been designated as a reference benchmark, provide information as to how the sustainable investment objective is to be attained.

However, where the stated investment objective of a financial product is the reduction in carbon emissions it must track an EU Climate Transition Benchmark or EU Paris-aligned Benchmark, where these exist.

The Annex provides further clarification to the regulatory requirements applicable to a financial product for an FI to represent that it falls into the Article 9 category. Specifically, it states that Article 9 products can make investments in any underlying asset provided that "these underlying assets qualify as 'sustainable investments'", where sustainable investments are defined as:

"an investment 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, or an investment 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 an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance".

However, an Article 9 product may include investments which are not sustainable investments for certain specific purposes, such as meeting prudential and product-related sector specific rules (for example, making investments for the purposes of hedging or liquidity). Any such investments must still meet minimum environmental safeguards – the Annex clarifies that this means that they must still be aligned with the sustainable investment objective.

Taxonomy Regulation

The Taxonomy Regulation determines when a FI can make a claim that a specific investment is environmentally sustainable. The Taxonomy Regulation does this by establishing the concept of "environmentally sustainable investments" and defining these as investments in one or more economic activities which qualify as environmentally sustainable under the Taxonomy Regulation.

For an economic activity to be environmentally sustainable under the Taxonomy Regulation, it must:

a) contribute substantially to one or more the environmental objectives (set out in Article 9, and in accordance with Articles 10 - 16 of the Taxonomy Regulation);
b) do no significant harm to any of the environmental objectives;
c) be carried out in compliance with the minimum social safeguards (laid down in Article 18 of the Taxonomy Regulation); and
d) comply with the Taxonomy Regulation's technical screening criteria.

Green Bond Standard

In the EU, there is currently no uniform green bond standard. On 6 July 2021, the European Commission published its "Proposal for a Regulation of the European Parliament and of the Council on European green bonds" (COM(2021) 391) (the "EUGBS Proposal"). The draft regulation set out in the EUGBS Proposal are to be implemented as a voluntary standard.

Nonetheless, whilst the EUGBS itself is intended to be voluntary, FIs may only describe their product as an "EU Green Bond" where it complies with the EUGBS.

Therefore, in order to be able to claim that a product is an EU Green Bond, FIs must ensure the following:

a) That the proceeds of the bonds are used exclusively, without deducting costs, to fund one, or a combination, of the following:
   (i) Fixed assets;
   (ii) Capital expenditures;
   (iii) Operating expenditures that were incurred more recently than three years prior to the issuance of the bond; and
   (iv) Financial assets, which may be a combination of debt and/or equity, provided that the proceeds of the financial assets are allocated to (i) – (iii) above. The proceeds from financial assets may also be allocated to other financial assets, provided that those second financial assets are allocated to (i) – (iii) above.

b) That, regardless of to what assets or expenditures the bond proceeds are allocated, they relate to "sustainable economic activities" as identified under Taxonomy Regulation. Alternatively, the proceeds of the bond can be allocated to assets or expenditures which will relate to "sustainable economic activities" over a defined period of time (not to exceed five years, or ten years in exceptional circumstances) as set out in a taxonomy-alignment plan.

The EUGBS will provide a limited framework in respect of environmental claims, in that it only applies to claims that a product is an "EU Green Bond". A product which describes itself as simply a "Green Bond" will not be required to comply.

2. Focus on environmental impact claims

Why regulate impact claims?

Regulating impact claim is a matter of protecting European investors against impact washing, a specific form of greenwashing, given that:

- Impact is an important motivation for a significant fraction of individual savers. Indeed, a large proportion of investors will seek impact through their investment;
- Secondly, in order to capture this demand from savers, impact is announced or suggested in many commercial documents of responsible financial products;
- However, the impact of financial products is in fact very difficult to prove;
- And the potential impact seems limited for most of sustainable financial products currently offered to individual investors (given the strategies used).

Therefore, there is therefore a strong and specific risk of greenwashing linked to impact.

The importance of impact for savers

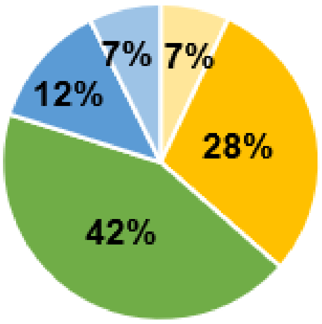
2DII conducted two studies that gave us a better understanding of the motivations of retail investors, in 2019 and 2021.

Our 2019 study showed that 43% of savers interested in sustainable investing want to have a positive environmental impact in the real economy. Other types of investors want to align their investment with their value or simply believe that sustainable investing is a more profitable investment choice[21].

Fig. 1: Motivations for purchasing financial products taking into account environmental criteria

HAVING AN IMPACT IN THE REAL ECONOMY (42%)

■ I want to have a positive environmental impact in the real economy by investing in the financial product: I want the investment strategy behind the financial product to be designed and managed in such a way that **the more money invested the more positive environmental impacts are generated.**



AVOID GUILT BY ASSOCIATION (19%)

■ I want to invest in companies that have positive environmental impact (e.g. operators of windfarms) even if my investment does not change anything to their activity, because it is a way to **symbolically show my support to the environmental cause.**

■ I want to avoid investing in any company that has a negative environmental impact, even if my choice does not affect their activities, because it is a **way to show my support to the environmental cause.**

OPTIMIZE RETURNS ON INVESTMENTS (35%)

■ I want to invest in companies that have positive environmental impacts (e.g. operators of windfarms) even if my investment does not change anything in their activities, because I believe these companies will have a better **financial performance.**

■ I want to avoid investing in any company that has a negative environmental impact, even if my choice does not change anything in their activities, because I believe these companies will have a bad **financial performance in the future.**

2DII (2020) A Large Majority of Retail Clients want to Invest Sustainably

Our 2019 study focused on France and Germany. In 2021, we expanded our research to other European countries. We also looked for more nuance by differentiating between investors looking for impact only or impact plus a better return.

We arrived at roughly the same results: "Making an impact" with their savings is important for 46% of European savers.[22]

This is therefore a key theme for savers. And the financial players have understood this. This is why the impact argument is widely used by the marketing teams of financial institutions.

Strong use of environmental impact claims

[21] 2DII, 2020, A large majority of clients want to invest sustainably

[22] 2DII, NYP, Quantitative Survey on Retailers' ESG preferences and Misleading Claims

68% of funds with ESG claims highlight an impact in the real economy (2019 study on a sample of French funds)[23]. The vast majority of commercial environmental claims therefore promise or lead the investor to believe that they will have an impact on the real economy and/or society.

These are very difficult promises to keep and to prove. Indeed, not only is the definition of impact unclear, but it is also difficult to prove.

What is impact?

If we refer to the scientific literature and in particular to the work of researchers at the University of Zurich[24], whose work was largely taken up in the development of the EU Ecolabel for the definition of the impact of a financial product.

“The impact of the investment is described as a specific change in the social and environmental parameters caused by the action of the investor.”

This implies important issues for its evaluation (and therefore its communication):

- Change/ baseline: The impact must be over time and measured against a baseline (situation where the impact investor would not exist).
- The notion of additionality: We must be able to answer the question: if the asset had not been financed (or invested) by this financial actor via this particular financial product, what would have been the difference?

In other words: what does this investment solution add to the other? And therefore, indirectly, how does this investment/financing solution have a better environmental impact than another?
A quick and simple example of the concept of additionality would be financing that is offered at a lower rate than the market/competitors.

- Proof of the causal link between the investor's action and the company's impact: The proof by nature is very difficult to obtain. It involves answering the question, complementary to that of additionality: "Is the fund's action (via its commitment, its allocation strategy) responsible for the company's impact?"

This link is particularly difficult to establish for certain markets, such as listed markets, which are by nature essentially indirect, complex financing mechanisms where the investor's action is part of a set of actions carried out by all investors in a global process of price formation.

It is very difficult, from this perspective, to evaluate the specific contribution of a financial product, which is most often part of a larger mechanism, integrating all actors.

- And finally, the need to distinguish the impact of the investor from the impact of the company, or the impossibility of automatically appropriating, for an investment or a financing, the impact of the underlying (company's impact).

[23] 2DII, 2021, Sustainable finance and market integrity: promise only what you can deliver
[24] Kölbel, J., Heeb, F., 2020, The investor’s guide to impact

Impact of the investor vs. Impact of the company

It is therefore essential to distinguish - as the scientific literature emphasizes – between:

- The impact of the company, which can be defined as the change that the company's activities cause in society and global CO_2 emissions. For example, the replacement of a coal power plant. This is mainly a matter of the company's own strategic/investment decisions.

- Investor impact defined as the change that investors' activities cause in the company's impact. For example: Encouraging the company to change to a sustainable model/growing its sustainable business.

The point here is to ensure that the impact of the company is indeed caused by the investor's action. This refers to the notions of causality and additionality, which are the key elements in determining the attribution of this impact to the investor.

The impact of the company remains an essential element, without the impact of the company there is no impact of the investor. On the other hand, it does not, on its own, justify the impact of the financial product and cannot therefore be automatically attributed to it.

Looking at the impact of the investor, we distinguish 3 mechanisms through which investors can have an impact[25]:

(1) Capital allocation

This is the choice of assets in which the fund chooses to invest, expose or exclude - what allocation strategy does the sustainable fund follow?

How can my choice of asset allocation generate an impact (does excluding or selecting companies on specific criteria generate an impact?

This is a central mechanism but very difficult to assess. For example, the action of buying/selling a stock on the secondary markets - which represents the vast majority of trading - has no direct impact on the financing of the company or on the company's emissions (there is no cash flow to the company). But it may have an indirect effect on its financing, notably through an effect on its cost of capital (the market being a price formation process) which depends on a mass effect - which makes it difficult to evaluate. It requires complex procedures, such as modeling, to evaluate it, making it difficult, if not impossible, to justify a causal link.

(2) Engagement

This refers to voting and shareholder dialogue activities (or even campaigns on social networks): more direct, they present a higher level of evidence.

[25] Kölbel, J., Heeb, F., 2020, The investor's guide to impact.

This is a mechanism that is often highlighted as having a significant potential impact.

(3) Indirect Impacts

Very difficult to prove, these are all the indirect effects that the investor's actions could have on the company. For example, stigmatization or endorsement: excluding or including a company may encourage people to leave/work there. One can ask whether and how the current supply meets these requirements and the demand for impact.

The reality: the current offer does not meet the demand for impact, or meets it very little

Academic research has clearly identified the different mechanisms - classified according to the level of evidence provided - that allow an investor to have impact through his investments:

1) Funding actors in need of funding
2) Providing financing on advantageous terms
3) Actively engage with invested companies
4) Signal to other stakeholders that the impact is significant (notably via a price signal)

These mechanisms are rarely used today by sustainable financial products offered to individual investors, which rely mainly on capital allocation strategies in secondary markets:

- Exclusions;
- Selection based on ESG scoring (best in class, in universe, etc.);
- Thematic investment (E, S or G);
- Investment aligned with a 1.5° scenario - how the emissions trajectory of all companies in the portfolio;
- Investment in green bonds.

The conclusion is that the impact potential of current responsible financial products is likely to be limited for several notable reasons:

- The difficulty, given both the implications of a rigorous and scientific definition of impact but also the inherent constraints of financial markets to meet all of these requirements (proof, additionality, etc...) - requirements that are otherwise necessary to convey a fair message.
- Restricted access to non-listed markets for individual investors and therefore to the strategies associated with them - surely more impact-generating (but also more risky).
- The lack of a clear framework for the impact of a financial product.

Against this backdrop, in an analysis of environmental impact claims of ESG retail funds sold across Europe, we identified the following five most misleading impact marketing tricks:

Environmental benefits of investees' activities = Investing in the fund leads to environmental benefits The fund manager suggests that there is a causal link between a specific allocation of capital to an investee company in a portfolio and the environmental benefits generated by that investee company, where there is no solid evidence to support such a statement.	
Changes in portfolio boundaries = GHG emission reductions in the real economy The fund manager ambiguously presents changes in the exposure of a portfolio to environmental features (e.g. carbon footprint) as if they corresponded to an equivalent outcome – often quantified – in the real world, which is technically incorrect. This merely leads to a reallocation of carbon emissions across financial actors. For instance, a fund manager divesting from high-carbon sectors will sell its assets to other investors, leaving the real-economy untouched.	
Investees are better than their peers = Investing in the fund reduces GHG emissions The fund manager suggests that an ESG best-in-class approach can be specifically related to an actual environmental outcome, which is not supported by any evidence, and is most probably incorrect. The same reasoning as above applies here i.e. that investing in best-in-class companies will leave the financing of worst-in-class ones to other investors more prone to invest in such activities. The impact on the reduction of emissions is therefore, at best, very indirect and unmeasurable.	
Earmarking green activities = Financing more green projects The fund manager suggests that earmarking implies additionality and a measurable investor contribution when the current framework and practices do not provide the tools to substantiate such conclusions.	
Any ESG process implemented = Environmental outcomes in the real economy The fund manager suggests that an ESG integration approach can be specifically related to an actual environmental outcome, which is not supported by any evidence.	

Source: 2DII, 2021, Sustainable finance and market integrity: promise only what you can deliver

3. Absence of reference to impact in the finance-specific legal and regulatory framework

There is no requirement under SFDR for FIs to evidence that their products achieve a real-world environmental outcome. To the contrary, current market practice is for financial products which operate negative screening criteria to classify themselves as Article 8, despite the fact that such an investment strategy is unlikely to have an environmental impact. Moreover, despite the confusion existing on the market between article 9 and impact products, we think that article 9 of SFDR does not require products to have impact according to our definition as laid down previously[26].

In addition, Taxonomy Regulation provides a binary framework for whether an economic activity is sustainable or not. It does not explicitly categorize any economic activities, or investments in such activities, as achieving environmental impact. Indeed, Taxonomy compliant investments are intended to reflect economic activities that are environmentally sustainable (in accordance with the Taxonomy Regulation) but do not necessarily bring about positive change. In this respect investment in impact activities may bring about more positive change than investments in Taxonomy compliant investments.

No legislation specifically addresses impact claims. In addition, it is important to be aware that current legislation does not recognize environmental impact as a recognized legal concept or definition. Therefore, the current legal and regulatory framework is not consistent with the theories of attribution which distinguish between investee company impact and financial institution impact. While SFDR and the Taxonomy Regulation, in practice, effectively require that some investments exhibit investee company impact in order to be marketed as "Article 9" or "sustainable", respectively, there is no requirement for an FI to demonstrate attribution between the purchase of the financial product and the environmental impact.

In the absence of finance specific rules, we will study how consumer protection rules can apply to environmental impact claims of financial products.

The EU consumer protection law consists of rules of the Unfair Commercial Practice Directive (1) which application to environmental impact claims of financial products requirements faces in practices several obstacles and reveals being insufficient to prevent against greenwashing risks linked to such claims (2).

[26] Please see 2DII article “Does the SFDR help the impact-focused retail investor? “ (2021)

Chapter 3

Application of consumer protection law to environmental impact claims of financial products

1. The Unfair Commercial Practices Directive (UCPD) and environmental claims

In the EU, consumer law is primarily dealt with at the member state level. However, there is relevant legislation and regulation which is applicable. Whilst not specifically designed to address environmental claims in the financial sector, the general principles and obligations under the Unfair Commercial Practices Directive will apply to FIs which make environmental claims in respect of their financial products.

UCPD is not directly applicable in Member States. It first requires transposing legislation at state level.

The requirements under the UCPD apply in respect of "consumers", which are defined as "natural person[s] who, in commercial practices covered by this Directive, [are] acting for purposes outside his trade, business, craft or profession". The UCPD will therefore only apply in respect of "retail" investors (as the term is defined under MiFID), as well as any "opt-up" professional clients (e.g. high net worth). For the purposes of this section on the UCPD in this report, references to "retail clients" shall include opt-up professionals which fall within the definition of "consumer" in the UCPD.

The EU also published a "Guidance on Compliance Criteria on Environmental Claims (“MDEC Principles”).

The MDEC Principles is intended to support economic operators and EU Member State enforcement authorities in their application and implementation of the principles of the UCPD. While the MDEC Principles is not legally binding, Member State enforcement authorities and advertising self-regulatory bodies are likely to use it as an enforcement standard when scrutinizing environmental claims made on goods and services marketed in the EU/EEA.

The MDEC Principles define “environmental claims” as “the practice of suggesting or otherwise creating the impression (in the context of a commercial communication, marketing or advertising) that a product or service is environmentally friendly (i.e., it has a positive impact on the environment) or is less damaging to the environment than competing goods or services."

Article 5 UCPD prohibits "unfair commercial practices", which specifically include practices which are misleading as set out in Article 6 and Article 7 UCPD.

<u>Definition of misleading practices</u>

Under Article 6 UCPD, a commercial practice is regarded as misleading (and is therefore prohibited) if it:
"contains false information and is therefore untruthful or in any way, including overall presentation, deceives or is likely to deceive the average consumer, even if the information is factually correct, in relation to one or more of the following elements, and in either case causes or is likely to cause him to take a transactional decision that he would not have taken otherwise:

a) the existence or nature of the product;

b) the main characteristics of the product, such as its availability, benefits, risks, execution, composition, accessories, aftersale customer assistance and complaint handling, method and date of manufacture or provision, delivery, fitness for purpose, usage, quantity, specification, geographical or commercial origin or the results to be expected from its use, or the results and material features of tests or checks carried out on the product;

c) the extent of the trader's commitments, the motives for the commercial practice and the nature of the sales process, any statement or symbol in relation to direct or indirect sponsorship or approval of the trader or the product;

[…]"

A commercial practice shall also be regarded as misleading:

"if, in its factual context, taking account of all its features and circumstances, it causes or is likely to cause the average consumer to take a transactional decision that he would not have taken otherwise, and it involves:

(a) any marketing of a product, including comparative advertising, which creates confusion with any products, trade marks, trade names or other distinguishing marks of a competitor;

(b) non-compliance by the trader with commitments contained in codes of conduct by which the trader has undertaken to be bound, where:
(i) the commitment is not aspirational but is firm and is capable of being verified, and
(ii) the trader indicates in a commercial practice that he is bound by the code."

Article 7 UCPD identifies further scenarios where omissions of information may result in a commercial practice being misleading and therefore prohibited:

"1. A commercial practice shall be regarded as misleading if, in its factual context, taking account of all its features and circumstances and the limitations of the communication medium, it omits material information that the average consumer needs, according to the context, to take an informed

transactional decision and thereby causes or is likely to cause the average consumer to take a transactional decision that he would not have taken otherwise.

2. It shall also be regarded as a misleading omission when, taking account of the matters described in paragraph 1, a trader hides or provides in an unclear, unintelligible, ambiguous or untimely manner such material information as referred to in that paragraph or fails to identify the commercial intent of the commercial practice if not already apparent from the context, and where, in either case, this causes or is likely to cause the average consumer to take a transactional decision that he would not have taken otherwise. 3. Where the medium used to communicate the commercial practice imposes limitations of space or time, these limitations and any measures taken by the trader to make the information available to consumers by other means shall be taken into account in deciding whether information has been omitted.
[…]"

2. Application of UCPD to environmental impact claims

The UCPD does not specifically consider impact claims, but it is interesting to analyse how the UCPD may be applied to environmental impact claims.

Whilst the UCPD contains requirements which clearly should be applied by FIs to financial claims, there is a clear gap between the applicability of these requirements to environmental claims and current market practice – where environmental claims often do not comply with the requirements under the UCPD[27].

Article 6 and Article 7 of the UCPD set out a framework for identifying where commercial practices are misleading. Whilst the UCPD does not relate specifically to environmental claims, it should apply where an FI makes an environmental claim about a financial product to a retail investor. This is because in the majority of cases, an environmental claim about a product will amount to a claim about the "*existence or nature of the product"* or "*the main characteristics of the product*".

Article 6 UCPD prevents FIs from making environmental impact claims which contain false information in relation to their financial products. The European Commission Guidance on the Implementation/Application of Directive 2005/29/EC on Unfair Commercial Practices (the "**UCPD Guidance**") provides additional context and states that "green claims can be misleading if based on vague and general statements of environmental benefits". Based on the UCPD Guidance, an environmental claim that a financial product is "environmentally friendly" (for example) could be misleading if it is not supported by substantive evidence.

Similarly, Article 7 UCPD prevents FIs from making omissions in their environmental claims which prevent consumers from making an informed transactional decision, and which cause (or are likely to cause) the consumer to take a transactional decision that they otherwise would not have made. The extent to which this may be applied in practice is less clear.

Article 12(a) of the UCPD provides that enforcement authorities should have the power "to require the [FI] to furnish evidence as to the accuracy of factual claims in relation to a commercial practice". In addition, under article 12(b) courts in relevant Member States should "consider factual claims as

[27] See 2DII, 2021, Sustainable Finance and Market Integrity: Promise Only What You Can Deliver

inaccurate if the evidence demanded in accordance with (a) is not furnished or is deemed insufficient by the court or administrative authority."

A barrier to effective regulation of impact claims under the UCPD relates to the definition of impact itself. Under the current regulatory framework, there is no legal definition of "impact". Consequently, it may be difficult to argue that an FI has made a misleading/prohibited impact claim about a financial product under the UCPD where the FI can demonstrate that the product exhibits some investee company impact, even where it cannot attribute any of this impact to the investment/purchase of the product itself.

Article 12 UCPD also states that member states must ensure that they provide the courts and administrative authorities with the powers to require FIs to provide evidence as to the accuracy of a claim. Where this evidence is not provided, such a claim is to be considered inaccurate.

Whilst Article 12 UCPD requires FIs to ensure that environmental claims are supported by evidence, it does not necessarily manifest itself this way in practice. FIs are only required to produce this evidence when challenged in the courts or by a competent authority, rather than ensure that it is available to consumers at all times.

Conclusion

Whereas the framework for the protection of consumers against wrong environmental claims for consumer goods have been developing and evolving since the 80's, rules applying specifically to financial products do not seem consistent and sufficient.

No legislation specifically addresses impact claims in the financial section. In contrast to the consumer good sector and the evolvement of legislation on environmental claims there, the current legislation on sustainable finance does not recognize environmental impact as a recognized legal concept or definition. Therefore, the current legal and regulatory framework is not consistent with the theories of attribution which distinguish between investee company impact and financial institution impact. While SFDR and the Taxonomy Regulation, in practice, effectively require that some investments exhibit investee company impact in order to be marketed as "Article 9" or "sustainable", respectively, there is no requirement for an FI to demonstrate attribution between the purchase of the financial product and the environmental impact.

The same holds true for the applicability of the Unfair Consumer Protection Directive (UCPD). The barrier to effective regulation of impact claims relates to the definition of impact itself. Under the current regulatory framework, there is no legal definition of "impact". Consequently, it may be difficult to argue that an FI has made a misleading/prohibited impact claim about a financial product under the UCPD where the FI can demonstrate that the product exhibits some investee company impact, even where it cannot attribute any of this impact to the investment/purchase of the product itself.

Given the large demand for real environmental impact by investors and in the context of lack of adequate product offering as well as misleading market practices, there is a real need for integrating impact in the regulatory framework. Only then investors may benefit from a real protection against environmental impact claims of financial products. Such developments should happen before investors are discouraged from investing in sustainable product due to scandals related to greenwashing[28].

Further analysis by 2DII will scrutinize more in detail the applicability of legislation on environmental marketing claims in single EU member states and provide clear policy recommendations.

[28] Notably the latest cases from SEC & BaFin investigations against DWS for alleged "ESG washing" and Deka on misleading positioning of its impact equity fund

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