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Avoiding Greenwashing - your 6 Point CHECKLIST

From 6 April 2022, over 1,300 of the largest UK-registered companies and financial institutions are required to disclose climate-related financial information on a mandatory basis. **There are enormous financial and reputational risks if you get it wrong**.

To whom does this apply?

Big players: This will include many of the UK's largest traded companies, banks and insurers, as well as private companies with over 500 employees and £500 million in turnover.

Smaller funds businesses: Although this is not yet applicable to small fund businesses, many are finding the amount of regulation detail a challenge to wade through and to understand what elements are specifically relevant to them to ensure their products are fully compliant and not just greenwashed.

The risks and challenges

The risks of getting product categorisation and ESG reporting wrong could be financially or reputationally disastrous, or both!

It's a complex matrix of understanding and realism.

We're finding that clients feel paralysed in this area owing to a dearth of knowledgeable resources and a lack of time to fully focus and understand the complex minutiae.

And there's more…

Regulators and investors, as was seen in 2021, are increasingly focusing on greenwashing. In this regard, asset managers, who have grappled with disclosure obligations under the EU's disclosure framework since March 2021, have even more challenges to face in 2022.

For example, the UK will become the first G20 country to make it mandatory for Britain's largest businesses to disclose their climate-related risks and opportunities, in line with Taskforce on Climate-related Financial Disclosures (TCFD) recommendations.

Where to start when developing new ESG fund products…

Your 6 Point Greenwashing Check-list

This high-level checklist has been produced from years of experience.
It breaks down the steps and explains where your attention should be focused.

- ☐ 1. Understand and apply the ESG taxonomy, if relevant, and reporting rules to your product ideas
- ☐ 2. Identify your target market and establish what they want from your fund
- ☐ 3. Draft your fund product documentation
- ☐ 4. Decide on the relevant ESG fund product categorisation
- ☐ 5. Model and decide how you expect fund performance to be achieved
- ☐ 6. Review product creation process and adhere to a periodic product review

In our role as fund consultants, we inspect our clients' fund products at multiple stages along the process to ensure they are robust and ESG compliant.

As experts in the field, where needed, we help clients adjust their product to meet the new regulations.

Ideally, we do this at the product initiation stage, before the fund products are put before the regulator for ESG approval and, often, during the approval process, before the funds are finally badged as ESG compliant. From this repeated process, we've seen the same issues arise.

Now let's dive into each of the 6 points…

☐ 1. Understand and apply ESG taxonomy and reporting rules to your product ideas

At over 550 pages (with more to come), the EU Taxonomy can be daunting – even to the initiated. Let's start with the basics.

The Taxonomy is primarily a classification system for economic activities. Like any classification system, it has definitions and rules. The EU Taxonomy's definitions and rules determine which economic activities are environmentally sustainable.

As a classification system, the Taxonomy was created to address greenwashing by enabling market participants to identify and invest in sustainable assets with more confidence. However, the Regulation also places new Taxonomy linked disclosure obligations on companies and on financial market participants.

As a financial market participant**, you need a solid understanding of the relevant regulations whether these are the **Taxonomy Regulations, SFDR/SFD, CBDF/R, AoV, and/or FCA Handbook Rules.

Look at the regulations governing the desired product structure and ensure you are absolutely clear on what you must achieve from a regulatory perspective.

Be realistic about the structure of your product and what is actually possible to create.

- In the product development stage, consider ways to address how your product will meet the requirements in the most efficient and effective way.

Be clear what the relevant regulations are for your product/business.

- Depending on the size of your organisation, you may not be mandated to follow all the reporting regulations, but make a business decision to apply the rules as part of best practice.

As you identify your regulatory knowledge strengths and resources within your in-house teams, consider possible solutions which may include:

- Training your legal and product people with Merlys Know-how Workshops
- Buy in fund-specialist consultancy advice and/or hands-on implementation support
- Get flexible and quick access to knowledge and support as and when you need it via Merlys-on-Tap

2. Find out what your target market wants from an ESG fund.

Are you building something that people will want to buy?

Closing a fund due to little or no demand is a very expensive exercise; possibly up to six figures in wasted costs, time and depleted capacity. As you develop your ESG fund product idea, ensure the finished product is going to deliver the right outcome to your target market.

Who is the target market for your new ESG product?

- Look at how your target market could be segmented and understand why it's important.

Ask your target market what they want.

- Use investor research to provide valuable feedback that you can use to better develop, target, and promote your products.

How long does this product need to be held for a return to be realised?

- Ensure you identify whether the length of time a return will be realised is relevant for your intended audience.

3. Draft your fund product documentation

Ensure that your in-house team's familiarity with your products does not lead to lack of awareness of how the product may appear to investors and other third parties.

- Check that the descriptions, investment policies and objectives match what you have set out to achieve and what you're telling the FCA you are expecting to achieve.

- Be transparent and explain to your investors the length of time it will likely take to make a return from these areas of a portfolio.

4. Decide on the relevant fund product categorisation

You need to be prepared to be challenged over product/fund categorisation, as it pertains to Articles 6, 8 and 9 and be prepared to explain your categorisation. (click here to see a little more information on these 3 Articles)

- Check that what you are saying about your fund product is accurately labelled and fully ESG badge compliant.

5. Model and decide how you expect fund performance to be achieved

How do you expect performance to be achieved?

Regulators (in the UK and elsewhere) scrutinise your performance expectations and set out clear rules for what they expect asset managers to do if issues arise with performance.

ESG is a long-term play and it's likely that these assets need to be held for longer. As a boutique fund company, you need to be realistic about the returns and the length of time it'll take to make the returns.

Although the market, peer assessments and benchmarking are critical to this, you do have to understand where you're going with your particular type of investors.

What returns can be achieved?

- Conduct market assessments, peer assessments and benchmarking to ensure your performance modelling is robust.

How long does your product need to be held for a return to be realised?

- Ensure you identify whether the length of time a return will be realised is relevant for your intended audience.

What happens if performance goes off-track?

- Be sure you know what you must do, from a regulatory perspective, if fund performance goes off-track.

6. Review product creation process and adhere to a periodic product review

Remember: once the fund is created, it belongs to the investors and it's very hard to make further product changes. Conducting a product review periodically will ensure that your fund(s) maintain their categorisation and do not inadvertently fall into what may otherwise be perceived as greenwashing.

- Your existing processes should be designed so that there is no inadvertent deviation from permitted investments but you may need to review this to ensure that there are "early warning systems" in place.
- Ensure that due diligence on ESG investments is refreshed periodically.
- Monitor regulator's guidance on ESG to maintain best practice.

Insight into how Merlys helps you bring ESG-compliant funds to market

Before ‘greenwashing’ was a recognised term, our MD, Verena Charvet, ensured that clients were not creating products that were inadvertently non-compliant. She is used to talking to product developers as well as fund boards and helping them with articulating their product intentions, both as a lawyer in private practice and as in-house legal counsel of large asset management companies.

Most notably, over the last 7 years, Verena and her team have provided invaluable support leading up to **SFDR and EU Taxonomy regulations** coming into force:

- The Merlys team reviewed products in relation to the **SFDR legislation** and ensured that clients weren’t going to get caught out by the new regulations and find that their funds were identified as greenwashing.
- As a trusted partner, Merlys ensured clients applied the relevant rules to their product, shared best practices for drafting the fund documents and – throughout the product development process – assessed and reviewed to make sure the fund would be compliant.

Whatever the level of support you need – we’ve got you covered

Addressing your needs, with an eye on your purse-strings, we arm your business with the highest level of specialist expertise and capability required to deliver your products and services efficiently and effectively, **without the need to increase your headcount**.

Our solutions fall roughly under 3 categories:

- Advice, Strategy, Research and Analysis - Consultancy and Legal
- Hands-on support for projects or challenges - short or long term
- Training, educating, informing your people via Workshops or 'On Call' advice

Get started…

CALL us to discuss your needs and explore how we can help +44(0)20 7821 0191
EMAIL us to book a time to talk or to raise your questions charles@merlys.uk

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