ISDA Safe, Efficient Markets

ISDA RESPONSE TO THE FCA'S GC23/3: GUIDANCE ON THE ANTI-GREENWASHING RULE

gc23-3@fca.org.uk

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<u>Response to the Financial Conduct Authority's (FCA) consultation on its guidance on the anti-greenwashing rule</u>

1. Overview

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to the FCA's GC23/3 on its guidance on the anti-greenwashing rule.

A financial instrument's contribution to sustainability can be looked at through different lenses. There is the provision of cash through lending or direct financing (the primary market), as well as stewardship and engagement and derisking/impact on cost of capital (the secondary market and derivatives). Derivatives have a role to play in sustainable finance as they contribute to liquidity, help mitigate risk, and impact the cost of capital. Therefore, any sustainable finance framework, which needs to consider financial instruments holistically, needs to incorporate derivatives to address product transparency and mitigate greenwashing and greenhushing risks.

ISDA has been a keen contributor to the ongoing discussion regarding the calibration of the regulatory framework for derivatives from a sustainability perspective. In January 2023, ISDA responded to the FCA's CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels[1] and in January 2024, it launched a clause library[2] for sustainability-linked derivatives (SLDs), designed to provide standardized drafting options for market participants to use when negotiating SLD transactions with counterparties. Prior to the SLD Clause Library, ISDA had developed resources relating to SLDs, including a paper that described the details of the early transactions, a set of proposed guidelines for drafting KPIs and an analysis of the key regulatory issues.[3] Following the 2022 survey, ISDA began drafting standard terms to improve efficiency while also retaining the necessary flexibility to allow SLDs to be tailored to meet firms' sustainability objectives.

As a trade association, ISDA believes that a robust voluntary carbon market plays an important role in delivering a reliable, market-based approach for investment opportunities that reduce greenhouse gas emissions and remove carbon from our atmosphere.

As a derivatives trade association, we have a strong interest in the development of a robust voluntary carbon offset market that will strengthen the functioning of the carbon credit

[1] https://www.isda.org/2023/01/27/response-to-fcas-consultation-on-sustainability-disclosure-requirements-and-investment-labels/
[2] assets.isda.org/media/0e0d180f/161fadc7-pdf/?_zs=5CRsN1&_zl=NO3L7
[3] https://www.isda.org/2022/05/12/sustainability-linked-derivatives-where-to-begin/
https://www.isda.org/2021/09/07/sustainability-linked-derivatives-kpi-guidelines/
https://www.isda.org/2021/12/01/regulatory-considerations-for-sustainability-linked-derivatives/

derivatives markets and enable the continued development of liquidity in derivatives products so that market participants can appropriately manage their business risks. Facilitating trading in carbon credit derivatives that serve as a hedge for climate mitigation projects will contribute to the development of deep and liquid voluntary carbon credit markets.

We are therefore pleased to provide input into the FCA's important work on addressing greenwashing risks. Actual or perceived misrepresentation of sustainability features may have a detrimental impact on investor and consumer perceptions of sustainable finance products, and we strongly support efforts to enhance trust in the market.

ISDA considers that Sustainability-Linked Derivatives (SLDs), ESG derivatives and voluntary carbon credits (VCCs) fall within the scope of the FCA's anti-greenwashing rule as set out in GC23/3. We note that, as drafted, the guidance – and the examples therein – is heavily retail-focussed. It would be helpful to ISDA members for future guidance to include a wholesale focus, with examples relevant to the OTC derivatives market. ISDA could provide further information to the FCA to inform any development of such material.

The application of the anti-greenwashing rule to financial products and services, including derivatives, should be based on stable regulatory provisions, otherwise it could expose firms selling these products to a significant risk of litigation and reputational risk, thus jeopardizing the use of these products by investors and corporates and ultimately the development of these markets.

We encourage the FCA to consider the importance for firms of international coherence and interoperability of rules. This is particularly important given the global nature of the sustainable finance market.

2. **Responses**

We have provided comments in response to the questions below, including questions we would ask the FCA to consider as it refines its guidance going forward.

Q1: Does the proposed guidance clarify the anti-greenwashing rule? If not, what more could we do to provide clarity?

- Our understanding is that the rule applies to regulated products and services, and that existing rules and guidance relating to communications and financial promotions continue to apply to materials that include references to the sustainability characteristics of a product or service. For example, relevant exemptions. It would be helpful if the FCA could confirm this understanding of the scope of the rule and the way that it interacts with existing rules on communications and financial promotions.

- Regarding the requirements that communications are "clear and presented in a way that can be understood" (paragraphs 18-23), would the threshold for understanding be for the product generally, rather than specifically for any statements around sustainability? For example, if the product is only aimed at wholesale clients, a firm is entitled to assume that the client's level of understanding of ESG issues is in line with their understanding of the product more generally, and they don't need to assess the clients' understanding of sustainability issues separately (where appropriateness / suitability obligations do not apply)? Alongside this, ISDA members ask that the FCA be mindful of the need for technical terms it refers to in its 'anti-greenwashing rule' (e.g., "net zero" and "carbon neutral") to be clearly and consistently defined/explained across relevant existing requirements including, for example, the Competition and Markets Authority's (CMA) and the Advertising Standards Authority's (ASA) guidance.

- In paragraph 6 of its guidance, the FCA states that is has "introduced the anti-greenwashing rule into the ESG Sourcebook to clarify its expectations when firms are making claims about their products or services which include references to sustainability characteristics (that is 'sustainability claims'). However, the new rule in ESG 4.3.1R states that "a firm must ensure that any reference to the sustainability characteristics of a product or service is consistent with the sustainability characteristics of the product or service". Does the guidance relate only to the references to sustainability characteristics (in line with ESG 4.3.1R), or to "claims which include" references? This is important because if a firm is promoting / offering a product that is sustainable but also includes other features (e.g., an interest rate / FX swap that isn't in and of itself sustainable), the promotion could be a "sustainability claim" but not a "reference to sustainability characteristics". Does this mean that firms need to expressly call out all the features of a product that might not be sustainable if they were standalone?

- The guidance refers to the need for approvers to monitor ongoing compliance of a financial promotion with all requirements that apply over the lifetime of the promotion, not just on approval (paragraph 16). Our understanding is that this only applies to authorised firms that approve financial promotions for unauthorised firms Is this also a requirement for firms making their own financial promotions? It would be useful to understand whether the FCA has any specific expectations for authorised firms of 'regular review' of their own communications and financial promotions (paragraph 16) or if firms can follow their current practices. Does this mean that any promotions need to be amended on an ongoing basis to reflect current guidance at any given time, or is it sufficient for firms to follow their normal practices for reviewing promotions? For example, if a firm reviews financial promotions for initial approval and thereafter on an annual basis, would they now need to re-review all promotions each time there is a change in relevant regulation? This would have the effect of making all new requirements retroactive. ISDA members have a similar ask of the guidance around the "full life-cycle" of the product and appropriate cut-off points, as covered in paragraph 27. It would be helpful to understand how the concept of the "full life cycle" in the context of product design and ESG integration could be substantiated.

- Can firms assume that if their claims comply with other relevant requirements (e.g., SDR), that they are also compliant with the requirements of the guidance?

- The focus of the guidance is on environmental claims. However, social claims are also referenced. It would be helpful to understand how the guidance will apply to social claims, for example around charitable donations, which often are connected to social or environmental issues. In addition, we think there should be a clearer distinction between social and environment characteristics. This would make it more straightforward to determine the extent to which we need to consider potential social characteristics when making an environmental characteristic claim (if at all).

- We would welcome more guidance on the concept of claims being "complete" and the level of detail required to ensure compliance. It would be helpful to confirm that this requirement only includes information about the specific product or service and does not include the product or service provider (unless there is a specific reason to consider the product or service provider). It would be helpful to have an example relevant to paragraph 28 of the guidance, and the concept of how information about the firm itself may be considered part of the 'representative picture' of the product or service.

Q2: Do you have any comments on the proposed guidance including the examples given?

- It would be useful to have more clarity around what the FCA considers to be a "claim", what satisfies the guidance and, importantly, the role of the Terms and Conditions underlying a product. If the promotional statement in example 1 described the product as "sustainable", and the T&Cs provide more information about the product (even though some points mentioned in the T&Cs are not sustainable), what does that mean in terms of compliance with the rule? Does this issue also arise in bilaterally negotiated arrangements where the client / counterparty should be reading the full terms - e.g., OTC derivatives? Would it contravene the guidance to have a "sustainability linked derivative" where the derivative is in part linked to sustainable objectives, but the parties have agreed the extent to which it is linked to sustainability objectives?

- Regarding example 4, the examples that the FCA gives should aim for consistency with general approaches to sustainability, otherwise we risk ending up in a situation where a firm legitimately identifies a product as sustainable in line with other applicable regulation, but the FCA considers it to be "greenwashing" because it takes a different view of sustainability. If assisting fossil fuel production and distribution to be more energy efficient can be justified as a sustainable activity, it is difficult to say that a firm is misleading its clients.

- Under the proposed anti-greenwashing rule, firms are required to substantiate their sustainability claims. In general, it would be helpful to understand what the FCA would expect and consider to be reasonable steps in this regard, particularly where a firm relies on a third party. Voluntary carbon credit (VCC) derivative contracts allow market participants to hedge their risk exposure on underlying VCC positions and/or VCC projects. In the context of the voluntary carbon market (VCM), sustainability claims are often based upon the retirement of VCCs. For example, a firm may retire VCCs to achieve net zero emissions. Therefore, many sustainability claims - in the form of net zero claims or targets - are contingent on the VCCs having a real and measurable impact on emissions. The responsibility of ensuring the VCCs emission impacts are real is on the carbon crediting programme, the entity that issues those credits for sale. Thus, it is reasonable to assume that a firm has substantiated its VCC-based sustainability claim by buying and retiring credits from a reputable carbon crediting program. Considering recent credit quality scandals, where certain VCC projects (from reputable programmes) were found to be ineffective, is the firm retiring the credit liable for greenwashing? Under the FCA anti-greenwashing rule, the liability of greenwashing, if a claim is based upon non-effective VCCs, seems to squarely fall on the firm who retired the credits. Should the greenwashing liability instead be on the carbon crediting programme who guaranteed the quality, or should the FCA at least provide some form of "a safe harbour" to firms if they substantiate their claims by relying on reputable carbon crediting programs? If the FCA added an example where a firm retired VCCs that, ex post, were faulty, this may be helpful to clear up some of these questions.

- We would suggest that a proportional approach should be taken in relation to cases of greenwashing that involve a degree of fault (e.g., intentionality or negligence) by one market participant whilst another market participant is not at fault and has in place reasonable due diligence and risk management processes to mitigate greenwashing risks. To this end, we would suggest that responsibility to adhere to the greenwashing rule should be reflective of the relative roles each FCA-authorised firm plays in the product or service.

- ISDA members would appreciate the FCA publishing examples relating to social characteristics claims, including charitable donations and the use of imagery. We would be happy to provide more information to support the development of these examples.

Q3: Do you agree that the guidance should come into force on 31 May 2024?

- It is the understanding of ISDA's members that the Anti-Greenwashing rule already exists in the Handbook, but does not come into force until 31 May 2024. We ask the FCA to confirm if this is not the correct interpretation.

- If there are material changes to the guidance following this consultation process, it would be helpful to have a sufficient gap between (i) the publication of the guidance and (ii) the guidance (and ideally the associated rule as well) coming into force.

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Contacts

Stevi Iosif
Senior Advisor to Public Policy
SIosif@isda.org

Toby Coaker
Assistant Director
UK Public Policy
TCoaker@isda.org

Kai Moritz
Assistant Director
European Public Policy
KMoritz@isda.org

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

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