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Failure to prevent and how it could impact greenwashing

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Introduction



We are concerned that firms are making exaggerated or misleading sustainability-related claims about their investment products; claims that don't stand up to scrutiny (greenwashing). This may lead to consumer harm and erode trust in the market for sustainable investment products.

Financial Conduct Authority (FCA)¹

There is increasing demand for ethical and sustainable business practices from regulators, investors and consumers. The commercial benefits that can be gained from meeting this demand can also lead to firms portraying services and products as "green", even if the underlying business activities do not strictly warrant these claims.

The UK Government's Economic Crime and Corporate Transparency Bill received royal assent in October 2023. The bill will make a firm criminally liable if it fails to prevent a fraudulent act perpetrated by one of its associated persons² for the organisation's benefit. This is likely to come into force in 2024 after the government publishes guidance on the "reasonable procedures" it expects firms to have in place to prevent fraud.

This article focuses on whether greenwashing, in relation to environmental, social, and governmental (ESG) products and services, could be widely considered as fraud and if so, what are the implications of the new failure to prevent fraud offence. We will also explore how the risk of greenwashing can be managed and if it can align with existing fraud typologies and fraud risk management frameworks.

¹ CP22/20: Sustainability Disclosure Requirements (SDR) and investment labels | FCA

² An associated person is defined as an employee or agent acting on behalf of the firm, its subsidiaries or agents



Definitions of greenwashing and fraud

Greenwashing can be defined as the act of making inaccurate, misleading, or unsubstantiated claims about the sustainability benefits of products/services offered, or about a firm's strategic aspirations and actions. In comparison, the definition of fraud, as per the Association of Certified Fraud Examiners (ACFE), is "any activity that relies on deception in order to achieve a gain".³ There is alignment between these definitions. When a firm makes inaccurate, misleading, or unsubstantiated claims about the sustainability benefits of their products/services offered, this could be considered as making a false representation or failing to disclose the true nature of the sustainable aspects of the product service.

In the UK government's Economic Crime and Corporate Transparency Bill, the failure to prevent fraud offence categorises fraud into several offences,⁴ which could manifest in an ESG disclosure programme:

Fraud offence	ESG example
Fraud by false representation (section 2 Fraud Act 2006)	A firm promotes a product or service as "green" which does not meet ESG criteria and cannot be substantiated by the firm's underlying data.
Fraud by failing to disclose information (section 3 Fraud Act 2006)	A firm claims to have "green" products whilst withholding information which demonstrates that this is not the case.
Obtaining services dishonestly (section 11 Fraud Act 2006)	A firm misrepresents the strength of their ESG programme to obtain green credentials which increases the firm's likelihood of new partnerships with counterparties.
False statements by company directors (Section 19, Theft Act 1968)	The director's statement in the annual financial statements makes claims towards ESG which are inaccurate and misleading. Given the way many directors' incentives are increasingly tied to ESG metrics this is a rapidly rising risk.
Fraudulent trading (section 993 Companies Act 2006)	A firm mis-sells a product to an investor by presenting its green credentials inaccurately and the misrepresented information does not align with the investor's objectives.

³ "Fraud 101: What is Fraud?", ACFE. [Find it here](#)

⁴ "Factsheet: failure to prevent fraud offence", UK Government website. [Find it here](#)

Regulators' views



Green fraud not only takes savings from investors, but also erodes trust in climate progress and legitimate sustainable investments.

Serious Fraud Office (SFO) Chief Investigator Michael Leo Gallagher⁵

Regulators are increasingly focusing on greenwashing and its impact on market integrity:

- ▶ The FCA released its Sustainable Disclosure Requirements (SDR) and investments labels guidance at the end of 2023. The guidance has been under consultation since late 2022. This includes anti-greenwashing measures such as requirements for regulated firms to ensure claims made about sustainability products are “clear, fair and not misleading”.
- ▶ In February 2023, the US Commodity Futures Trading Commission (CFTC) Commissioner discussed a proposal to promote market integrity by increasing enforcement resources and expertise to combat greenwashing and other forms of fraud.⁶
- ▶ Certain regulators have also released disclosure standards, such as the International Financial Reporting Standards (IFRS) S1 General Requirements for Disclosure of Sustainability-related Financial Information and the UK Task Force on Climate-related Financial Disclosure (TCFD) mandatory climate-related financial disclosures for large private companies and LLPs.

Regulators are also becoming more active in the investigation and enforcement space:

- ▶ The UK Competition and Markets Authority (CMA) opened investigations into several retailers to look into some of their “green” claims.
- ▶ The UK Advertising Standards Authority (ASA) banned a bank’s green advertisements due to misleading information. The ASA stated that future marketing communications featuring environmental claims should be adequately qualified and not omit material information about the bank’s contribution to carbon dioxide and greenhouse gas emissions.
- ▶ The U.S. Securities and Exchange Commission (SEC) issued penalties, ranging from \$1.5million – \$4million, to several banking firms for failing to follow internal policies and procedures involving ESG investments, and also misstatements and omissions concerning ESG considerations.

- ▶ The German Federal Financial Supervisory Authority (BaFIN) and the German police raided offices of a bank in Germany, following allegations from the former global head of sustainability that the firm had made misleading statements on ESG in a recent annual report.

What does this mean for you?

We believe that greenwashing meets the definition of fraud under the new failure to prevent fraud offence. Whilst guidance for upcoming regulations is not yet available, firms need to be prudent in assessing their internal control frameworks and establish if they are prepared for the new regulations including the failure to prevent fraud offence, FCA’s anti-greenwashing rule, the SDR and increasing risks in relation to ESG-related products and financing. Focus should be on the proportionality of the offence and risk mitigation.

Firms will often use lack of corporate knowledge or intent as a defence for inadvertently committing fraud. However, as seen with the UK government’s previous two “failure to prevent” acts – the Criminal Finances Act 2017, which details the Corporate Criminal Office (CCO) of the failure to prevent the facilitation of tax evasion, and the UK Bribery Act 2010 – authorities are now focusing on firms being liable where they didn’t have reasonable procedures in place.

Given the extraterritorial reach of the previous two acts, we believe that a similar principle will apply to the failure to prevent fraud offence. When firms are examining their risk and control frameworks, it is important not to confine scrutiny solely to the UK but to adopt a broader perspective.

We expect the failure to prevent fraud offence to follow in line with the CCO and the UK Bribery Act and therefore firms should seek to review current ESG and fraud frameworks to determine where there are potential risks which require mitigation. This should include helping ensure the presence of a robust framework to detect greenwashing risks and can also demonstrate there are “reasonable procedures” in place.

⁵ City AM article. [Find it here](#)

⁶ Keynote Address by Commissioner Christy Goldsmith Romero”, CFTC. [Find it here](#)

When looking at emerging regulations the six principles used within the UK government's two previous failure to prevent acts are useful in helping ensure frameworks appropriately address new regulatory requirements. Therefore, consideration should be given to the following:

Governance and oversight	<ul style="list-style-type: none"> ▶ Does current management information (MI) cover monitoring of ESG risks, particularly greenwashing? ▶ Are committees and governance accountabilities clear, documented and operational? 	<ul style="list-style-type: none"> ▶ Is greenwashing risk a standing agenda item in relevant governance forums? ▶ Does the firm have a culture of integrity reinforced through regular communications from senior leadership ("tone from the top")?
Risk-based approach	<ul style="list-style-type: none"> ▶ Have you performed a self-assessment to identify how the firm may be exposed to greenwashing risk at client and product level? ▶ Have you reviewed current fraud risk assessments and fraud risk registers to determine if ESG and greenwashing fraud risks are assessed and relevant mitigatory controls are applied? 	<ul style="list-style-type: none"> ▶ Is there co-ordination between risk and relevant business and control functions to incorporate greenwashing risks within the broader fraud risk management framework? ▶ Have you performed a recent assessment of the state of regulatory, legal and reputational risk and monitoring and mitigating measures including review of the compliance framework and establishment of monitoring and testing regime?
Policy and procedure	<ul style="list-style-type: none"> ▶ Do current policies and procedures cover ESG and related greenwashing risks? 	<ul style="list-style-type: none"> ▶ Are business and compliance involved in new product approval and ongoing product monitoring?
People	<ul style="list-style-type: none"> ▶ Are employees aware of ESG and how it relates to fraud? ▶ Has a capacity assessment (skills, experience, budget, staffing, data and IT) been performed? 	<ul style="list-style-type: none"> ▶ Is there targeted greenwashing risk training to first- and second-line staff to help staff identify and manage greenwashing risk during business as usual (BAU)?
Data and monitoring	<ul style="list-style-type: none"> ▶ Is there sufficient data available to effectively monitor for greenwashing risks? ▶ Are you performing testing and monitoring of ESG data to determine if the data accurately backs green statements made by the firm and if there is evidence and a sufficient knowledge base to meet regulators' definitions of ESG and "green" products? 	<ul style="list-style-type: none"> ▶ Have you reviewed data sources to determine if data on ESG is being used effectively and appropriately? ▶ Have you reviewed trade monitoring platforms to determine if investments are in-line with ESG criteria? ▶ Are there processes in place which monitor whether investments sold by the firm, or its distributors are in line with sustainability objectives? ▶ Are there greenwashing KPIs/KRIs, metrics and limits?
Reporting and disclosures	<p>Where ESG disclosures are being reported:</p> <ul style="list-style-type: none"> ▶ Have you reviewed the reporting processes to determine how disclosures are formed and what assumptions the disclosures are based on? ▶ Is there sufficient oversight of the reporting process and disclosures? ▶ Is public disclosure and transparency a priority for ESG credentials and products (subject to commercial sensitivity considerations)? 	<ul style="list-style-type: none"> ▶ Are ESG credentials and products clearly described to enable the consumers to understand the intended purpose? ▶ Is sufficient information about the methodologies underlying ESG products and credentials published, and have you helped ensure consistent implementation?

In conclusion

We believe greenwashing meets the definition of fraud and therefore will be in scope for the new failure to prevent offence. We recommend being proactive in assessing your internal control environments, helping ensure that fraud risk management frameworks are set up to consider ESG and specifically greenwashing risks. You will also need to demonstrate risk mitigation and adequate procedures for detection and prevention.

How EY can help

EY teams can support firms with conducting a Fraud Health Check service to provide an initial diagnostic, to identify critical gaps in their framework that require urgent attention and identify next steps.

Furthermore, EY teams can support with specific ESG focuses such as performing investigations, technology and data analytics, compliance ethics and integrity as well as reputational business intelligence.

We are able to perform a rapid greenwashing risk management pulse check, with an associated roadmap of prioritised actions for compliance to help EY clients proactively prepare for regulations in the ESG and fraud space.

Key contacts

For further information, please contact the Forensic & Integrity Services team.



Jonathan Mills

Partner

Forensic & Integrity Services
Ernst & Young LLP

+ 44 20 7951 5576

jmills2@uk.ey.com



Ted Rugman

Director

Forensic & Integrity Services
Ernst & Young LLP

+ 44 20 7951 4331

trugman@uk.ey.com



Michelle Acton-Phillips

Senior Manager

Forensic & Integrity Services
Ernst & Young LLP

+ 44 20 7951 9551

mactonphil@uk.ey.com



Victoria Johns

Manager

Forensic & Integrity Services
Ernst & Young LLP

+ 44 20 7980 9364

vjohns@uk.ey.com

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