Global Counsel

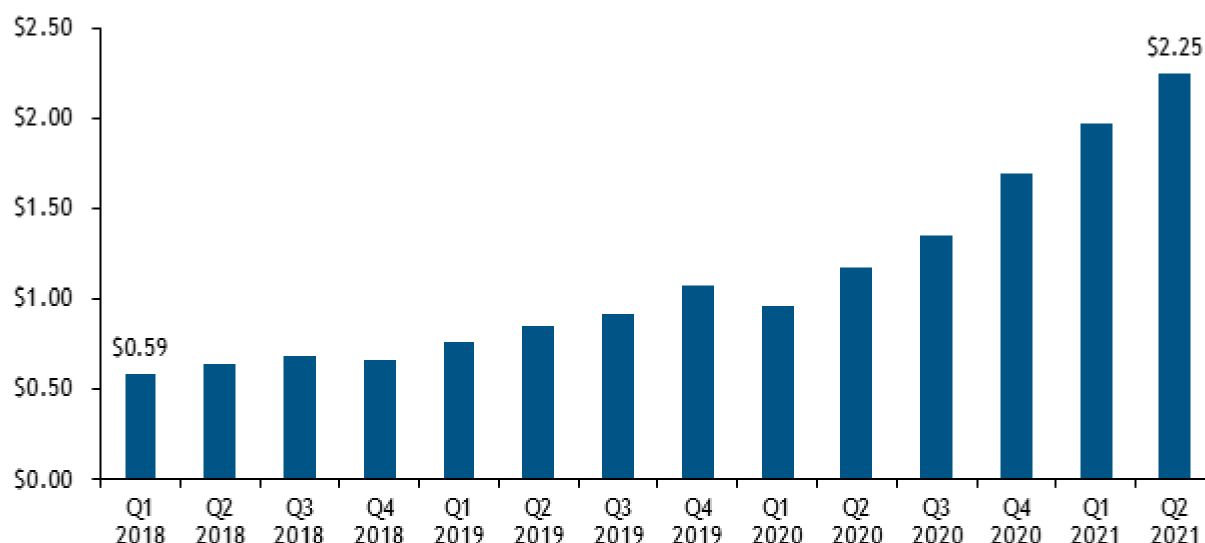
Will regulators use DWS to send a message about overexaggerated ESG claims?

Blog post by Senior Associate Felicity Hall and Associate Ben Bassett, 15 September 2021

The increase in sustainable fund flows in recent years has rapidly outpaced ESG regulation. Trillions of dollars are now held in products which are marketed as integrating environmental, social and governance issues into their investment process. At the end of the second quarter in 2021, assets held by sustainable funds reached $2.25 trillion, more than tripling since 2018. Despite this rise, regulators across the globe are still trying to grasp how to define and regulate sustainable finance, including what disclosure requirements to impose on investors, and how to address accusations of greenwashing.

The recent investigation launched by the Securities and Exchange Commission (SEC) and the Federal Financial Supervisory Authority (BaFin) – the US and German financial regulators – into DWS is likely to serve as a test case for how regulators, eager to establish their own ESG credentials, will discipline firms guilty of greenwashing. In late August, the former sustainability director at DWS – the asset management arm of Deutsche Bank which currently has $1trn in assets under management – accused the firm of overstating the sustainability of its investments and ESG capabilities. DWS' 2020 annual report stated that over half of its then-$900bn in assets were subject to an ESG-integration process, a system through which investments are reviewed through an ESG risk lens. The director claimed further that DWS had no clear ESG strategy despite the fund's claim that ESG is at the "heart of everything" they do. DWS denies the accusations.

Assets held by global ESG funds (in $ trillions), 2018-2021



Source: Morningstar

As the popularity of sustainable investment products has grown (see above), investors have continued to make bolder statements about the ESG credentials of their investments. Initially, regulators were slow to engage on ESG – perplexed on how to address this new, and rapidly growing, investment phenomenon. This dynamic enabled fund houses and other investors to overstate - purposefully or not - the ESG credentials of their products without much policing. However, engagement from regulators has started to grow in the last year or two, with much of the focus on disclosure requirements and definitions of sustainability (most famously the EU's Green Taxonomy). Yet a big question which continues to trouble regulators is how to use these policies to guard against greenwashing.

The underlying issues in the US, like many countries in the early stages of regulating ESG, are primarily driven by the lack of a clear definition for what constitutes a sustainable investment, and a disclosure framework built on this. Solving these issues is a clear priority for SEC Chairman Gary Gensler. His agency recently ended the public comment period (the federal rulemaking process requires agencies to solicit and respond to questions and comments from the public about an agency's proposed rule; the SEC received over 400 comments) on a rule that would expand the climate risk disclosure framework. This new rule would require firms to provide detailed information about the effects of climate change on their business, disclose their greenhouse gas emissions and how they intend to meet industry specific ESG metrics.

Gensler remains optimistic that the rule will be developed by the end of the year. And while the US rulemaking process is long and onerous, especially for a rule expected to be as sweeping and influential as this one, the DWS investigation suggests that firms accused of making exaggerated ESG claims will be intensely scrutinized under Gensler's SEC. This means that, even without a finalized and implemented rule, we could see a significant increase in the number of investment firms finding themselves the target of similar investigations. The Biden administration has repeatedly emphasized that climate change must be treated as a threat to all sectors – even ones outside the traditional purview. By going after DWS, Gensler has sent a clear signal that he too is of this viewpoint and more importantly, that the SEC will not wait for a rule to flex their muscles.

In Germany, the timing of the investigation could not be more opportune as regulators have recently launched a consultation on proposed guidelines for sustainable investment funds. The draft guidelines set out requirements which asset management firms will be required to meet when setting up retail investment funds that are labelled or marketed as being sustainable. The DWS case will reinforce the importance of these guidelines, potentially driving greater levels of ambition from both BaFin and those responding to the consultation on ESG regulation.

The accusations against DWS and subsequent investigation has also served as a reminder to investors about the dangers of overstating their sustainability credentials. DWS shares fell 13.6% on the day the SEC and BaFin's investigation was announced and have yet to recover. This alone will generate ripple effects throughout the industry, as firms reconsider their sustainable investment criteria and tread more carefully when making claims about how green and socially impactful their funds are.

Ultimately, the result of the DWS investigations will provide insight into how regulators on both sides of the pond plan on handling greenwashing accusations. Regulators are increasingly clear that an ESG reckoning is coming to the financial services industry. Until now, they have little to show aside from rhetorical warnings. DWS is their opportunity to demonstrate they mean business.