A&L Goodbody

ASSET MANAGEMENT & INVESTMENT FUNDS

ESMA Consultation Paper on funds' names using ESG or sustainability-related terms

On 18 November 2022, ESMA published a Consultation Paper (**CP**) on Guidelines on funds' names using ESG or sustainability-related terms (**Guidelines**).

ESMA's proposal aims to establish common standards on the fair, clear and not misleading character of funds' names and introduces quantitative thresholds for names that use ESG or sustainability related terms. ESMA expects to issue the final Guidelines by Q2/Q3 2023 following its consideration of the CP feedback.

The proposals contained in the Guidelines are designed to complement ESMA's previous principles-based guidance to national competent authorities (**NCAs**) on funds' names using ESG or sustainability related terms. The Central Bank of Ireland (**CBI**) references ESMA's previous guidance in its recently published findings on the extent of compliance with the SFDR Level 1 and the EU Taxonomy Regulation (**TR**) disclosure requirements. Read more in our recent publication.

5 MIN READ

Investor protection objective

ESMA's justification for the proposed Guidelines is that the name of a fund can have a significant impact on the investment decisions of investors, who are allocating an ever-increasing proportion of their portfolios to ESG strategies. To combat the incentives for asset managers to include terminology in their funds' names designed to attract investors, and to reduce greenwashing risks, ESMA is seeking to ensure that the use of ESG and sustainability related terminology in funds' names should be used only when supported in a material way. This would be achieved by evidence of sustainability characteristics, or objectives that are reflected fairly and consistently in the fund's investment objectives, policy and strategy, as described in the relevant fund documentation.

ESMA applies the proposed Guidelines to the rules of conduct principles of the UCITS and AIFMD Directives, which include that management companies act honestly and fairly. Likewise, ESMA associates the proposed Guidelines with the Regulation on cross border distribution of funds' requirements, that all information included in marketing materials is "*fair, clear and not misleading*".

Proposed requirements for fund names

1. If a fund has any ESG or impact related words in its name, a minimum proportion of 80% of its investments should be used to meet the environmental or social characteristics or sustainable investment objectives which are disclosed in Annexes II[1] and III[2] of the SFDR Delegated Regulation.
2. In addition to the 80% threshold, if a fund has the word "sustainable" or any other term derived from the word "sustainable" in its name, it should allocate at least 50% of the investments meeting the environmental or social characteristics or sustainable investment objectives, to sustainable investments as defined by Article 2(17) SFDR.
3. For investments that are not used to meet the environmental or social characteristics or objectives of the fund, certain minimum safeguards exclusion criteria applicable to EU Paris-aligned Benchmarks as defined by the Benchmark Regulation Delegated Regulation Article 12(1)-(2) will apply. These exclusions incorporate:
   a. companies involved in any activities related to controversial weapons
   b. companies involved in the cultivation and production of tobacco
   c. companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises
   d. companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite
   e. companies that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels
   f. companies that derive 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels
   g. companies that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100g CO2 e/kWh
   h. companies that are found or estimated by them or by external data providers to significantly harm one or more environmental objectives referred to in Article 9 TR

[1] *RTS template pre-contractual disclosure for Article 8 products that promote environmental or social characteristics.*

[2] *RTS template pre-contractual disclosure for Article 9 products having a sustainable investment objective.*

Additional recommendations

- funds designating an index as a reference benchmark could use ESG and sustainability related words in their name only if the relevant quantitative thresholds are met
- funds using the word "impact" or "impact investing" or any other impact-related term in their name should meet the quantitative thresholds, and additionally the investments under those minimum proportions should be made with the intention to generate positive, measurable social or environmental impact alongside a financial return

ESMA also seeks views from stakeholders as to whether derivatives should have a specific calculation method for the purpose of calculating the naming thresholds.

Application and transitional period

ESMA proposes that the Guidelines will apply three months after the publication of their translation on the ESMA website. A transition period of six months will be provided for those funds launched prior to the publication date and those funds should either:

- bring their investments in line with the Guidelines by six months after the publication date, or
- change their name not to have ESG or sustainability-related terms within the same deadline

Practical considerations

No legislative amendment to the SFDR is envisaged. However, in practice the impact of the Guidelines, if introduced, will be significant for fund management companies in relation to the name of their funds and related SFDR pre-contractual and periodic disclosure requirements. The proposals introduce measures that will form a key component of 'ESG' or 'sustainable' fund product design and marketing strategy.

Funds disclosing under Article 8 of the SFDR are the most likely to be impacted by the Guidance since there are currently no minimum threshold requirements for investments for funds promoting environmental or social characteristics. Funds disclosing under Article 8 of the SFDR may also be required to apply the "do no significant harm" principle of the TR to investments that are not used to meet the environmental or social characteristics or sustainable investment objectives in order to meet the exclusion safeguards outlined above.

Funds currently disclosing under Article 8 and Article 9 of the SFDR must disclose what safeguards are applied to investments which promote environmental or social characteristics or have a sustainable investment objective. However, there is currently no specific guidance as to what those safeguards should be.

Supervisory expectations

ESMA recommends that NCAs consider the requirements of the Guidance throughout the life of a fund. Information on the minimum proportion of investments will be disclosed in the pre-contractual disclosures of the fund in the SFDR Level 2 templates and verified through the SFDR Level 2 template periodic disclosures. ESMA provides that a temporary and non-deliberate deviation from the thresholds should be treated as a passive breach and corrected in the best interests of unitholders. ESMA also provides that discrepancies in the level of quantitative thresholds which are not passive may be considered by NCAs, as a risk indicator warranting further investigation. ESMA proposes that where a fund does not demonstrate a sufficiently high level of investments to use ESG terms in its name, and where the NCA considers that this would result in misleading investors, NCAs are invited to communicate on these issues at an early stage and cooperate effectively to find a common position.

Greenwashing

As recently highlighted in its strategy for 2023 to 2028, tackling the risks of greenwashing remains a long term strategic priority for ESMA. This goes hand in hand with ESMA's earlier Sustainable Finance Roadmap where it identified misrepresentation or wrongful disclosure, mis-selling or the lack of clear and common labels for ESG investment products or incorrect information about the alignment with the TR as an area that can directly give rise to greenwashing. It is therefore not unexpected that ESMA has commenced this consultation.

Other regulators are adopting similar measures to clamp down on greenwashing. The UK's Financial Conduct Authority (FCA) is proposing a package of new measures that seek to include investment product sustainability labels and restrictions on how

terms like 'ESG', 'green' or 'sustainable' can be used. The US Securities and Exchange Commission intends to implement a rule requiring funds to give disclosures in support of the use of names using words such as "green" or "sustainable".

We can expect to hear more about other measures on the transparency and comprehensibility of ESG disclosures in future. The European Supervisory Authorities (**ESAs**) published a Call for Evidence on greenwashing and ESMA will be undertaking a Common Supervisory Action (CSA) on sustainability risk and disclosures in 2023. The ESAs have also been mandated to review principal adverse impact indicators and financial product disclosures.

Please speak with your usual contact on the ALG Asset Management & Investment Funds team if you would like to discuss the consultation or contribute to our response. ESMA will consider all comments received by 20 February 2023.

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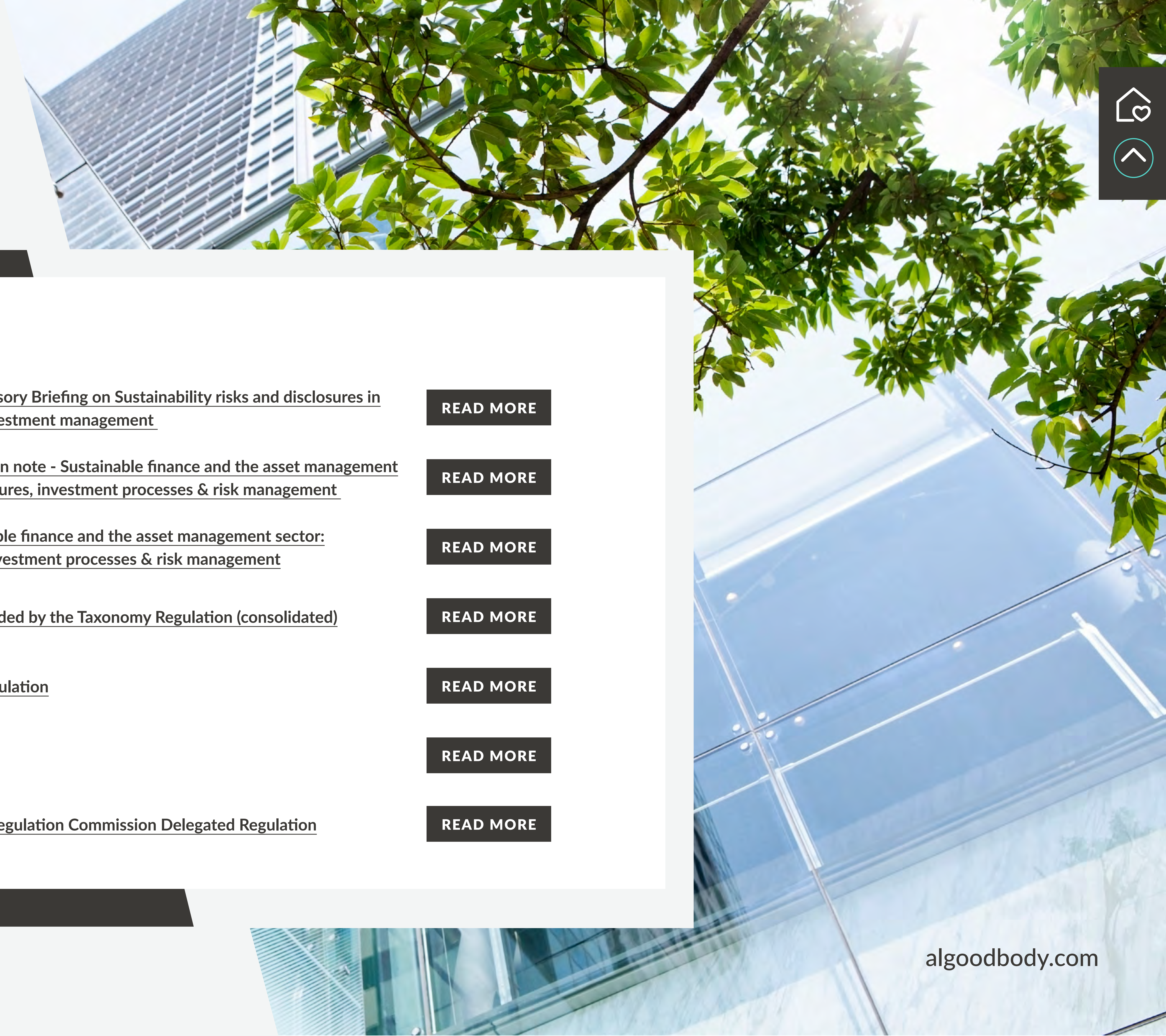

Resources

- [ESMA Supervisory Briefing on Sustainability risks and disclosures in the area of investment management] READ MORE
- CBI Information note - Sustainable finance and the asset management sector: Disclosures, investment processes & risk management — READ MORE
- CBI - Sustainable finance and the asset management sector: disclosures, investment processes & risk management — READ MORE
- SFDR as amended by the Taxonomy Regulation (consolidated) — READ MORE
- Taxonomy Regulation — READ MORE
- SFDR RTS — READ MORE
- Benchmarks Regulation Commission Delegated Regulation — READ MORE