SMSG Criticizes ESMA's Consultation on Guidelines on Fund Names

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On 21 February 2023, the Securities and Markets Stakeholder Group (the "SMSG"), the European Securities and Markets Authority's ("ESMA") advisory body appointed by its Board of Supervisors, issued advice to ESMA on ESMA's consultation on "Guidelines on funds' names using ESG or sustainability-related terms" (the "Guidelines").

The consultation phase for the Guidelines ended on 20 February 2023. ESMA expects to publish the final Guidelines by Q2/Q3 2023, with the Guidelines applicable three months after their publication. Under the draft, there shall be a transition period of six months for funds established before the application date to comply with the Guidelines.

Quantitative Requirements. According to the Guidelines, fund names using ESG-, impact- or sustainability-related terms must meet the following requirements (through the lifetime of the fund) not to be considered misleading:

- If the fund name contains ESG- or impact-related words, the fund must invest a minimum proportion of 80% of its investments aligned with promoted environmental or social characteristics in accordance with the investment strategy disclosed in the pre-contractual disclosure under Regulation 2019/2088 ("SFDR"). The consultation paper does not contain a definition of impact- or ESG-related words, but gives a few examples (e.g. "climate change", "biodiversity", "impact"). We expect the interpretation to be fairly wide, considering that investor protection is a topic of great importance for ESMA.

- If the fund name contains the word "sustainability" or any other term derived from the word "sustainable", within the 80% of investments that must be aligned with the promoted environmental or social characteristics a minimum proportion of 50% must be sustainable investments in line with Article 2(17) SFDR. A sustainable investment according to SFDR is an investment in an economic activity that contributes to an environmental or social objective, provided that such investment does not significantly harm any of those objectives and that the investee companies follow good governance practices.

In addition, if the fund name contains the words “impact” or “impact investing” or any other impact-related term, in addition to the above quantitative thresholds, the fund’s investments under the above minimum proportions need to be made with the intention to generate positive, measurable social or environmental impact alongside a financial return.

The SMSG’s response is interesting. It states that it is “not convinced by the proposed quantitative threshold approach”, arguing that definitions of concepts under SFDR as well as underlying data are not yet finalised. In its view, it may be confusing for investors to add a second threshold, i.e., the Sustainable Investment threshold, and this quantitative proposal may therefore miss its goal at this stage of development of the sustainable finance framework. The SMSG concludes that a two-step approach may be more appropriate, with qualitative criteria at a first stage and quantitative criteria at a second stage. Recent national approaches to sustainability-related naming rules by national regulators (most prominently in Germany and France) have also entailed qualitative criteria alongside quantitative criteria to enable more flexible approaches for fund sponsors, given the scarcity of sustainability-related data available to determine quantitative thresholds. Due to this scarcity, we also take the view that a qualitative threshold will help more adequately to balance the interests of fund sponsors and investor protection concerns. It should be in ESMA’s interests to support the continuous growth of sustainability-related funds to finance the European economy’s transition according to the European Union’s Green Deal. Rules of a strict nature, such as quantitative thresholds which are hard to meet, can have the potential to slow down this important transition.

With respect to temporary passive breaches of the quantitative thresholds, the SMSG disagrees with ESMA’s approach to calculate breaches based on the value of a fund’s assets. Instead, the SMSG favours the calculation as based on the exposure value of the investment portfolio (i.e., without ancillary liquid assets). This critique rightly takes into account that ESMA’s consultation could be better aligned with the legislative approach that has been followed to date. SFDR requires funds that disclose under Article 8 or 9 SFDR to indicate the proportion of their investments that are sustainable investments under SFDR or that are aligned with environmental or social characteristics. In addition to that, the connection of the Guidelines with product-related SFDR requirements would lead to an interconnection that has been in the heart of the European Union’s sustainable finance framework from the beginning.

Link to ESA’s Greenwashing Consultation. The SMSG also mentions the ESAs’ consultation on greenwashing, which is closely linked to ESMA’s initiative, but as the SMSG emphasizes, the greenwashing consultation involves all three ESAs working on a two year timeline, while the ESMA Guidelines apply to funds only and have a timeline of less than one year. The SMSG also explicitly states that the ESAs have received a

formal mandate from the European Commission on the greenwashing theme, while the Guidelines are not based on such a formal mandate.

Link to Existing Strategies and Transition Investing. The SMSG expressed its regret that the Guidelines do not assess existing strategies nor link the proposal to existing rule-based efforts included in some national regimes or labels, indicating there is a need for clarification regarding ESG investment strategies and processes. It highlights that ESG strategies implemented by asset managers go much further and are more diverse than negative screening and that it is ESMA's role to establish a list of key ESG investment approaches/strategies with their corresponding characteristics, for example thematic investing on an ESG theme, engagement strategies, relative rating improvement approach, relative selection approach and KPI improvement. As elaborated above, an emphasis on simplifying qualitative criteria would further improve the ultimate goal of the European Union's Green Deal to allocate more private capital to the transition of Europe's economy through investment funds. ESMA could even facilitate that idea with inspiring fund sponsors by setting standards for approaches to sustainability-related strategies with which investors with sustainability preferences could be attracted without the constant fear of being exposed to greenwashing allegations.

According to the SMSG, strategies that constrain the portfolio's investments on an ex-ante basis on sustainability aspects/factors should be recognized, resulting in transitions investments to be included in ESMA's consideration. The SMSG criticized that ESMA's approach relies too much on a static view of "green" or ESG funds. Therefore, the SMSG raises the provocative question: "*If 'naming' compliant Art. 8 and 9 funds would no longer be allowed to invest in any transition investments in their portfolio, the SMSG wonders which will ultimately be the impact on the environment of the European sustainable finance agenda implementation?*"

The role of the SMSG is to facilitate ESMA's stakeholder consultation by providing technical advice on ESMA's policies under development, with a particular focus on promoting supervisory convergence and assessing market developments. It remains to be seen to what extent ESMA will consider the SMSG's advice in the final Guidelines. We will keep you posted about any further developments.

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Please do not hesitate to contact us with any questions.

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