ESMA Introduces Minimum Thresholds for ESG and Sustainability-Related Fund Names

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The European Securities and Markets Authority ("ESMA") recently published an update (the "Statement") to ESMA's consultation (of November 2022) on Guidelines on the use of ESG or sustainability-related terms in the names of funds (the "Guidelines") managed by fund managers in the European Union ("EU"). The Guidelines are directed at EU fund managers operating under the Alternative Investment Fund Managers Directive ("AIFMD"). Non-EU managers marketing funds in the EU will likely also have to comply with the Guidelines, consistent with the scope of the Sustainable Finance Disclosure Regulation ("SFDR").

The Guidelines list certain terms that, if used in the name of the fund, trigger minimum requirements for the fund's investment strategy, as summarised below. In practice, it may not be easy to determine which set of requirements applies, partly because funds use words in their names in different contexts and partly because funds may use names that fall into more than one set of requirements.

ESMA has agreed to certain amendments to the Guidelines since the original proposal in November 2023, but did not take into account important feedback raised by the industry. For example, the Guidelines appear to apply to both retail and professional funds. ESMA will adopt the Guidelines on entry into force of the Directive amending the AIFMD ("AIFMD II"), which is expected to be by the end of Q2 2024.[1]

We summarise in this Debevoise Update the most important points under the new regime.

Funds Whose Names Include the Term "Sustainable" or Related Terms. Funds that use the word "sustainable" or related terms in their names must meet **each of** the following conditions:

[1] Note that, whilst AIFMD II is expected to enter into force by the end of Q2 2024, AIFMD II will apply at the conclusion of the two-year transposition period into national law. However, it appears that ESMA's Guidelines will apply following the earlier entry into force date.

- At least 80% of the fund's investments should meet the sustainability characteristics or objectives;
- Apply an exclusion list prohibiting them from investing in companies:
  - involved in controversial weapons;
  - involved in the cultivation and production of tobacco;
  - that derive at least 1% of their revenues from exploration, mining, extraction, distribution or refining of coal;
  - that derive at least 10% of their revenues from the exploration, extraction, distribution or refining of oil fuels;
  - that derive at least 50% of their revenues from exploration, extraction, manufacturing or distribution of gaseous fuels or from electricity generation with GHG intensity exceeding 100g CO2 e/kWh; or
  - found to be in violation of the UNGC principles or OECD Guidelines for Multinational Enterprises;[2] and
- Invest "meaningfully" in SFDR-aligned "sustainable investments" (in the original proposal ESMA referred to a 50% threshold).

ESMA may provide further guidance in the final Guidelines as to what they consider to be "meaningful". It is fairly unclear what is meant by "related terms", although this may refer to the use of terms such as "sustainability" and "sustain".

Funds Whose Names Include the Term "Transition" or Related Terms. ESMA introduces a category for funds that use the word "transition" or related terms in their names. These funds will need to ensure that:

- at least 80% of their investments meet the promoted environmental and/or social characteristics; and

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[2] These are the exclusions for EU Paris-aligned Benchmarks contained in Article 12(1) of Commission Delegated Regulation (EU) 2020/1818.

- its investments are subject to a limited exclusion list, restricting investment in controversial weapons, cultivation and production of tobacco, and companies in violation of UNGC principles or OECD Guidelines for Multinational Enterprises.[3]

As above, ESMA recommends that such an exclusion list become a requirement for all funds that use either categories of names and that are in scope of the final Guidelines. The industry regarded ESMA's original proposal in this regard as problematic, noting that, for instance, it is not appropriate for all sustainable funds—such as those investing in the developing world or those with purely social characteristics—to apply a fossil fuel screen, and some strategies such as fund of funds or credit cannot always obtain the data required to apply a full screen. Some types of excluded investments are of limited relevance to some types of funds, and the exclusion of companies in violation of UNGC principles or OECD Guidelines for Multinational Enterprises is a type of "do no significant harm" check that under SFDR applies only to funds that make sustainable investments.

ESMA clarifies how to deal with cases where a fund combines terms that fall under different categories in its name. For example, a fund using "ESG" and "transition" (or related terms) in its name at the same time, the requirements set out under the Guidelines for both categories will apply cumulatively. Where a fund uses "environmental terms" combined with "transition terms" in its name, only the more limited exclusions will apply, reflecting that climate transition funds may invest in fossil fuels as part of their transition activities. However, where a fund uses "sustainable" or related terms in its name, it will always be required to apply the full exclusion list.

A fund using the word "impact" or related terms in its name must also meet the minimum proportion of 80% of investments that meet the sustainability characteristics or objectives.

Summary of the Listed Names and Related Restrictions. This table contains a non-exhaustive list of restricted names and the corresponding restrictions imposed by ESMA in the Guidelines.

Restricted Fund Names	Restriction
"ESG" or ESG-related terms in its name (e.g.,	At least 80% of the fund's investments must meet (a) the promoted environmental and/or social characteristics or (b) sustainable investment objectives of the fund.

[3] These are the exclusions for EU Climate Transition Benchmarks contained in Article 10(1) of Commission Delegated Regulation (EU) 2020/1818.

"Climate Change", "Biodiversity")	ESMA **recommends**, in the Guidelines, the application of a full exclusion list for funds using ESG or related terms.
"Environmental" terms in its name	At least 80% of the fund's investments must meet (a) the promoted environmental and/or social characteristics or (b) sustainable investment objectives of the fund. In addition to the quantitative thresholds above, it appears that funds with environmental terms will need to apply a full exclusion list prohibiting investments in companies that *inter alia* derive a significant amount of revenue from activities relating to fossil fuels or GHG intense electricity generation. This will be confirmed in the final Guidelines.
"Sustainable" or sustainability-related terms in its name (e.g., "Sustainable Water", "Sustainable Society")	At least 80% of the fund's investments should meet the sustainability characteristics or objectives. Apply an exclusion list prohibiting from investing in companies that *inter alia* derive a significant amount of revenue from activities relating to fossil fuels or GHG intense electricity generation. The fund should invest meaningfully in SFDR-aligned "sustainable investments".
"Impact", or "impact investing" or impact-related terms in its name (e.g., "Global Impact").	At least 80% of the fund's investments must meet (a) the promoted environmental and/or social characteristics or (b) sustainable investment objectives of the fund. The fund should intend to generate a positive and measurable social or environmental impact, in addition to financial return. It appears that the final Guidelines will require these funds to apply a full exclusion list in line with "sustainable" funds, prohibiting investments in companies that *inter alia* derive a significant amount of revenue from activities relating to fossil fuels or GHG intense electricity generation.

Terms relating to “transition” in its name, including where combined with environmental terms (e.g. “Green Transition”)	At least 80% of the fund’s investments must meet (a) the promoted environmental and/or social characteristics or (b) sustainable investment objectives of the fund. Investments are subject to a limited exclusion list avoiding involvement in controversial weapons, cultivation and production of tobacco, and violation of UNGC principles or OECD Guidelines for Multinational Enterprises. The fund should intend to make investments on a clear and measurable path to social or environmental transition.
“Social” or “governance” terms in its name	The Guidelines or the Statement do not explicitly set out any requirements for these funds other than ESMA’s acknowledgement that having a full screen, *inter alia*, the exclusion of fossil fuel investments being too restrictive. It appears that these funds will also be subject to a quantitative threshold where at least 80% of the fund’s investments must meet (a) the promoted environmental and/or social characteristics or (b) sustainable investment objectives of the fund, and will be subject to a limited exclusion screen in line with “transition” funds. This will be confirmed in the Final Guidelines.

Outlook and How to Prepare. It appears that ESMA will publish the final Guidelines following the entry into force of AIFMD II in mid-2024. Once the Guidelines are published, they will apply three months after publication. Managers will be expected to comply with the Guidelines from that time with regard to new funds, and for existing funds, they must comply within six months. Since SFDR does not have any specific transitional rules, funds that meet both of the following conditions will likely not be subject to the Guidelines: (i) they were raised prior to 10 March 2021 (effective date of SFDR), and (ii) they do not promote environmental and/or social characteristics or have a sustainable investment objective. However, funds that were raised prior to 10 March 2021, but promote environmental or social characteristics or have a sustainable investment objective, will likely be subject to the Guidelines, as a result of being in scope of SFDR as per the clarification from the European Commission.[4]

[4] Consolidated Q&A on SFDR and SFDR Level II, V. Financial Product Disclosures, Q&A 4.

Some restrictions may require the introduction of a new exclusion screen for the fund, an amendment of the investment strategy or a change to the name of Fund, each of which may require investor consent. Fund sponsors should consider carefully which of their funds may be within scope.

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