BaFin Responses to Industry Questions on ESMA's "Guidelines on ESG or Sustainability-Related Terms in Fund Names"

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On 2 December 2024, the German Federal Financial Supervisory Authority ("BaFin") informed German fund industry associations about its interpretation of industry questions on the "Guidelines on funds' names using ESG or sustainability-related terms" (the "Guidelines"; please find a link to our update on the Guidelines here) of the European Securities and Markets Authority ("ESMA").

BaFin's interpretation touches on the following important topics:

- application of the EU Paris-Aligned Benchmark exclusion list (the "PAB exclusion list")/Climate Transition Benchmark exclusion list (the "CTB exclusion list") prescribed by the Guidelines to fund of funds;
- application of the PAB exclusion list/CTB exclusion list prescribed by the Guidelines for investments in derivatives;
- application of the Guidelines to funds that are not actively marketing their units or shares.

It is important to note that BaFin's interpretation is only directly relevant to funds domiciled in Germany and that it may be overruled if ESMA publishes divergent guidance on its Guidelines. Moreover, national regulators from other EU jurisdictions (including Luxembourg and Ireland) may take the same or a different position on any of the points addressed by BaFin.

Application of Exclusion Lists in the Context of Fund of Funds. For fund of funds in scope of the Guidelines, it is in question whether its underlying target funds must apply the respective exclusion list, i.e., whether to look through to investments of the target fund to comply with the exclusion list. According to BaFin's view, a look-through approach must generally be applied by the fund of funds; however, BaFin makes a distinction in the appropriate approach between open-ended and closed-ended target funds.

If the target fund is open ended, BaFin does not require the exclusions to be stipulated in such target fund's investment policy but that the target fund "is oriented towards" the applicable exclusions—without having to **fully** comply with them. According to BaFin, the fund of funds manager remains responsible for checking adherence with the applicable exclusion list in regular financial reports and selling the relevant position if it detects a breach of the exclusion list.

For closed-ended target funds, BaFin takes a stricter view because the interests in the target funds cannot be redeemed. Consequently, BaFin requires the target fund to stipulate the applicable exclusion list in its investment policy (a compliance that is merely factual is considered insufficient) and to apply it on a look-through basis.

In practice, the decision to take such a rigid and restrictive approach is likely to make German fund of funds with ESG-or sustainability-related names less attractive for private funds sponsors and investors—many closed-ended target funds in non-EU jurisdictions will likely not apply fully the CTB or PAB exclusion lists and will therefore not be eligible investments for German private equity fund of funds because of BaFin's position described above.

Application of Exclusion Lists to Investments in Derivatives. Investments in derivatives have different purposes, depending on the investment strategy of a fund. Some derivatives may be part of the actual investments of a fund, whereas other derivatives only have hedging purposes to secure a fund's investment strategy. BaFin now clarified that derivatives used for hedging purposes do not have to be subject to the PAB or CTB exclusion lists as those are being used to protect sustainability-related investment strategies and are therefore important for sustainability-related funds. For derivative investments made for investment purposes, the PAB or CTB exclusions must be taken into account according to BaFin.

Application of the Guidelines to Funds That Are Not Actively Marketed. BaFin states that the Guidelines do not provide for an exception for funds that had their final closing and are thus not actively being marketed anymore (based on the argument that such funds' interests could still be traded on the secondary market). This means that funds, even if they had their final closing, will have to amend their investment strategy or their name to comply with the Guidelines.

BaFin's position in this regard will create additional cost burdens and work for sponsors with German funds before 21 May 2025. While this will likely cause confusion for German fund investors, it is hard to see any significant value in BaFin's approach because the risk of misleading (exclusively secondary) investors appears to be low given the visibility of a closed fund's portfolio and the typical sophistication of secondary investors.

No Fast-Track Process. In contrast to the *Commission de Surveillance du Secteur Financier* (the "CSSF"), which will provide a priority processing procedure (PPP) to Luxembourg managers of existing regulated funds that need to update their prospectus or issuing document to comply with the Guidelines by 21 May 2025, BaFin announced it will not provide for a fast-track process. In BaFin's view, the amendment of the investment policy to comply with the PAB or CTB exclusion lists is generally not considered to be a change to the investment principles or a change to material investor rights that is detrimental to investors. This applies particularly if the information in the pre-contractual disclosure under Article 8 or 9 of the SFDR already contains minimum commitments and exclusion criteria as binding characteristics that are comparable to the exclusions of the Guidelines.

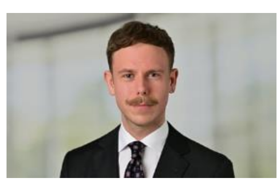
Conclusion. BaFin's interpretations of the Guidelines are likely to cause sponsors of alternative investment funds in Germany to not use ESG- or sustainability-related names for their funds. With fund of fund sponsors being limited to closed-ended target funds that must also adhere to the Guidelines and application of the Guidelines to funds that are not being marketed anymore, usage of ESG- or sustainability-related names becomes unattractive to some extent. It is to be hoped that ESMA or other national regulators will take a more pragmatic and appropriate approach.


Patricia Volhard
Partner, Paris, Frankfurt, London
+ 33 1 40 73 12 12
+49 69 2097 5150
pvolhard@debevoise.com


Jin-Hyuk Jang
Counsel, Frankfurt
+ 49 69 2097 5115
jhjang@debevoise.com


John Young
Counsel, London
+ 44 20 7786 5459
jyoung@debevoise.com


Harry Just
Associate, Frankfurt
+ 49 69 2097 5262
hjust@debevoise.com


Eike Björn Weidner
Associate, Frankfurt
+49 69 2097 5220
ebweidner@debevoise.com


Keith Moshe
Corporate Staff Attorney, Frankfurt
+ 49 69 2097 5123
kmoshe@debevoise.com

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