SIFMA response to ESMA Consultation Paper regarding Guidelines on funds' names using ESG or sustainability-related terms

Executive Summary

SIFMA AMG is supportive of ESMA's efforts to increase clarity for investors and reduce the risk of "greenwashing." However, SIFMA AMG has some concerns in relation to ESMA's proposals, in particular:

- The imposition of quantitative thresholds is inappropriate as they will result in arbitrary outcomes and rely on terms which are not precisely defined.

- A better alternative to quantitative thresholds would be an approach which focuses on the intentionality of the investment fund.

- An additional threshold for the use of the word "sustainable" is not necessary as it may confuse retail investors who may not appreciate the distinction between this and other ESG words.

- The use of safeguards based on Article 12(1)-(2) of Commission Delegated Regulation (EU) 2020/1818 is inappropriate as there are sufficient safeguards built into Article 8 and Article 9 and the DNSH test for sustainable investments, and, in any case, the safeguards proposed are not appropriate for many types of ESG funds.

- There is no added value in adopting specific requirements for funds with transition-related terms in their names given the lack of confirmed definitions of terms such as on "transition" and "transitioner."

Introductory Comment

SIFMA AMG appreciates ESMA's efforts to increase clarity for investors regarding investment funds which are named as green or socially sustainable and to reduce the risk of related "greenwashing" in sustainability disclosures.

However, we disagree with introducing quantitative thresholds for particular ESG terms used in fund names because such quantitative thresholds will inevitably lead to arbitrary outcomes. There is no justification as to why the thresholds of 80% and 50% have been selected as opposed to 75% and 40% or, indeed, any other threshold. Adopting such thresholds will result in substantive distinctions in the naming of funds despite (potentially) small percentage differences in their actual asset allocation (i.e., a fund achieving 79% will not meet the threshold and a fund achieving 80% will). Such thresholds will not help investors make informed decisions because the focus will be entirely on quantitative thresholds for asset allocation instead of other factors that distinguish funds with a more substantive focus on ESG.

Q1. Do you agree with the need to introduce quantitative thresholds to assess funds' names?

No. As noted above, we are opposed to the use of quantitative thresholds in this space as they are inherently arbitrary and there is no clear basis for the thresholds being set at 80% and 50% versus any other threshold.

Moreover, the imposition of quantitative thresholds focuses on outputs rather than funds' intentions and processes. SIFMA AMG believes the intentionality, processes and design of an investment fund are more useful indicators of their sustainability approach for investors rather than arbitrary percentage outputs based on terms which are not uniformly implemented.

In addition, the mechanisms used to define the quantitative thresholds rely on the terms 'environmental and social characteristics' and 'sustainable investments' under Article 8 and Article 9 of Sustainable Finance Disclosure Regulation ("**SFDR**"), which are not themselves precisely or narrowly defined. As a result, whether the threshold will be met is partially subject to the discretion of fund managers in how they characterize these terms. This undermines the ability of the proposed thresholds to provide clarity to investors.

As each Article 8 fund defines its own 'environmental and social characteristics' this can (per guidance from the Commission) encompass a wide range of investment approaches which incorporate environmental or social considerations in some way. For example, environmental or social characteristics could vary from the implementation of exclusions of certain sectors for environmental or social reasons to commitments that a certain proportion of investments be made in the renewable energy sector. The consequence of this is that in the former scenario, where a fund applies exclusions to its whole portfolio it may meet the 80% threshold under the proposed Guidelines because all investments would meet the environmental and social characteristic. However, in the latter scenario a fund may not meet the 80% threshold if the proportion of renewable energy investments committed to was less than 80%, simply because the environmental and social characteristics they have committed to are not applied broadly to the whole portfolio in the way exclusions are. Therefore, a potential unintended consequence of these guidelines could result in greenwashing by encouraging fund managers to design their 'environmental and social characteristics' to arbitrarily meet the 80% threshold, rather than actually promoting social or environmental good.

There is also no uniform implementation of what a 'sustainable investment' is under SFDR, and the definition remains subject to uncertainties. Notably, methods for assessing positive environmental or social contributions may vary across different fund managers, as will the precise thresholds and mechanisms used for the "do no significant harm" ("**DNSH**") test. It is also unclear how the term is to be applied in certain circumstances. This lack of clarity is reflected in the questions submitted by the European Supervisory Authorities ("**ESA**s") to the Commission in September 2022. The first two of these questions relate to the meaning of 'sustainable investment' and remain outstanding. Requiring a specific percentage of a fund's portfolio to be 'sustainable investments' to use particular names will result in confusion and the creation of non-comparable results which will not assist investors or prevent potential greenwashing. Notably, fund managers who internally set higher standards for determining whether an investment is a 'sustainable investment' would be at a disadvantage when it came to marketing their funds. Hence, a potential unintended consequence of the guidance would be an incentive to reduce these standards.

Alternative approach

An alternative approach which focuses on the intentionality of the fund would be more beneficial to investors. This can be achieved via a requirement for funds to demonstrate in a clear way the ESG integration strategy via specific binding elements of the investment process and how these apply to asset allocation. To the extent outcomes are considered, they should be supplementary to a demonstrated commitment to ESG in the binding elements of funds' investment processes.

While we are opposed to quantitative thresholds, if they are to be adopted, given they are mainly focused on mainstream retail investors (who may be expected to rely more on fund names when making investment decisions rather than a more detailed consideration of other disclosures), we consider it should be limited to Undertakings for Collective Investment in Transferable Securities ("**UCITS"**) fund funds and not also applied to funds directed towards more sophisticated investors.

If the above intentionality proposal is not adopted, a clear definition of "sustainable investment" would be important for consistency across funds. To avoid different treatment for different types of funds we would recommend the Guidelines take into consideration a variety of products including systematic/passive funds using derivatives for investment purposes and private funds.

Q2. Do you agree with the proposed threshold of 80% of the minimum proportion of investments for the use of any ESG-, or impact-related words in the name of a fund? If not, please explain why and provide an alternative proposal.

No. SIFMA AMG does not agreed that there should be any quantitative thresholds (see our response to Question 1 above). But if quantitative thresholds are to be used, the 80% threshold is too high compared to thresholds used in other contexts, such as the supervisory guidance in some jurisdictions regarding whether products can use names implying particular asset allocations which are typically about 60%.

We are also concerned that what words will amount to an ESG or impact-related word is unclear. Whilst we appreciate ESMA may be reluctant to specify a definitive list of such terms, a non-exhaustive list (which could potentially be updated over time) would be helpful. This list could be put out for notice and comment. Furthermore, ESMA should provide guidance on how words that could be interpreted as relating to ESG or could be interpreted as relating to other considerations such as sectoral allocations (for example "healthcare" or "energy") should be treated for the purposes of any guidelines.

Q3. Do you agree to include an additional threshold of at least 50% of minimum proportion of sustainable investments for the use of the word "sustainable" or any other sustainability-related term in the name of the fund? If not, please explain why and provide an alternative proposal.

No. We do not think that retail investors will generally appreciate the distinction between words such as "sustainable" and other ESG words in fund names so we do not think that there should be a specific threshold. For example, comparing the names "Green Technology Fund" and "Sustainable Technology Fund", we do not think the word "sustainable" implies the latter is subject to more restrictive standards than the former. We also oppose the introduction of any form of quantitative thresholds and would preference an alternative which is based on the intentionality of the fund as outlined in our introductory comment and response to Question 1 above.

If ESMA does, however, decide to proceed with specific criteria for terms such as "sustainable", we reiterate our comment in Question 1 on the need for a clear definition of 'sustainable investment' to provide clarity. Furthermore, we also think further clarity should be given on whether terms using the word "sustainable" which are not related in any way to "sustainable investments" (e.g., references to the UN Sustainable Development Goals) should be viewed.

Q4. Do you think that there are alternative ways to construct the threshold mechanism? If yes, please explain your alternative proposal.

No. As discussed in our response to Question 1 above and our introductory comment, we oppose the introduction of any quantitative thresholds.

Q5. Do you think that there are other ways than the proposed thresholds to achieve the supervisory aim of ensuring that ESG or sustainability-related names of funds are aligned with their investment characteristics and objectives? If yes, please explain your alternative proposal.

Yes. We favor an approach which is focused on intentionality rather than the imposition of quantitative thresholds as outlined in our response to Question 1 above.

Q6. Do you agree with the need for minimum safeguards for investment funds with an ESG- or sustainability-related term in their name? Should such safeguards be based on the exclusion criteria such as Commission Delegated Regulation (EU) 2020/1818 Article 12(1)-(2)? If not, explain why and provide an alternative proposal.

We are opposed to the use of safeguards based on Article 12(1)-(2) of Commission Delegated Regulation (EU) 2020/1818 for several reasons.

Firstly, we consider that sufficient safeguards are already built into Article 8 and Article 9 and more broadly in the DNSH test for sustainable investments. In particular, we note that Article 8 funds are required to ensure that all investee companies follow good practices and that sustainable investments in Article 8 and 9 funds are subject to the DNSH test which includes minimum safeguards.

Secondly, because Article 12(1)-(2) was drafted from the perspective of EU Paris-Aligned benchmarks (which are subject to the highest standards of low carbon benchmarks), some of the safeguards in Article 12(1) are inappropriate for many funds with ESG- or sustainability-related terms in their names. Notably the safeguards in Articles 12(1)(d)-(g) do not apply to EU Climate Transition benchmarks, and are generally inappropriate for funds focused on transitional activities, or which have environmental or social characteristics or objectives which are not focused on stringent avoidance of fossil fuel exposures or carbon emissions. It would seem odd that a fund tracking an EU Climate Transition benchmark presumably could not, under the proposed guidance, use the term "Climate Transition" in its name since the benchmark would not be applying the safeguards in Articles 12(1)(d)-(g). In addition, it would be problematic that a fund with a social focus would presumably not be able to use the term social in its name if it did not comply with the safeguards, despite them being related to environmental (and specifically climate and carbon emissions) issues rather than social ones.

Thirdly, the meaning of Article 12(2) (and how exactly it should be implemented) is unclear. The DNSH test under Article 12(2) is only defined in the Taxonomy Regulation in relation to activities which could be Taxonomy aligned. As a result, activities that do not have technical screening criteria associated with them (for example, because they are not capable of "substantially contributing" to a relevant objective, or are actively harmful activities) do not have defined measures of the DNSH test under the Taxonomy Regulation. Hence some activities that are significantly harmful to the Taxonomy Regulation objectives do not have a defined way of being assessed as such. Further, entities which are subject to obligations

to report Taxonomy eligibility and alignment under Article 8 of the Taxonomy Regulation are not obliged to separately report on the DNSH test. They instead just report on Taxonomy eligibility and/or alignment as a whole, and so it cannot necessarily be assessed from this reporting whether the DNSH test is ensured. Finally, many entities are not subject to Taxonomy reporting (either because their obligations have not yet been phased in through the Corporate Sustainability Reporting Directive, or because they are simply out of scope of reporting obligations). Hence it is difficult to see how the safeguard in Article 12(2) can be consistently applied to funds. In any case, we do not think that this safeguard is appropriate for all funds with ESG- or sustainability-related terms in their names. For example, funds focused on social concerns should not necessarily have to apply this safeguard.

If standards are to be imposed that increase the minimum safeguards already imposed on Article 8 and 9 funds discussed above, it would be more effective to draw on the SFDR concept of minimum social and governance safeguards under the DNSH test for sustainable investments, which includes an explanation of "*whether the sustainable investment is aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights*".

Q7. Do you think that, for the purpose of these Guidelines, derivatives should be subject to specific provisions for calculating thresholds?

> **a) Would you suggest the use of the notional value or the market value for the purpose of the calculation of the minimum proportion of investment?**
>
> **b) Are there any other measures you would recommend for derivatives for the calculation of the minimum proportion of investments?**

No. There is a lack of clarity as to how derivatives would be counted towards these calculations. For the same reason, cash and other liquidity or hedging instruments should not count towards these calculations.

Q8. Do you agree that funds designating an index as a reference benchmark should also consider the same requirements for funds' names as any other fund? If not, explain why and provide an alternative proposal.

While we disagree with the imposition of quantitative thresholds, if such thresholds are applied funds designating an index as a reference benchmark should not be subject to different requirements from active funds.

Q9. Would you make a distinction between physical and synthetic replication, for example in relation to the collateral held, of an index?

No.

Q10. Do you agree with having specific provisions for "impact" or impact-related names in these Guidelines?

Yes. While we disagree with the adoption of quantitative thresholds in the guidance, we consider that the additional requirement that investments made by funds using impact or impact-related terms in their names are "made with the intention to generate positive, measurable social or environmental impact alongside a financial return" to be sensible and more appropriate. However, for the avoidance of doubt, we do not think that funds using impact or impact-related terms in their names should be subject to quantitative thresholds, as discussed in our response to Question 1 above.

Q11. Should there be specific provisions for "transition" or transition-related names in these Guidelines? If yes, what should they be?

Given the continuing lack of confirmed definitions on "transition", "transitioner", "improvers", we believe there is no added value with pursuing with specific rules or requirements for funds with transition-related terms in their names. We also do not think these terms should be subject to quantitative thresholds, as an asset allocation focused approach, as well as being generally problematic for the reasons discussed in our introductory comment and response to Question 1, is particularly inappropriate for funds focused on transition or improvement (which is more about processes than asset allocation outcomes). There should not be a specific definition for a transition fund as there is continuing debate about how these should be defined, and we note that there is an outstanding question from the ESAs with the EU Commission regarding how transition plans, commitments and strategies should be considered in the context of the "sustainable investment" definition. We also note our concerns about the

appropriateness of applying the safeguards that have been proposed to transition funds discussed in our response to Question 6.

Q12. The proposals in this consultation paper relate to investment funds' names in light of specific sectoral concerns. However, considering the SFDR disclosures apply also to other sectors, do you think that these proposals may have implications for other sectors and, if so, would you see merit in having similar guidance for other financial products?

While our members disagree with the imposition of quantitative thresholds and several aspects of the proposed Guidelines as discussed above, if the Guidelines are applied there is no particular reason why their application should be restricted solely to investment funds. For example, the names of insurance-based investment products may have a similar impact on investor's ESG related expectations as the names of investment funds.

However, we do note that portfolio management services (which are a financial product under SFDR) are somewhat different from investment funds and hence the name used for the portfolio may be less relevant to marketing the product. For example, where a portfolio is entirely bespoke and any environmental and social characteristics or sustainable investment objective are agreed between the client and portfolio manager, the name given to the portfolio is not particularly relevant from a marketing perspective given the client's active engagement. Hence, we do not think it would be appropriate to apply name guidance to these types of portfolio management services.

Q13. Do you agree with having a transitional period of 6 months from the date of the application of the Guidelines for existing funds? If not, please explain why and provide an alternative proposal.

No. Eighteen (18) months is more appropriate given the large number of funds likely to be impacted by the Guidelines. In ESMA's open hearing on the Consultation Paper on 23 January 2023, it estimated that over 4,000 funds which use ESG or sustainability related terms in their names could be impacted by the Guidelines. As the application of the Guidelines may result in amendments to fund names, prospectuses and other legal documentation, marketing materials and the refinement of fund processes, with some of these changes potentially requiring investor consent, 18 months is necessary for the industry to implement any guidelines of this nature and adjust.

Q14. Should the naming-related provisions be extended to closed-ended funds which have terminated their subscription period before the application date of the Guidelines? If not, please explain your answer.

No, as they are no longer being marketed to investors and hence their names are no longer relevant from a marketing perspective. Given the intention of the proposed Guidelines is to combat greenwashing in marketing through fund names, it would be unnecessary to apply the Guidelines to funds which are no longer actually marketed.

Q15. What is the anticipated impact from the introduction of the proposed Guidelines?

As noted in our introductory comment and response to Question 1, we do not think the proposed Guidelines, given they are based on a quantitative approach, would have a positive impact in providing greater clarity for investors or combatting greenwashing.

Q16. What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

At ESMA's open hearing on the Consultation Paper on 23 January 2023, it estimated that over 4,000 funds which use ESG or sustainability related terms in their names could be impacted by the Guidelines. As noted in our response to Question 13, application of the guidelines would result in significant costs for these funds given the complexity of the necessary changes.