sifma
asset management group

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Evert van Walsum,
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ESMA
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Dear Evert

Re: Update on the guidelines on funds' names using ESG or sustainability-related terms

The Securities Industry and Financial Markets Association's (SIFMA Asset Management Group[1] (AMG) is supportive of ESMA's efforts to increase clarity for investors and reduce the risk of "greenwashing." We submitted feedback to the ESMA Consultation Paper regarding Guidelines on funds' names using ESG or sustainability-related terms on February 15, 2023. However, we have serious concerns about the impact of the proposed *timing* for implementation as well as some of the *details* of the final guidelines. We believe addressing these concerns now is important to support investor confidence and business certainty needed for a more sustainable future.

Our principal concern is that the ongoing European Commission review of the Sustainable Finance Disclosure Regulation will catalyze changes in the definitional foundations of the ESMA guidelines on fund names. The subsequent impact on ESMA's treatment of fund names will undermine investor confidence, inject uncertainty into efforts to transition to a more sustainable future and undermine ESMA's assumption – stated in the cost-benefit analysis of the original consultation – that the compliance costs will be one-off.

Proposed timing

On December 13th, 2023, ESMA issued an Update on the guidelines on funds' names using ESG or sustainability-related terms. This update announced ESMA would postpone the adoption of the Guidelines to ensure that the outcome of ongoing AIFMD and UCTITS reviews may be fully considered – particularly given the expectation of two new mandates for ESMA to develop guidelines specifying the circumstances where the name of an AIF or UCITS is unclear, unfair, or

[1] SIFMA's Asset Management Group (SIFMA AMG) brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms – both independent and broker-dealer affiliated – whose combined assets under management exceed $62 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

misleading. The update confirmed, however, that ESMA regards implementation as a matter of when rather than if the guidelines will go ahead:

> *‘ESMA plans to adopt the Guidelines shortly after the date of entry into force of those amended legal texts and is publishing this statement to highlight the key content of the guidance that it intends to provide in the upcoming Guidelines’.*

On existing implementation timetables, the ESMA guidelines will apply three to six months after the final version is published which suggests summer 2024. However, in making this announcement, there is no acknowledgement of the ongoing review of the Sustainable Finance Disclosure Regulation (SFDR) by the European Commission. In December 2022, Commissioner Mairead McGuinness announced:

> *‘a comprehensive assessment of the framework to assess potential shortcomings –on legal certainty, the useability of the regulation and its ability to play its part in focusing tackling greenwashing’.*

The Commission consultation itself took place between 14 September and December 15, 2023. SIFMA AMG’s response to that consultation can be found here. Thus, we now know that the European Union will almost certainly make changes to the SFDR framework in the lifetime of the next Parliament which will necessitate changes in key definitions and information types of the names rule. As Commissioner McGuiness stated when launching the review:

> *‘We want to get a full picture of how the Regulation is working in practice. And we want to make sure that it evolves alongside the growing market for sustainable finance’.*

That process is still ongoing – the Targeted Consultation alone generated well over 300 submissions providing feedback for the Commission to consider.

ESMA’s Fund Names Guidance is anchored to the SFDR, both in terms of the definitions it provides and the information its disclosure mandates require companies to collect and make available. ESMA’s original consultation in 2022 referred to the SFDR 31 times. The December statement, for example, confirms that:

> *‘Following the consultation, ESMA considers it more appropriate that sustainability-related terms in funds’ names should…….invest meaningfully in sustainable investments defined in Article 2(17) SFDR, reflecting the expectation investors may have based on the fund’s name’*.

It is important that ESMA recognizes the potential for those definitions to change – as well as taking time to reflect and clarify what to ‘invest meaningfully’ means in this context.

In addition, the proposed Fund Names Guidance would leverage off SFDR disclosures to measure the proportion of funds invested in projects regarded as sustainable. SFDR also defines Article 6, 8 and 9 Funds SFDR disclosure type. ESMA’s original consultation determined that there were 4,192 Funds using at least one ESG term with which 13 percent were Article 6 SFDR, 13%, 65 percent Article 8 SFDR: and 22 percent Article 9 SFDR.

SIFMA AMG is of the view that regulation of sustainable investments should be tied to concepts that are clear and for which adequate data exists already and is accessible. Those concepts also need to be durable and not subject to continuous change, especially for something like sustainability that requires a long horizon. This mismatch between ESMA forging ahead with new Guidance this year and the European Commission having signaled material change to the foundation of that Guidance has negative implications for European investors, the EU economy, and the transition to a sustainable future.

In addition, for the Guidelines to achieve their objective of addressing greenwashing risks and enhancing regulatory and supervisory convergence, it remains critical that these concepts are clearly deriving from the main SFDR Rulebook – and keep pace with those rules - and aren't left to the discretion of National Competent Authorities, leading again to a diverging approach, e.g. sustainable investments.

ESMA's own Cost-Benefit Analysis of its Names proposal recognizes the costs of complying with new Guidelines.

> *'It is anticipated that fund managers would incur additional cost to comply with these new requirements set out in the Guidelines. In particular, fund managers may have to amend their pre-contractual and periodic disclosure documents and the relevant marketing material in case of changes to the name of their fund or its relevant strategy.'*

But the same Cost Benefit analysis downplays the significance of these costs by basing it on the now redundant assumption that there will be no changes to the foundations of the Guidance (i.e. the SFDR)

> *'However, it is expected that the costs of compliance with the Guidelines may be incurred only on a one-off basis after the application of these Guidelines and only for existing funds'.*

This assumption, that the costs are a one-off, is no longer accurate in the context of the upcoming changes to the SFDR. Asset managers will have to incur costs to comply this year if ESMA goes ahead. But further costs will be incurred on firms and investors when there are changes to the SFDR in the coming years. These costs will fall across a spectrum of market participants. For example, index providers will need to recalibrate their product offerings and shareholders will have to grant new approvals. Some restrictions may also 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.

Moreover, this analysis does not account for the costs that the existing SFDR framework itself also imposes. SFDR disclosures are at present lengthy, complex, and difficult for investors (particularly retail investors) to navigate, overly narrow, rigid and create significant compliance costs for the industry (borne by investors). Furthermore, the lack of clarity surrounding SFDR has forced financial market participants to seek external legal advice, leading to further increase in the costs of implementation. SIFMA AMG requested the European Commission to be mindful of the financial market participants' efforts and costs spent on the implementation of SFDR, in their review of the existing requirements.

We recognize that supervisors need guidance. However, investors and asset managers need clarity and predictability to make sound choices from both a sustainability and economic perspective. With guidance that gets finalized before the SFDR review being rendered redundant within five years, going ahead now risks implementing guidance or its own sake – not because it will be particularly helpful to investors with a medium to long-term horizon or do anything to promote confidence. We believe it would be better to temporarily maintain ESMA's principles-based approach until the SFDR review has been completed.

Specific concerns about the final guidance

In addition to our concerns regarding timing, we would also like highlight aspects of the Guidance which it is paramount ESMA consider further – regardless of when that Guidance is in final firm. These surround both the proposed exclusions and the 80 per cent threshold.

a) Exclusions

In relation to the content of the statement and the anticipated Guidelines we consider it challenging, and less fit for purpose, that a single set of pre-defined exclusions are foreseen for all investment strategies and applying across the portfolio even though a big portion (but not all) of the funds' assets are to be linked to the ESG characteristics or objectives. In particular, the Paris Aligned Benchmark (PAB) exclusions when applied across all assets of funds with sustainability terms in their names would render the universe of assets too strict. While a set of exclusions should be foreseen to apply in the remaining part avoiding contradiction with the ESG characteristics and/or objectives of a fund, we are highly concerned that pre-determining them for all strategies in the same way and even more linking them to the PABs exclusions, will have important countereffects for the appropriateness and proportionality of the rules that will be applicable; whereas we consider that setting the exclusions should be at the level of the fund manager.

ESMA also updated that:

> *For "transition"-related terms, ESMA suggests introducing a new category for which in addition to the 80% threshold, Climate Transition Benchmark (CTB) exclusions should be applied.*

However, the use of CTB exclusions for funds with ESG-related terms will also be costly to investors and the transition to a sustainable economy, specifically:

- In relation to CTB exclusions our interpretation of what ESMA has conveyed is that it would capture companies found, or estimated, to significantly harm one or more of the environmental objectives referred to in Article 9 of Regulation (EU) 2020/852 of the European Parliament and of the Council. If this is the accurate interpretation, we would find such a requirement both highly challenging to implement and potentially leading to additional exclusions not envisaged by existing strategies.
- It is not clear to us whether CTB exclusions will apply to funds with social objectives. If so, we do not consider this appropriate due to the EU taxonomy related exclusions.
- It is not clear to us which exclusions will apply for funds pursuing multiple ESG objectives.

b) Eighty percent threshold

With regards to 80% threshold that ESMA described in its update as the minimum proportion of investments by a fund used to meet the sustainability characteristics or objectives, we request additional detail to ensure effective application of thresholds across different asset classes and to allow portfolio managers sufficient flexibility to act in the best interest of clients/investors:

- Exclusion of cash, derivatives, and other efficient portfolio management instruments from the denominator.
- Waiver of thresholds during Initial period prior to full investment.
- Corrective Period: In the case of a breach of a threshold, an appropriate corrective period should be allowed to address such a temporary/passive breach; the timescale for taking corrective action should also be consistent with existing regulatory obligations, including the “best execution” obligation (such that firms may, for example, prioritise achieving best price, rather than speed of execution).
- Application to Less Concentrated Funds: A lower active risk fund will generally have more investments and may need more flexibility on how to implement a robust ESG/Sustainability strategy while achieving a more diversified portfolio with a low active risk profile; therefore, we believe a considerate approach is needed to accommodate these types of funds.

Conclusion

We would welcome an opportunity to discuss these issues further and to offer a deeper industry perspective on the negative consequences for the EU economy and its sustainability objectives by not properly reflecting on the interaction between the Names Guidance and the SFDR.

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