EU Market Regulator Finds 400% Increase in Use of ESG Language in Fund Names

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On October 2, 2023, the EU markets regulator, the European Securities and Markets Authority (ESMA), **published a study** indicating that the proportion of investment funds in Europe using ESG-related terms in their fund names has grown by 400% over the past ten years.

Funds with ESG-related language in their names have grown to represent 14% of assets under management in the EU in 2023, reaching €974 billion out of a total €6.8 trillion AUM. The use of the terminology gained momentum after the 2015 Paris Agreement was signed and escalated from 2018 to 2022, although the pace of new ESG investment product development slowed in 2023. The report highlights the increasing demand for funds with ESG-related terms in their names, surpassing demand for other funds consistently over the past six years. Global sustainable fund assets have tripled to over €2.1 trillion in the last three years.

The study also notes a preference among fund providers for more generic ESG terms, potentially posing challenges for investors in verifying whether fund investments align with the ESG claims in their names. This trend has implications for both retail and institutional investors. ESMA's natural language processing techniques reveal that funds sold to retail investors are associated with more ESG claims in standardized documents compared to funds sold to institutional investors. ESMA emphasizes the importance of monitoring such communication channels for investor protection.

Taking the Temperature: It is notable that ESMA continues to be highly focused on the use of ESG-related terms in fund names and investor and marketing communications. This is consistent with two of its strategic priorities: (i) strengthening the supervision of EU financial markets, and (ii) enhancing the protection of retail investors. The findings of ESMA's study and the significant increase in the use of ESG language in fund names bring into further focus ESMA's delayed fund names rules. These were initially proposed in November 2022 for a Q3 2023 publication but are still awaited.

As we covered earlier this year, another significant recent issue that highlights the difficulties around ESG fund names, classifications and sustainability descriptions is the controversy around the classification of funds under Article 8 and Article 9 of the EU's Sustainable Finance Disclosure Regulation (SFDR), and the use of the disclosure categories as de facto labels. The resulting mass downgrades by asset managers of funds previously classified as Article 9-compliant – i.e., those that have specific sustainable goals as their objective – to less restrictive Article 8-compliant funds prompted the European Commission to launch a review of the SFDR in September 2023.

One of the primary concerns around the use (and potential misuse) of ESG-related terms in fund names is greenwashing. In February 2023, ESMA announced the launch of a common supervisory action (CSA) to cover the application of MiFID II (Markets in Financial Instruments Directive) disclosure rules to marketing communications for financial products across the EU. One of the objectives of the CSA was to ensure that such communications are fair, clear and not misleading. ESMA, the European Banking Authority, and the European Insurance Occupational Pensions Authority agreed on a common, high-level definition of greenwashing and outlined greenwashing risks, impacts, proposed mitigation efforts and challenges for their respective industries, providing much sought clarity for EU operators. ESMA then issued a public statement outlining its expectations for sustainability-related disclosures to be incorporated into prospectuses. In September this year, it was announced that EU institutions are to vote to ban misleading advertisements and enhance product information provided to consumers. The so-called Green Claims Directive will prohibit companies from making statements such as "carbon neutral" or "environmentally friendly" unless they can substantiate those claims.

ESMA's focus on potentially misleading practices in marketing materials for ESG-linked financial products across the EU is consistent with a global trend and echoes similar initiatives by other financial regulatory authorities. As we previously reported, the SEC adopted amendments to the Investment Company Act of 1940, most notably to the "Names Rule" governing the names of funds to ensure that they do not mislead investors regarding the fund's risks and investment characteristics. The SEC commented that the updates are designed to "address materially deceptive and misleading use of ESG terminology in fund names." In the UK, the Financial Conduct Authority announced its intention to publish rules around the use of ESG terms in investment product sustainability labels and how these can be used.