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EU Financial Markets Regulator Publishes Criteria for ESG and Sustainable Fund Names

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On May 14, 2024, the European Securities and Markets Authority (ESMA) published final guidelines for funds using ESG or sustainable terms in their names (the Guidelines). If competent authorities in each Member State elect to adopt them, in-scope funds will need to be in compliance with the Guidelines within nine months. The Guidelines apply to all alternative investment funds (AIFs) that are managed by EU alternative investment fund managers (AIFMs), and funds that fall within the scope of the **Undertaking for the Collective Investment in Transferable Securities (UCITS) Directive**. The Guidelines include criteria based on the ESG or sustainability-related terms used by AIFMs and UCITS funds, and can be summarized as follows:

Descriptions of key terms

The Guidelines set out descriptions of relevant key terms.

- Transition-related:
    - This includes terms derived from the base word “transition” e.g. “transitioning,” “transitional,” etc. and terms deriving from “improve,” “progress,” “evolution,” “transformation,” “net-zero,” etc.
- Social-related:
    - This includes terms which give the investor any impression of the promotion of social characteristics, e.g. “social,” “equality,” etc.
- Governance-related:
    - This encompasses words which give the investor any impression of a focus on governance, e.g. “governance,” “controversies,” etc.
- Environmental-related:
    - This includes words which give the investor any impression of the promotion of environmental characteristics e.g. “green,” “environmental,” “climate,” etc. Such terms may include abbreviations such as “ESG” and “SRI.”
- Impact related:
    - This encompasses terms derived from the base word “impact,” e.g. “impacting,” “impactful,” etc.

- Sustainability-related:
    - This includes terms only derived from the base word “sustainable,” e.g. “sustainably,” “sustainability,” etc.

Asset allocation

At least 80% of the assets of funds using transition-, social-, governance-, environmental- and impact-related terms must be used to meet the environmental and/or social characteristics or sustainable investment objectives in accordance with the binding elements of its investment strategy.

The same asset-allocation threshold also applies to funds using sustainability-related terms but in addition, these funds must also make a commitment to invest “meaningfully” in “sustainable investments,” as such term is defined in Article 2(17) of the Sustainable Finance Disclosure Regulation (SFDR). ESMA explains that investing “meaningfully” is a requirement that replaced what was an additional threshold of at least 50% of sustainable investments for funds using sustainability-related terms. The latter requirement was removed following feedback from stakeholders, some of whom cited the lack of clarity of the sustainable investment definition provided in the SFDR. **We have previously discussed** the mass downgrades in fund classification that resulted from that uncertainty. However, no further guidance as to the definition of “meaningfully” has been provided. The lack of a clear definition of what it means to commit to “invest meaningfully in sustainable investments” generates a degree of uncertainty and as such, asset managers will need to carefully consider what they take the term to mean.

Exclusionary criteria

For funds using transition-, social- and governance-related terms, investments should not be made in companies that are excluded from Climate Transition Benchmarks (CTB). CTB exclusions refer to companies involved in any activities related to controversial weapons, the cultivation and production of tobacco, or any activities that benchmark administrators hold in violation of the United Nations Global Compact (UNGC) principles or the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

The same CTB exclusions apply to funds using environmental-, impact- or sustainability-related terms, but such funds must also adhere to additional criteria under the Paris Aligned Benchmark (PAB) by excluding companies that derive:

- 1% or more of their revenue from exploration, mining, extraction, distribution or refining of hard coal and lignite;
- 10% or more of their revenue from the exploration, extraction, distribution or refining of oil fuels;
- 50% or more of their revenue from the exploration, extraction, manufacturing or distribution of gaseous fuels; and
- 50% or more of their revenue from electricity generation with a greenhouse gas intensity of more than 100 g CO2 e/kWh.

Further recommendations

The Guidelines include further specific criteria:

- Funds designating an index as a reference benchmark should only use transition-, social- and governance-related terms, environmental- or impact-related terms or sustainability-related term in their name if they fulfil the relevant requirements set out above.
- Funds using "transition-" or "impact"-related terms in their names should also ensure that investments used to meet the relevant threshold are on a clear and measurable path to social or environmental transition or are made with the objective to generate a positive and measurable social or environmental impact alongside a financial return.

Timelines

The Guidelines are due to be translated into all EU languages, and will be published on ESMA's website. Application will commence three months after that publication. Competent authorities will have two months after the Guidelines are published on ESMA's website to notify the regulator whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines. Funds existing before the application date will have six months after that date to comply.

Conclusion

Although it remains to be seen how each Member State implements the Guidelines, fund managers will need to familiarize themselves with them and ensure that any in-scope terms are being used in compliance with the rules. Such a review must be conducted – and any necessary changes implemented – within the next nine months. Non-compliance could potentially lead to greenwashing allegations and therefore carries risk of enforcement and litigation, as well as other consequences such as adverse publicity and reputational damage.

As noted by the U.S. Securities and Exchange Commission when introducing their "names rule" (**which we discussed in detail in a previous edition**), a fund's name "is the first piece of information that investors receive" and signals to investors the types of investments the fund will pursue. It is hoped that the Guidelines published by ESMA will provide clarity, enhance transparency and protect investors from unsubstantiated or exaggerated claims in fund names, increasing confidence and ultimately driving further investment.

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