ESMA: How to name your ESG investment fund

*By Dr. Marcel BARTNIK, Partner and Sebastian DITTRICH, Legal Trainee, Vandenbulke **

"*The beginning of wisdom is to call things by their proper name*", or so Confucius is supposed to have said. The European regulator ESMA acted on this philosophy and, after a lengthy consultation period, recently published its guidelines on names of funds that use ESG or sustainability-related terms.

The first justification of yet another set of rules applying to the world of sustainable finance is the prevention of greenwashing, i.e. promising more in the name than actually is in the content (or portfolio in this case). Another reason is avoiding a fragmented set of national rules on this topic, a risk which already started to materialise when the French regulator AMF published a recommendation on marketing of retail funds that also included naming rules back in 2020.

The present article aims to summarise these new Guidelines, to outline the timing of their applicability but also to highlight some inconsistencies – after all, "*The road to hell is paved with good intentions*", as a proverb attributed to Samuel Johnson states.

Some context: SFDR & Co.

The new Guidelines are part of a larger framework of rules in the investment funds space. The protagonist is the sustainable finance disclosure regulation (SFDR) that introduced, back in 2019, inter alia the distinction between investment funds that have social or environmental characteristics (so-called art. 8 funds) and those that pursue sustainable investments as their objective (art. 9 funds or impact funds). Each of those categories needs to comply with certain disclosure requirements, the details of which were set out – after significant delays – by way of regulatory technical standards (RTS)[1]. Both of these texts required major overhauls of existing fund documentation from investment funds and their managers at the latest at the end of 2022 and again in 2023, in addition to significant investments into reporting workflows.

A recent consultation process[2] about the SFDR as such, as a result of criticism and questions of interoperability with other parts of EU legislation, might end up as another fundamental change of the regulatory rulebook in the near future. As to the RTS, their amendment is also waiting in the wings, with the European Supervisory Authorities having published their proposal to that end a few months ago[3].

This creates a challenging environment of permanent regulatory uncertainty and complexity, which the new Guidelines add to and that will generate further costs, which in the end will be borne by investors.

Their legal basis, by the way, is very recent: It stems from the amended AIFM and UCITS directives that only entered into force on 14 April 2024, and which both provide an explicit mandate to ESMA for the development of such guidelines[4].

Who and what do the Guidelines apply to?

They apply to all investment fund managers such as UCITS management companies and AIFMs, including EuVECAs, EuSEFs, ELTIFs and money market fund managers. Logically they concern all documentation of the relevant funds where their name is typically mentioned, such as the prospectus, issuing document or also any marketing communications. Albeit only a technical detail, the Guidelines do not apply directly as ESMA does not have any direct authority to impose them; they have to be implemented by national supervisory authorities (such as the CSSF by way of a circular).

The details (1): Which types of names are concerned by the Guidelines?

The Guidelines distinguish six different categories of terms that, if they are used in the name of an investment fund, require compliance with certain minimum thresholds in their investment strategy and other rules: These are understandably terms that compose the acronym ESG and therefore relate to (1) environmental, (2) social or (3) governance; but also those relating to (4) sustainability, (5) impact or (6) transition.

Considering the potentially vast possibilities of linguistic variance, no conclusive list of such terms is given but rather examples for illustration purposes: Environmental terms could be words such as "green", "climate" or the acronym "ESG" itself; a term such as "equality" could refer to the social category, or "controversies" to governance. The connection to the "transition" category for some examples that are given appears more tenuous, as words such as "evolution" or "progress" could also appear in a different context.

Surely, all of these should be read in view of the objective of the Guidelines to avoid misrepresentation in the world of sustainable finance, so that investment funds active in different fields should still be able to use them as long as there is sufficient clarity as to what they relate to.

The details (2): Compliance with an 80% threshold

The first consequence of using terms that fall into one of the aforementioned categories is that the relevant investment fund has to meet a threshold: 80% of its investments need to be used to meet environmental or social characteristics, or sustainable investment objectives. The thresholds as such were already required to be disclosed pursuant to the SFDR RTS in the pre-contractual documentation as binding elements of the fund's investment strategy, but so far no specific percentage has been imposed for art. 8 or art. 9 funds.

In addition, funds using terms from the "sustainability" category have to commit to invest "meaningfully" in sustainable investments, without such term having been defined any further. While this does not improve clarity, it appears preferable to the initially discussed 50% minimum threshold of sustainable investments that was finally not included.

If a fund uses terms from more than one category, it has to comply with all requirements for these categories. This rule, however, does not apply to names of the "transition" category.

Index tracking funds can only use words from these categories in their name under the same circumstances, i.e. if the fund as a whole complies with the relevant threshold. That could potentially lead to issues if the fund has to retain a percentage of liquid assets (for example to fulfil redemption requests) and the proportion of the compliant part of the benchmarked portfolio is not high enough to allow the entire fund to reach the 80% threshold.

The new rules can lead to surprising results: A fund that invests 75% into assets with environmental characteristics cannot use a name that describes its strategy with any environmental terminology; however, it can still be classified as an art. 8 fund pursuant to the SFDR. In particular funds that are more conservative with the percentages they disclose, for example due to data shortage in target countries or lack of availability of suitable targets, can now only use names without such ESG terminology, which is certainly counterproductive to any fundraising efforts – and could be qualified as misleading in turn (green hushing). Also, you can combine a transition term in the name with environmental terminology, but the relevant fund would not be obliged to have any kind of investments with environmental characteristics – not really a consistent result of the new rules.

More details (3): Exclusions or companies a fund is not allowed to invest into

The second main set of rules concerns certain types of companies that funds using ESG or sustainability terminology in their names cannot invest into. For this purpose, the Guidelines refer to a EU Regulation that defines how certain climate-mitigation equity benchmarks should be composed[5] and in which certain such exclusions can be found. This regulatory copy and paste exercise results in only few exclusions that apply to the categories "transition", "social" and "governance", mainly no companies involved in controversial weapons and tobacco. Only the categories "environmental", "sustainability" and "impact" are subject to further exclusions (mainly fossil fuels related).

While the reference to the benchmark regulation may be appropriate for funds investing into listed equity, it makes less sense for a multitude of other strategies employed particularly in the alternative sector (real estate or private credit for example). It is also not clear why an investment fund that aims at having a social impact needs to comply with largely environmentally driven exclusions.

Timing: from when is compliance mandatory?

The next step will be for the Guidelines to be translated into all EU languages. After the publication of such translations, the national regulators will have three months to decide whether they intend to implement these (which should be a given). If they do, the Guidelines apply after such three months period immediately for new investment funds. Existing funds have a further six months to comply. Unfortunately, no exemption is provided for such funds that are no longer raising capital and where changing the fund documentation makes little sense.

To-Do

Initiators and managers of investment funds should verify whether the names (to be) chosen for their products comply with the Guidelines. If they do not, the choice will be to either amend the investment strategy or the name of the fund – knowing that the latter could result in a significant obstacle to its future marketability.

* https://www.vdblaw.com/

1) Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022.
2) A summary report on the results of the consultation was published on 22 December 2023.
3) Final Report on Draft Regulatory Technical Standards of 4 December 2023.
4) Art. 23 (7) of the AIFM Directive and Art. 69 (6) of the UCITS Directive, each as amended.
5) Commission Delegated Regulation (EU) 2020/1818 of 17 July 2020 supplementing Regulation (EU) 2016/1011 on standards for EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks.