International
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Association

ICMA

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Response to the ESMA's Guidelines on funds' names using ESG or sustainability-related terms

The International Capital Market Association (ICMA) welcomes the opportunity to provide feedback on the ESMA's consultation on Guidelines on funds' names using ESG or sustainability-related terms.

ICMA is a membership association, headquartered in Switzerland, committed to serving the needs of its wide range of members. These include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms and others worldwide. ICMA currently has over 620 members located in 66 jurisdictions. See www.icmagroup.org.

This feedback is given on behalf of ICMA and its constituencies, and especially the Asset Management & Investors Council (AMIC).

Yours faithfully,

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ICMA response to ESMA's Guidelines on funds' names using ESG or sustainability-related terms

ICMA welcomes the opportunity to provide feedback on ESMA's proposed "Guidelines for the use of ESG or sustainability-related terms in funds' names". We are supportive of efforts to bring more clarity to the sustainable investment landscape, and we believe that clarity in fund naming can be an important enhancement to the existing Sustainable Finance Disclosure Regulation (SFDR).

In order to tackle the issue of greenwashing and enable investors to better navigate the landscape of products offered to them, we consider it vital to differentiate between three main types of fund labels based on the sustainability objective they are seeking to achieve which should then also be reflected in the fund names:

1. Funds that focus on "ESG integration", i.e., the consideration of ESG risks, opportunities and impacts that may be material to the future financial performance of a company or funds that employ strategies such as "exclusion/negative screening" or basic "ESG tilts"
2. Funds that contain companies or financial instruments that are sustainable as measured by their effect on the environment and society
3. Funds that contribute to a measurable improvement such as financing the transition to net-zero.

With ESMA having added ESG disclosure to supervision in October 2022, it would be helpful to better understand how supervision will be conducted on fund naming.

Greenwashing and Fund Labelling

We understand that one of ESMA's main priorities as listed in its Sustainable Finance Roadmap 2022-2024, is to tackle greenwashing. This is in line with the wider EU aim to address greenwashing in the financial market as specified in its "Strategy for financing the transition to a sustainable economy".

The absence of an agreed definition of "greenwashing" is an impediment to combatting it. In its response to the European Supervisory Agencies'(ESA) Call for Evidence on greenwashing, ICMA proposed the following definition: "*For financial regulatory purposes, greenwashing is a misrepresentation of the sustainability characteristics of a financial product and/or of the sustainable commitments and/or achievements of an issuer that is either intentional or due to gross negligence*." We also identified for fund products three categories of greenwashing concerns including "unclear or misleading fund labelling and naming".

The biggest challenge that retail investors face when it comes to ESG funds, is that they often do not fully understand and, as a result, can misinterpret a label or name which may primarily refer to "ESG integration" (as explained above), rather than the (real economy/real world) impact that the company is having on the environment and wider society. This is not immediately obvious to non-professional investors, but also does not imply any intentional greenwashing by the fund manager.

Both professional and non-professional investors can be confused by the lack of official fund labels that set out minimum requirements, or the emergence of quasi labels under SFDR. The Sustainable Finance Disclosure Regulation (SFDR 2019/2088) which is part of the EU's Sustainability Disclosure Regime, has as its objective to strengthen protection of end-investors and improve disclosures to them. However, financial market participants from the beginning have interpreted SFDR as a potential labelling tool and started to market their funds as Article 6, 8 or 9 funds with the latter seen as the most ambitious. The gradual clarification of definitions through Q&As published by EU regulators so far led to substantial reclassifications between these Article 6, 8 or 9 based funds.

As a result, rather than making it easier to compare different financial products and create a level playing field, the current lack of clarity around SFDR has thus arguably contributed to confusion and accusations of greenwashing. In the absence of further clarification and precision on SFDR terminology (or even a potential revision of Level 1 which is likely impractical in the near term), we therefore think that regulatory guidance, such as the proposed Guidelines could help address this situation. We have several comments on various elements of the proposal.

Main elements of the proposed Guidelines

Use of ESG terminology

We are generally supportive of ESMA's objective to provide guidance to investment funds with respect to the use of clear terminology. Investment funds should be marketed as ESG or sustainable or any related term only if they can substantiate such a claim. We agree that the use of ESG- and sustainability-related terminology in fund names should be used only when supported in a material way by evidence of sustainability characteristics, or objectives that are reflected fairly and consistently in the fund's investment objectives and policy as well as its strategy as described in the relevant fund documentation. We also agree that fund names play a crucial role in an investor's (and more specifically a retail investor's) understanding of the product's features, and therefore that appropriate naming Guidelines can add value from an investor protection perspective.

Thresholds

We generally support the introduction of quantitative thresholds, but we underline the many practical challenges for their conception and implementation, as well as possible alternatives. Such terminology can clarify what is acceptable on funds names and ensures a level playing field as well as comparability among funds.

When designing thresholds, the guiding principle should be that the approach chosen should be in line with investors' expectations. It should be simple and transparent to understand and not add additional complexity to the EU's (already complex) sustainable finance regime. This also means that the percentages must be set at an appropriate level, and what they represent has to be clear, in order to ensure they are manageable in practice as well as non-ambiguous.

That said, the use of thresholds raises questions in respect of their calculations and their application to different types of underlying assets. While some asset managers agree that ESMA's approach (tied to the SFDR pre-contractual disclosure asset allocation template) would allow the quantitative threshold of 80% to apply at the level of the whole investment strategy others consider it either too high altogether or in the case of less traditional asset classes like, for example, real estate or CLOs. There is also the view that the 80% threshold should be calculated on the non-cash assets of the portfolio and that there needs to be a clear distinction between how this calculation is applied to funds that set key performance indicators (KPIs) at an asset level versus funds that set KPIs at a portfolio level.

We broadly support the idea of a more stringent threshold for funds having a sustainability-related label but there is more scepticism among asset managers about setting a threshold for sustainable investments (SI). While the term "sustainable investment" exists as a legal definition under SFDR Art. 2 (17), we are aware that questions by the ESAs to the Commission about the practical meaning of sustainable investment sent in Sept 2022 are still outstanding and a clarification of the definition cannot be expected in time for our response to be submitted. Relatedly, the proposed 50% SI threshold is extremely difficult to attain as only a very low number of investments currently meet the SFDR definition.

Another view is therefore that it might be premature to set numerical thresholds, until sustainable investments have been better defined, including their calculation methods. Furthermore, asset classes are not aligned in SI calculation and therefore equity funds will appear greener than balanced or bond funds which can as a consequence raise the risk to retail investors, as only equity funds will be seen as sustainable enough because of the current regulation.

We therefore think that a more flexible approach to the thresholds could be an alternative solution. Sustainability is not static. ESG data (especially with the forthcoming adoption of CSRD in the EU) and companies' sustainability will increase over time in both quantity and quality. As such, there is merit in imposing lower thresholds initially and increasing the thresholds over time.

Minimum Safeguards (Exclusions)

We are generally supportive of introducing the concept of minimum safeguards in the form of exclusions although in a calibrated and differentiated manner. We do not see the exclusions for EU Paris-aligned Benchmarks (PAB) listed under Article 12 (1) and 12 (2) of the Benchmark Regulation, as a suitable proxy. Applying PAB exclusions to all funds that have ESG or sustainability in their name is too stringent. It would reduce the investible universe to the detriment of funds otherwise able to meet the environmental or social characteristics or sustainable investment objectives as well as to financial returns.

Instead, we would suggest for example adopting the EU Climate Transition Benchmark (CTB) exclusions set out in Article 12(1), points (a) (controversial weapons), (b) (tobacco) and (c) (UN OECD Guidelines) of the EU Benchmark Delegated Regulation. In particular, this should apply for: i) funds using ESG terms in their names; and ii) funds using the terms impact or transition in their names. Also, by definition, impact or transition funds (mentioned further below) will, intentionally, include investments that, currently, will not meet the PAB fossil fuel exclusions or may not meet the 'do no significant harm requirements' of the Taxonomy Regulation's environmental objectives.

Another option could be to apply the UN's Global Compact Principles, International Labor Organization's (ILO) Conventions, OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs) corresponding to the way asset managers address good governance – as defined in SFDR.

Impact Funds

Impact funds are one of the fastest growing products in the funds industry, so they should be covered under the proposed guidelines. **We agree that funds using the word "impact" or "impact investing" or any other impact-related term in their name may need to meet thresholds as well, but only for environmental or social characteristics**. Imposing the sustainable investment threshold seems indeed mostly contrary to what impact funds seek to achieve which is real-world change i.e., to improve sustainability, not to invest in already sustainable investments as defined under SFDR (although Article 2 (17) mentions "…or on its impact on biodiversity and the circular economy…" but again more clarity is required).

For funds investing in sustainable bonds, impact reporting could be used as a criterion to establish the intention to generate positive and measurable impact. Funds invested in sustainable bonds aligned with the ICMA Principles contain impact reporting based on guidance from the Harmonized Frameworks for Impact Reporting.

More generally, we think the label could use the definition of impact investing by the Global Impact Investing Network (GIIN). In addition to being globally recognized, we would like to highlight that the GIIN definition does not include additionality which is an important criterion for investing in a large portion of the sustainable bond market.

Other feedback

Transition

Investment interest in the transition to a low carbon economy varies from strategies that seek to capture investment opportunities from anticipated technological changes to specific investments that can potentially help accelerate the energy transition in certain sectors or areas. **Given this context, we would argue against introducing specific provisions that might have the unintended effect of limiting the diversity of approaches to transition investing that are developing.** We believe that a well-designed naming rule should be able to accommodate the range of developing transition-related products and strategies. Fund managers should be encouraged to use accurate and appropriate terminology in the "transition" products they develop and should be able to detail how the assets substantiate the overall portfolio outcome of the product.

Market participants including investors understand that in order to reach the goals of the Paris Agreement certain sectors and companies need to transition. Transition already plays an important part in the EU's renewed strategy and is included in its name: "Strategy for financing the transition to a sustainable economy". **However, to be able to (re)-orient capital flows to companies that need to transition, investors need to understand which funds are including such investments.** This should therefore also be made explicit through the fund name.

Recognising transition related terminology for the naming of funds with related investment strategies would be very beneficial given the very significant transformative sustainability improvements such investments can deliver. The EU can look to ongoing developments in other jurisdictions such as the UK FCA's proposed SDR 'Improvers' label.

A key aspect to transition funds is the role that stewardship and engagement play to increase investee companies' commitments to environmental and social outcomes. **ESMA should acknowledge that transition strategies take time to come to fruition and, accordingly, the minimum time for demonstrating improvements of transition funds should be at least 3 years** (and longer at the discretion of the investment manager). As criteria and thresholds will be more difficult to establish, they should also be related to, for example, transition plans which are a requirement in various reporting standards and frameworks such as CSRD, ISSB, TCFD etc.

Similarly, to impact funds, we think only the environmental or social characteristics threshold is appropriate and should be applied. In our view it defeats the objective to apply a sustainable investment threshold to transition funds. Moreover, as mentioned above, using the PAB exclusions as minimum safeguards for transition funds might be too strict as using these criteria (e.g. Article 12 f)) could affect access to the capital markets for energy companies as well as utilities, which have been among the biggest issuers of transition themed sustainable bonds.

Harmonization

While it would be most helpful to achieve global harmonization on fund labelling or even guidelines for fund names, at a minimum, fragmentation in the EU should be avoided. To that end, we think that ESMA's provisions should supersede any existing or potential local rules on ESG or sustainability-related fund names, which prevent the actual smooth functioning of the Single Market for investment funds and their passporting (e.g. existing local rules in France, or potential ones in Belgium and Germany).

In terms of global compatibility, other jurisdictions' regimes such as the proposed SEC ESG Names Rule and the UK FCA's Sustainable Disclosure Regime (SDR) thresholds operate by reference to characteristics similar to the EU's environmental or social characteristics and not with reference to sustainable investments.