EFAMA
European Fund and Asset Management Association

CONSULTATION RESPONSE

Brussels, 20 February 2023

EFAMA's RESPONSE TO ESMA's "CONSULTATION PAPER ON GUIDELINES ON FUNDS' NAMES USING ESG OR SUSTAINABILITY-RELATED TERMS"

INTRODUCTION

Please make your introductory comments below, if any:

EFAMA welcomes ESMA's consultation paper on guidelines on funds' names using ESG or sustainability-related terms (hereinafter "Guidelines"). We support the overarching objective to promote transparency and tackle the risk of greenwashing by ensuring that investors are protected against unsubstantiated or exaggerated sustainability claims.

These ESMA discussions are not taking place in a vacuum, as the nascent sustainable finance landscape evolves on a daily basis. While we appreciate ESMA's efforts to provide clarity, it is clear that the criteria to assess names of funds (including ESG or sustainability-related terms) goes beyond the current SFDR requirements. If additional rules and criteria are indeed needed, it should be up to the co-legislators' discretion and not be part of ESMA Guidelines.

If ESMA wants to proceed with these Guidelines, it should learn from previous challenges to ESG-related regulatory requirements. This would require ESMA to i) **delay** the Guidelines until there is **more clarity on the definition of "sustainable investment**" and until ESMA and the European Commission have worked together to **resolve interoperability issues** between the Guidelines and SFDR, MiFID/IDD, and other regulatory developments; or ii) consider either revising the Guidelines as per alternative proposals.

More specifically, rather than imposing a threshold, we believe that it will be **more proportionate** to require that funds that use 'sustainable' or any other related term should **reflect sustainability in their investment objectives.** We believe there might also be a merit for the guidelines to mirror ESMA's supervisory guidance on sustainability risks and disclosures in the area of investment management in ensuring that ESG-related terms should only be used when **supported in a material way** by evidence of sustainability characteristics, themes, or objectives that are reflected fairly and consistently in the fund's investment objectives and policy and its strategy as described in the relevant fund documentation as already required under SFDR.

If thresholds are decided to be set at 80%, we would suggest clarifying that cash, cash equivalents, and derivatives used for hedging or efficient portfolio management should be excluded from the ratio calculation. Alternatively, if ESMA wants to include cash and derivatives in the ratio calculation, we believe that the threshold should be at least lowered to allow fund managers to manage efficiently a fund, especially during extraordinary market circumstances.

In addition, we question the appropriateness of the **separate threshold of 50%** due to the lack of clarity as to what exactly qualifies as a sustainable investment under SFDR for which we are fully dependent on the definition and guidance to be provided by the European Commission. Setting a quantitative threshold without a clear underlying definition and no level playing field across product types will lead to **increased investor confusion instead of addressing the current greenwashing concerns.**

QUESTIONS AND ANSWERS

Question 1: Do you agree with the need to introduce quantitative thresholds to assess funds' names?

EFAMA supports the overall objective to set common rules that will enhance clarity, avoid misleading information, and therefore, enhance trust in the market. This is especially necessary for the fast-evolving ESG market space, where investor demand for investment funds incorporating ESG factors has been growing sharply, with no slowdown expected in the coming years.

To this extent, we agree that funds' names in fund documents or marketing communications should not be misleading. The disclosure of ESG or sustainability-related characteristics should correspond to the overall fund's characteristics.

We doubt whether investors base their investment decisions solely on funds' names. As such, we question whether the proposed threshold approach is the appropriate way to meet the regulatory objectives of avoiding greenwashing while enhancing clarity. Below we have set out several reasons why such an approach may not lead to the intended outcome.

I. Interoperability between the Guidelines, SFDR, MiFID, and other regulatory developments

SFDR

Although the alignment of funds' names with their underlying investment strategies is crucial, this issue cannot be viewed or solved in isolation. A situation must be avoided where a fund meets the SFDR Article 8 and 9 criteria but cannot use "ESG" and/or "sustainable" in its name, as the ESMA thresholds are not met. This will only risk further investor confusion. Such an outcome can only be avoided by aligning the Guidelines with SFDR, ensuring they complement each other, rather than introducing conflicting rules that could undermine the credibility of the overall regime in the eyes of investors.

Aligning the investment process

A threshold mechanism, as currently suggested by ESMA, focuses only on outcomes and holdings, leaving aside how these are generated and what the underlying process is that leads to them. It is, therefore, **crucial to align the final Guidelines with SFDR's focus on the investment processes**, rather than the outcomes and holdings.

For any criteria to effectively address greenwashing and allow a comprehensive view as to why an ESG claim is made in a fund's name, it needs to be inherently linked to the fund's investment process and the binding elements (i.e. clear binding Key Performance Indicators, KPIs) in relation to the fund's ESG strategy. This will provide both clarity and certainty to the appropriateness of an ESG claim and enhance the comparability between different products. It is the underlying process that allows specific holdings and justifies claims rather than a direct claim on holdings. Thereby, we consider it key for any fund naming rule to be linked to transparency with regard to the investment process and the ESG binding elements as reflected fairly and consistently in the fund's investment objectives and policy and its strategy as described in the relevant fund documentation.

Aligning timing

SFDR contains many unresolved issues with the way forward still being evaluated. In particular, there is a lack of clarity in the market with regard to what exactly qualifies as a **sustainable investment under SFDR** and it is clear that approaches vary significantly. Given that we are still waiting for the European Commission to respond to the ESAs (regarding the operationalisation of the definition of sustainable investments under SFDR), we believe now is **not the right time** to impose any parameters regarding the use of "sustainable" in a fund's name as it pre-empts the European Commission's upcoming response. Setting a quantitative threshold where the underlying definition is unclear and there is **no level playing field across products will not address concerns around greenwashing**. We believe it would be more beneficial to set numerical thresholds once sustainable investments have been better defined, including their calculation methods (and not the other way around).

At the very least, these Guidelines should be delayed until further regulatory guidance is issued and the fundamental interpretation issues are resolved (in particular when one of the thresholds' cornerstones is, as mentioned before, a concept that is still pending clarification). Temporary solutions not aligned with potential changes to SFDR are not only time and resource-consuming, but also entail great reputational risks and undue wariness towards the fund managers.

Avoiding unharmonized supervision by NCAs

In addition, national competent authorities (NCAs) are already diverging in their supervision approaches of fund's names in response to ESMA's recent supervisory briefing on sustainability risks and disclosures in the area of investment management. In this regard, we highlight the importance of a coherent approach by ESMA to ensure that NCAs do not provide more detailed guidance leading to unharmonized supervision (e.g. existing local rules in France, Germany, or potential rules in Belgium). Such unharmonized supervision eventually leads to an ineffective market with additional costs borne by the end clients.

Besides the final ESMA guidelines requiring alignment with SDFR, in an ideal world they should also not conflict with international requirements (e.g. UK Sustainability Disclosure Requirements (SDR) and other international investment labels). In our view, it is important that ESMA's final guidelines do not limit nor impede the cross-border distribution of EU funds outside the EU and do not affect the competitiveness of the EU fund industry.

MiFID Delegated Regulation and Directive

MiFID/IDD requirements of "sustainability preferences" add another layer of regulation and create further complexity, thus leading to further investor confusion. As such, i) clients indicating sustainability preferences under MiFID/IDD may be recommended a product that considers Principal Adverse Impacts (PAIs) to meet sustainability preferences, even though this product may not be labelled as "sustainable" under the Guidelines; or ii) clients indicating sustainability preferences under MiFID may be recommended a product that considers EU Taxonomy alignment to meet sustainability preferences, even though this product may not be labelled as "sustainable" or " ESG" under the Guidelines because it does not meet the 50% threshold for sustainable investments.

We are concerned that this lack of interoperability will be misleading for investors wanting to invest sustainably in Europe and make it very challenging for asset managers, distributors, and advisors to clearly explain products with sustainability features to investors.

We, therefore, strongly urge ESMA to **delay the Guidelines until ESMA and the European Commission can resolve the apparent interoperability issues between MiFID, SFDR, and proposed the Guidelines.**

Other regulatory developments

A **reform of the SFDR** is expected, which may consider binding requirements for product design and fund naming. This includes, among others, the ongoing Sustainable Finance Strategy plans to set out **minimum criteria for Article 8 funds** (as indicated in ESMA's roadmap); the initiated work on "**ESG benchmark" rules** whereby a benchmark could qualify as "ESG" and the ESAs' proposed **amendments to the SFDR RTS** scheduled to be published by October 2023 (at the earliest). All these future developments will likely require substantial changes to a fund's investment strategy, its fund name and fund documentation.

Moreover, the issue of the naming of funds is also being discussed in the ongoing **review of the AIFM Directive (AIFMD II) and the UCITS Directive.** The current European Parliament (as of January 2023) could serve as a gateway for sustainable fund naming if criteria for misleading names are developed. It must therefore be ensured that ESMA consultation takes into consideration the outcome of the upcoming trilogue negotiations.

From this perspective, ESMA's proposed guidelines front-run these developments and create an excessive burden, confusion, and uncertainty for both the management companies and (retail) investors.

II. Lack of clarity

Different thresholds for "ESG" and "sustainability" related terms

We think that using two distinct requirements for "ESG" and "sustainable" may cause further confusion among retail investors. Moreover, as retail investors cannot make a distinction between terms such as "sustainable" and "ESG", there is no reason to treat them differently. Other jurisdictions, like the UK or the USA, do not consider the use of "sustainable" in a different manner. This is not the case for the term "impact" which is perceived differently by investors contrarily to ESG/sustainability terminology.

"ESG/sustainability/impact" related names

There is no clear delineation between ESG/Sustainability/Impact related terms, which will lead to unintended consequences by not leaving room for contextualization. For example:

I. The term "responsible" is widely used but it remains unclear whether it would be deemed to be ESG-related.

II. The term "solutions" could arguably be considered both ESG and impact related

III. The term "SDG" could be argued whether it is to be considered as an impact-related term or sustainability-related word given the "S".

Threshold calculation

In addition to the overarching issue of thresholds being an inappropriate criterion for funds' names, the proposed Guidelines also lack **clarity on the threshold calculation methodology** (numerator, denominator). As already mentioned above, the level of the SI proportion threshold (50%) cannot be set "in abstracto" in the absence of a common definition of a SI. It should be aligned with the real economy stance, and relative to a single common definition. The same applies to the 80% threshold for an ESG-related name, which is also dependent on a clear definition and calculation methodology of such threshold.

In addition, the thresholds could prove challenging for **index-tracking funds** that are reliant on benchmark providers, which are out of the scope of these rules.

III. Level playing field

Last but not least, these guidelines raise **very important concerns about the equal treatment of all types of EU investment products.** Naming guidelines should not apply solely to funds but to all financial products and instruments which use ESG/sustainable/impact-related terms in their name. They should also apply to indexes so that fund managers (or other users) can align the name of the retail financial products referencing the index.

We, therefore, urge ESMA to liaise with EBA and EIOPA and to extend its guidelines to benchmark administrators (currently subject to BMR).

Should ESMA insist on pursuing these guidelines on funds' names, we use the subsequent answers to highlight some unintended consequences for certain asset classes and investment strategies and provide some alternative approaches.

Question 2: Do you agree with the proposed threshold of 80% of the minimum proportion of investments for the use of any ESG-, or impact-related words in the name of a fund? If not, please explain why and provide an alternative proposal.

Preliminary remark

As a preliminary remark, we would like to emphasize the following two concepts:

I. We have substantial reservations against a pre-set threshold of holdings justifying ESG claims in a fund's name regardless of the investment process and how these outcomes are generated. An ESG claim in a product's name should be held accountable based on the way the underlying investments are set and how these result in given outcomes. This approach seems absent from ESMA's currently suggested criteria. In any case, transparency around the investment process is the main counter stone to ensure substantiated marketing and naming practices.

II. Any new requirement needs to ensure that it is based on clear definitions and that any data necessary to comply is readily available. Requirements should cater to the wide range of approaches, asset classes, and geographies that may be included in ESG portfolios and should not discriminate against certain approaches by imposing additional constraints. The rules should also be well adapted for asset classes and geographies where data availability is problematic, namely private assets, sovereigns, high yield, and emerging markets. As already mentioned previously, there should also be a level playing field between all product types.

For this, a majority of our members do not believe that the threshold mechanism is the appropriate way forward. Instead, a clear requirement should apply for funds with ESG-related terms in their names to substantiate them via a clear demonstration of the underlying investment process and the investment binding elements.

However, we would also like to acknowledge that some members agree with the 80% threshold on the premise that the rules are appropriately calibrated to ensure that they do not discriminate against certain types of products and investment styles. Therefore, the application of this principle warrants further work, as set out below.

Appropriateness of 80% threshold

If ESMA decides to continue with the threshold mechanism, we would question the appropriateness of the 80% threshold and would like to better understand what underlying evidence ESMA has used to justify this particular numerical threshold. While we agree that a threshold for ESG terms must be sufficiently high, the proposed threshold of 80% may result in practical hurdles that cannot be easily overcome.

An 80% threshold would lead to unintended outcomes, such as putting aside some strategies, asset classes, or geographical areas while they could contribute to enhancing the ESG/sustainability features of the fund and most importantly finance the transition of a more sustainable economy. This will lead to further confusion in the products with sustainability preferences being offered to investors.

Furthermore, it would be extremely burdensome to maintain the bar at 80% or remaining assets, given that it would be challenging to apply for cash/cash equivalents, as well as sovereign debt and derivatives (at least at this level). For example, in France UCITS funds can hold up to 20% of cash (maximum ancillary cash a UCITS funds may have in France). Consequently, this means that the 80% threshold for ESG characteristics is already not attainable. Please refer to our response to question 4 wherein we highlight which assets are to be excluded from the calculation.

Alternative proposal

Therefore, **if thresholds were to be set at 80%,** we would suggest clarifying that cash, cash equivalents, and derivatives used for hedging or efficient portfolio management should be excluded from the ratio calculation (see our answer to question 7 for more details on the treatment of derivatives). We, therefore, propose the following:

- **The denominator** would be the exposure without cash and hedging/EPM (e.g FX or market risk hedging).

- **The numerator** would be the **exposure that contributes to meeting the ESG characteristics of the fund**. For instance, depending on the ESG objective/strategy, this could mean all assets and underlyings that are subject to the binding elements of the strategy.

Alternatively, if ESMA wants to include cash and derivatives in the ratio, we believe that the threshold should be lowered to at least 70%. Fund managers need certain flexibility to have cash and to use derivatives, otherwise, it will be impossible to efficiently manage a fund, especially during extraordinary market circumstances which call for such flexibility in order to protect the investors' interests (i.e. additional collateral movement, etc). Only, as the market matures and data challenges are alleviated, ESMA can, in a later stage, look into increasing the threshold of 70% threshold.

Other observations

Fully invested funds

During the Q&A session at the open hearing, ESMA suggested that if a private fund was not going to reach the 80% threshold until it was fully invested, then the name would be misleading (particularly for retail investors) until it reached the threshold. We have set out the following reasons why we fundamentally disagree with this line of argumentation:

- A private fund inherently takes time to deploy its capital and achieve its targeted investment allocation and diversification goals. Any investor – retail or institutional – knows and understands this fundamental principle from reading the fund.

- ESMA suggests that such funds should first adopt a neutral name to only include sustainability-related terms once the 80% threshold has been reached. However, at this point, there is little commercial reason to initiate a name change. No fund manager will make such superfluous and costly efforts for a fund that is no longer being marketed.

- The problem is even more profound, as ESMA seems to imply that a fund with sustainability-related terms in its name should meet the 80% threshold from the outset, i.e. as of its first investment. That is completely unrealistic: often, the manager cannot choose which investment opportunity presents itself first. Thus, any restrictions here could cause the fund to miss out on attractive investment opportunities.

We believe the quantitative thresholds should only kick in from the time the fund is fully invested, like any other diversification requirements. At the very least, there should be a ramp-up period during which the manager has the time to build the portfolio. If necessary, (retail) investors can be informed through a prominent statement in the fund document or the RTS templates that the targeted allocation will only apply as of that point in time, when the portfolio has been fully deployed.

Discrimination against certain types of products and investment styles

In addition, we would like to ensure that the rules do not discriminate against certain types of products and investment styles and therefore the application of this principle warrants further work.

Need for a guidance or non-exhaustive list of "ESG-related" terms

We also have problems understanding the terms "ESG-related". By default, "ESG-related" alludes to any environmental and/or social and/or governance theme in the name other than "sustainable" or "impact".

We understand that ESMA hesitates to publish a definitive list that may foster regulatory arbitrage. However, we would suggest at least **some level of guidance and a clear delineation** between the terms widely used today. This would provide fund managers with the clarity needed to accurately implement ESMA requirements. For example, guidance on whether certain themes like education, nutrition, or energy should be entirely seen as sustainable- or ESG-related, i.e. how should we consider names like "Edutainment" or "Energy evolution"?

Some members have also suggested **a list** of ESG/Sustainability/Impact-related terms that is **non-exhaustive** and can be updated whenever required. This would avoid discrepancies between NCAs' interpretations and allow a level playing field for cross-border distribution throughout the EU.

In addition, we believe it is important that ESMA clarifies whether the **terminology can be used in other materials**, in particular, marketing materials in case a product does not meet the thresholds. If the prohibition extends to other types of materials, the industry might not be able to accurately describe products to investors, proving very counterintuitive.

Q3. Do you agree to include an additional threshold of at least 50% of minimum proportion of sustainable investments for the use of the word "sustainable" or any other sustainability-related term in the name of the fund? If not, please explain why and provide an alternative proposal.

Preliminary remark

We would first question whether there is a need to differentiate "sustainable" and "ESG"-related terminology (i.e. Is an ESG strategy meant to be "sustainable"?).

Such an approach creates a disconnect with the MiFID sustainability preferences by discriminating against the other permissible approaches, such as the EU Taxonomy and PAIs.

Moreover, it is questionable whether a retail investor could differentiate between phrases such as "sustainable", "ESG" or "green". One could argue that "sustainable" does not necessarily give the impression to be more qualifying than "ESG".

Appropriateness of 50% threshold

In case ESMA decided to continue with the thresholds, we do not agree with the additional proposed threshold of at least 50% for the reasons set out below.

(i) Lack of clarity/convergence

Not only do we **question the separate threshold** for a fund that has "sustainable" or any other term derived from that word in its name but there is a **lack of clarity** as to what exactly qualifies as a **sustainable investment under SFDR**. It is abundantly clear that approaches vary significantly. Given that we are still waiting for the European Commission's response on the operationalisation of the definition of sustainable investments under SFDR, now is not the right time to impose any conditions regarding the use of "sustainable" related terms in a fund name in connect with a minimum percentage of sustainable investments, as it would pre-empt the upcoming clarification. **Setting a quantitative threshold without a clear underlying definition and no level playing field across product types will further confuse investors instead of addressing the current greenwashing concerns.**

Last but not least, the 50% SI portion might deviate from the method used by the industry regarding the Article 8 / 9 disclosure rules, leading to an additional mismatch between naming and classification.

(ii) Arbitrary absolute threshold

As a result of the uncertainty regarding how to define sustainable investments, it is hard to say whether 50% threshold is the right one. Based on preliminary evidence from SFDR disclosures, the market standard that seems to be emerging for Article 8 products that commit to sustainable investments is within 20% level, with over 35% of Article 8 products committing within 10% level (according to the latest Morningstar figures[1]).

Again, the ultimate threshold is fully dependent on the definition and guidance to be provided by the European Commission. Once defined, it should reflect current market realities. For example, one of our members surveyed its SDG-aligned revenue database, screening for any company having more than 50% of revenues contributing to any of the SDGs. It found that only 137 stocks out of the entire universe of MSCI ACWI have 50% aligned revenues or less than 5% of the entire index. Should the European Commission thus decide that funds must employ a narrow definition using pro-rated revenues for activities contributing to an environmental or social goal, it will become very challenging to meet a 50% threshold, potentially leading to significant concentration risk in a small number of eligible investments.

Additionally, an absolute threshold can **favour certain asset classes**, creating an uneven level playing field. As such, a separate threshold for the use of the word "sustainable" or any other term derived from it will be **more problematic** for funds that invest in **sovereign bonds**, especially since there is currently no clear common understanding across NCAs about whether/how they can be considered as "sustainable". This could also lead to unintended consequences, leading to a preference for corporate over sovereign holdings. At the same time, this can have the unfortunate side effect that funds with high bond exposure cannot use the word "sustainable". Therefore, risk-averse investors with a high preference for sustainable investments investing in sustainable products through execution-only channels may end up having a stronger equity exposure than otherwise would, thereby shouldering a higher financial risk.

Alternative proposal

Rather than imposing a threshold, it will be more proportionate to require that funds that use "sustainable" or any other related term should reflect sustainability in their investment objectives. This is consistent with IOSCO's Good Sustainable Finance Practices regarding naming. If this is not sufficient, we believe there is merit for the guidelines to mirror ESMA's supervisory guidance on sustainability risks and disclosures in the area of investment management which states that (in order to avoid confusion with investors) the use of the term "sustainable" or "sustainability" should be used only by (1) funds disclosing under Article 9 SFDR, (2) funds disclosing under Article 8 SFDR which in part invest in economic activities that contribute to environmental or social objectives and (3) funds disclosing under Article 5 TR. In addition, index-tracking funds should be allowed to use the same ESG-related terms of the designated index. They should be exempted from using quantitative thresholds at this stage. We consider this to be a temporary solution pending work to align BMR and SFDR.

This approach is consistent with two of the elements of **MiFID II sustainability preferences** which do not prescribe a minimum threshold in relation to commitment to sustainable investments, including taxonomy alignment. To ensure coherence with sustainability preferences, qualitative and/or quantitative consideration of PAIs could also be added.

As per supervisory guidance, ESG-related terms should only be used when supported in **a material way by providing sufficient evidence.** Instead of using holdings as evidence we prefer to demonstrate, as already required under SFDR, in a clear and measurable way the **ESG strategy/objective** via specific **binding and measurable elements (i.e. binding clear KPIs)** of the investment process and how these apply to the asset allocation/selection; and explain how ESG and/or sustainable considerations are defined. In this context, we would like to emphasize that it should ultimately be up to the consumer to decide whether the process, as disclosed in the investment objective and policy, is sufficiently credible and materially supports the use of an ESG- or sustainability-

[1] Source: Morningstar, SFDR Article 8 and 9 Funds: Q4 2022 in Review

related term in its name.

Alternatively, ESMA could prescribe that funds using sustainability-related terms should **measure the SI proportion relative to the SI proportion of its benchmark or its investment universe**, using the same assessment methodology. In such a case, the word “sustainable” could be used provided that the fund commits to have a % SI exceeding significantly the % SI of its investment universe.

For funds without a reference benchmark or investment universe, the fund could identify a proxy reference to be in line with this requirement. It should be made clear that such an option would apply as long as the European Commission has not precisely clarified the definition of SI.

Q4. Do you think that there are alternative ways to construct the threshold mechanism? If yes, please explain your alternative proposal.

Please refer to our answers to Q2 and Q3.

Q5.Do you think that there are other ways than the proposed thresholds to achieve the supervisory aim of ensuring that ESG or sustainability-related names of funds are aligned with their investment characteristics and objectives? If yes, please explain your alternative proposal. If yes, please explain your alternative proposal.

Rather than imposing a threshold, we believe that it will be more proportionate to require that funds that use ‘sustainable’ or any other related term should **reflect sustainability in their investment objectives.** This is consistent with IOSCO’s Good Sustainable Finance Practices regarding naming. If this is not sufficient, we believe there is merit for the guidelines to mirror **ESMA’s supervisory guidance on sustainability risks and disclosures in the area of investment management** in ensuring that ESG-related terms should only be used when supported in a material way by evidence of sustainability characteristics, themes, or objectives that are reflected fairly and consistently in the fund’s investment objectives and policy and its strategy as described in the relevant fund documentation as already required under SFDR. Please refer to our response in Q4 for more information.

Question 6: Do you agree with the need for minimum safeguards for investment funds with an ESG- or sustainability-related term in their name? Should such safeguards be based on the exclusion criteria such as Commission Delegated Regulation (EU) 2020/1818 Article 12 (1) – (2)? If not, explain why and provide an alternative proposal

Preliminary remark

Minimum safeguards should be defined by the manufacturer in accordance with the SFDR and based on the characteristics promoted by the specific fund.

In addition, the consultation paper on the Guidelines explains that ESMA seeks views about any potential safeguard that might be necessary for **remaining investments of the funds**, i.e. investments not used to meet the environmental or social characteristics or objectives of the fund. To address this, ESMA proposes minimum safeguards based on the exclusion criteria which apply to **all investments**

of the fund. We recommend that ESMA clarifies in its final Guidelines whether the exclusions apply to the remaining or all investments of the fund.

Appropriateness of the minimum safeguards rule

Should ESMA decide to continue with the minimal safeguards rule, then we disagree with using the minimum exclusions under the Paris-Aligned Benchmark as these were designed for very ambitious climate products and therefore are not suitable for the broad universe of ESG subject to the Guidelines. We do not agree that the minimum safeguards should be based on the exclusion criteria such as Commission Delegated Regulation (EU) 2020/1818 Article 12(1)-(2) due to the majority of these exclusions being irrelevant to:

i. Funds with social objectives or promoting social characteristics, subject to these guidelines (exclusion criteria in Art 12(1) are mainly climate-focused and not suited for other labels nor strategies which are not fully climate oriented)

ii. Certain asset classes (e.g. sovereigns, real estate) and

iii. Funds that are not aiming to be Paris-aligned.

In addition, Article 12(2) states that companies that "significantly harm one or more of the environmental objectives referred to in Article 9 of Regulation (EU) 2020/852" should be excluded. The concept of "environmental DNSH" is very vague and therefore would create confusion and opportunities for regulatory arbitrage.

Last but not least, the current proposal is overly restrictive and would, for example, potentially exclude the entire energy sector. An exclusion of this sector would prohibit funds from supporting climate transitions. It also discriminates against investments in corporates in emerging markets.

Alternative Proposal

Instead, should ESMA decide to continue with the minimal safeguards rule, we propose to use a set of **exclusions that are aligned with current market standards**. This could be the following:

i. No investment can be made in the production of weapons prohibited by the Oslo Convention on Cluster Munitions and the Ottawa Treaty on Anti-Personnel Mines

ii. Violations of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises

iii. Companies involved in the cultivation and production of tobacco and the addition of thermal coal

Or alternatively, if the product meets the option of the MiFID sustainability criteria of consideration of PAIs in a quantitative or qualitative manner wherever applicable.

ESG products can invest in a range of asset classes, including sovereigns, real estate, derivatives, etc. Therefore, we recommend that ESMA should clarify whether the exclusions only apply in the case of corporate holdings (equity or debt) or whether a different set of exclusions should be applied to other asset classes. We believe that further thought and consideration will be needed on this front.

For sovereign bonds, the minimum safeguards could for instance be based on the following exclusions: governments that (a) are subject to UN sanctions (b) are included in FATF AML/CFT blacklist (sometimes referred to as the OECD blacklist) and/or (c) have not ratified the Paris Climate Agreement.

Other observations

External providers have different views on which companies are violators, hence hard exclusions would potentially be based on subjective and or outdated information (UNGC or OECD).

Additionally, **demonstrating harm** is potentially **subjective** and at risk for greenwashing. Some companies are found or estimated by internal assessments or by external data providers to significantly harm one or more of the environmental objectives of the EU Taxonomy. Also, four of the six environmental objectives of the EU Taxonomy remain undefined.

Q7. Do you think that, for the purpose of these Guidelines, derivatives should be subject to specific provisions for calculating thresholds?

We believe taking into account ESG/sustainability considerations extends beyond only fund naming thresholds, as it also relates to the SFDR disclosure more generally and the Taxonomy's treatment of derivatives. Any approach (to be developed and agreed upon at EU level between ESMA and the industry) should include, among other things, (i) the coherent treatment of the look-through in the numerator and denominator, (ii) the treatment of the derivatives to be disregarded and (iii) the necessary tolerance for indirect exposures.

Before incorporating any mandatory comprehensive methodology, we urge ESMA to **give the industry sufficient time to form a consensus** on the calculation thresholds for derivatives. A different result might expose market participants and underlying investors to a variety of different methodologies for determining the minimal proportion of investment for derivatives transactions, increasing inconsistency and running counter to ESMA's intentions.

However, if a detailed approach is required at this stage, we put forward our **interim proposal** containing the following elements:

- The calculation methodology for derivatives should be based on existing guidance (CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS).

- However, it is important to differentiate between the purpose of the derivative and the different types of derivatives when setting the calculation methodology.

- If the derivative serves to attain the ESG objective (like a derivative with an equity or corporate underlying which the issuer is taxonomy aligned for instance) it should be considered and the value to be used is the one referring to the delta approach (which reflects the economic exposure that the derivative provides to the underlying asset(s)/companies).

- If the derivative is used as an efficient portfolio technique or for temporary hedging/expo reasons (like subscribing in a large index to manage temporality subscriptions received before investing directly in the targeted securities), or in the case of FX or interest rate derivative, it should be disregarded.

- For synthetically-replicated passive funds, it should be made clear that the focus should be on the exposure of the fund, rather than purely investments.

- We also recommend that clarification is provided regarding which derivatives should be included in calculating thresholds and our preference is only those derivatives that reference equity or debt of a ‘portfolio company’ should be included.

Last but not least, we encourage ESMA to consult the response submitted by The International Swaps and Derivatives Associations (ISDA) on this topic for further information, given our shared interest to develop a common cross-industry methodology for the calculation of the minimum proportions of sustainable investments for derivatives transactions in the near future.

Question 8: Do you agree that funds designating an index as a reference benchmark should also consider the same requirements for funds’ names as any other fund? If not, explain why and provide an alternative proposal.

In principle, EFAMA does not believe that funds designating an index as a benchmark (e.g. ETFs/index funds) should presently adhere to the same requirements as (non-index tracking) funds. We base this consideration on the following elements:

- ETFs/index funds are often obliged under index licensing terms to include the name of the chosen benchmark in their fund names, implying hardly any flexibility on the choice of these by their managers. Any incongruence between the name of the chosen benchmark and that of the ETF/index fund could therefore be very confusing for investors. It is important in this respect to also recall that, as their objective is to “track” an index, ETFs/index funds are obliged to strictly adhere to the index methodology;

- With significantly “lighter” disclosure requirements applying to index providers under the amended BMR, the latters’ disclosure requirements remain non-aligned with those of the SFDR applying to ETF/index fund managers. Until this regulatory issue is solved via amendments to the relevant “Level 1” texts and the proposed ESMA Guidelines extended to index providers, it will be impossible for such managers to apply most measures being considered in this consultation, including the potential thresholds.

Until then, as a temporary solution, we recommend ESMA consider an exemption of at least two years for ETF/index-tracking funds from the application of its final Guidelines. Such exemption will offer ETF/index fund managers sufficient time to change their fund names if needed (and consequently amend their relevant SFDR disclosure documentation), or alternatively, choose a different index provider. Index providers are likely to have sufficient time to launch consultations around the evolution of their index rules as well.

Q9.Would you make a distinction between physical and synthetic replication, for example in relation to the collateral held, of an index?

We would caution ESMA from making a distinction between physical and synthetic replication models. In relation to UCITS funds (as the large bulk of ETFs/index-tracking funds in Europe are), these must commonly adhere to the existing investment limits under the UCITS Directive (i.e. Articles 52 et seq.), as well as to the collateral requirements specified in the subsequent 2014 *ESMA Guidelines on ETFs and other UCITS issues* (see par. 43 thereof) when relying on EPM techniques, or on OTC derivatives.

However, for consistency purposes with the tracked index, the portfolio of an ESG-labelled fund should, in the make-up of its holdings, be consistent with their companies’ stated sustainable investment policies and objectives. While discouraging a more prescriptive approach, fund managers are ensuring such outcome by relying on sets of legal exclusionary screens, minimum ESG constraints, et al.

Q10. Do you agree of having specific provisions for "impact" or impact-related names in these Guidelines?

We would, in principle, support specific provisions for the inclusion of "impact" related terms in funds' names, provided that they intend to generate positive, measurable social or environmental impact alongside a financial return. This is consistent with the Global Impact Investing Network's (GIIN) definition of impact investing, the leading global definition of impact investing.

However, we would caution against setting quantities thresholds for ESG, sustainable investments, or Taxonomy for impact products given the nature of many impact investments and the lack of reliable data. Today there is no common and unique definition of what "impact" is and the GIIN principles and the Operating Principles for Impact Management do not refer to any "thresholds" that could match with the thresholds as proposed in paragraphs 16 and 17. Current work is conducted around three main pillars (intentionality, additionality, and measurability) that mainly relate to qualitative concepts.

When making impact claims, we emphasize the importance of realizing where you are in the impact value chain and that this is communicated accordingly. E.g. when *company X* makes impact reports they must state that it is the estimated impact of investee companies that can be attributed to the fund based on how much of the company's enterprise value *company X* holds.

We would like to point out that paragraph 20 of the draft guidelines require funds that use the word "impact" or "impact investing" (or impact-related terms) to meet the quantitative thresholds set out in paragraphs 16 and 17. Paragraph 17 contains the 50% sustainable investment threshold. Nevertheless, the example of the impact fund provided (Global Impact Fund) is a fund with 0% sustainable investments. The wording of point 20 should therefore be clarified in the final Guidelines.

Q11. Should there be specific provisions for "transition" or transition-related names in these Guidelines? If yes, what should they be?

We believe that transition funds provide an important source of financing to companies that are decarbonising and the regulatory framework should be supportive of these approaches.

It is hard to give a definitive answer to this question, as it depends on the outcome of other related questions in this consultation and the other outstanding clarifications under SFDR.

In principle, we would support a framework that is agnostic about the approach taken and can be equally applied to climate, environmental, social, and other approaches rather that creating additional layers of regulation that will add, rather than reduce, the confusion in the market and for investors. In addition, we would highlight that there are myriad approaches to transition, and defining a clear and unambiguous standard could be challenging.

That said, the proposals above regarding minimum safeguards could, in particular, be challenging for transition strategies. Furthermore, it currently remains unclear where transition strategies sit within SFDR and whether transition strategies can be included under Article 9 and can be considered sustainable investments. Should the European Commission define sustainable investments narrowly and therefore exclude such strategies falling under Article 9, it could be helpful to introduce provisions regarding the transition to ensure that such strategies remain visible to investors.

Moreover, such funds must not be excluded from the use of ESG or sustainability-related terms, as it would put them at a significant disadvantage compared to other funds and would obstruct one of the most important objectives of the sustainable investment agenda, being able to meet the Paris Agreement targets, for which investments in companies and economies which are not yet green but are transitioning, is an important element.

Q12. The proposals in this consultation paper relate to investment funds' names in light of specific sectoral concerns. However, considering the SFDR disclosures apply also to other sectors, do you think that these proposals may have implications for other sectors and, if so, would you see merit in having similar guidance for other financial products?

Yes, ESMA and other regulators must aim for a level playing field and fair competition across the financial sector. Different requirements across financial products, on top of the already existing and complex regulatory framework, will only lead to increased consumer confusion and market fragmentation/unfair competition. This means a.o. applying the same guidance and consideration to:

- other retail financial products subject to SFDR
- financial instruments as defined in MiFID/IDD, considering they will be distributed through MiFID/IDD sustainability preferences
- financial instruments not subject to SFDR but claiming ESG or sustainability or impact features in their name (green bonds, notes, derivatives,…) and marketed to retail investors. For the latter instruments, guidelines should be adapted as far as references to SFDR definitions and binding information are concerned

EFAMA urges ESMA to work closely on the subject with EBA and EIOPA to ensure a level playing field across the financial sector.

Q13. Do you agree with having a transitional period of 6 months from the date of the application of the Guidelines for existing funds? If not, please explain why and provide an alternative proposal.

We would like to emphasize the importance of reasonable and realistic timeframes for any changes to the sustainable finance regime, allowing sufficient time for the industry to adequately prepare and adapt to the new rules. We would suggest a **<u>transitional period of, at least, twelve months for existing products</u>** whereby the implementation coincides with the first more general prospectus update. Combining multiple prospectus updates will reduce costs ultimately borne by investors and the supervisory burden triggered by any fund name changes. In parallel, we would **<u>suggest a transitional period of at least six months for new products.</u>**

To support our argument of the need for at least a 12-month transitional period, we have set out below **an example** of the different phases of managing such an implementation project.

- Analysis and design: starting the internal thought process and setting up your approach, i.e. should we change the name or the commitment of the product? This amount to **1, 2 or 3**

months depending on how complicated the process is (feedback from investors and clients might be required).

- Internal approval process: once the approach is set, the "Product Development Committee" needs to give its approval. Such a Committee usually meets on **a monthly** basis and needs a specific period, usually a month, to provide its approval.

- The decision goes to the **management company of the fund** (meeting on a monthly basis) after the internal process is approved. This can amount to **1 or 2 months**. Following it goes to the **fund board.** They usually meet on a quarterly basis. Depending on where you are in the quarter, this can amount **to three months.**

- Submission of the prospectus update to the regulator. This can amount to **1 or 2 months** depending on the NCA. It also needs to be taken into account that these guidelines will likely cause a significant wave of renaming in the whole European industry which will also be a challenge for the NCAs to approve the change. Enough time is needed to avoid creating bottlenecks in the supervisory process.

- Shareholder mailing: notifications to the client which has a minimum **4 weeks notice period**. In addition, **2 weeks** to sign up for shareholder mailings with service providers and co.

- Go live once the notice period is expired.

In addition, SFDR templates and prospectus changes for the year-end have been exhausting stream works within our membership. Authorities should also consider human capital, not only compliance costs, when proposing new requirements. In addition, an unlevel playing field among sectors and geographies might have effects on the competitiveness of the European industry and work to the detriment of the best interest of unitholders.

Also, should the EC clarify "sustainable investment" (SI), depending upon their definition, it could involve additional implementation time by the industry. Against this background, we advocate for an extended period of application of 12 months.

Q14. Should the naming-related provisions be extended to closed-ended funds which have terminated their subscription period before the application date of the Guidelines? If not, please explain your answer.

We consider the Guidelines' retroactivity to be inappropriate. These new requirements should not apply to closed-ended funds or open-ended funds that are not actively marketed and the subscription period already being over.

Since the legal basis for these Guidelines is to ensure that communications are "fair, clear and not misleading", any closed fund or not actively marketed that has terminated subscriptions would no longer be undertaking any marketing, otherwise, as mentioned before, applying these rules would be tantamount to retrospective application.

This would also be in line with the May 2022 SFDR Q&A from the European Commission that indicates that "where a financial product is no longer made available to end investors", such products must comply with requirements regarding "periodic report" and "websites disclosure" but not with pre-contractual requirements.

Should ESMA decide to extend these provisions to funds without new subscriptions can be made or Funds that are not actively marketed, adapting these structures to the proposed requirements would entail very high costs which would not result in greater protection for the unit-holders who subscribed to these Funds under the conditions set out in the relevant pre-contractual documentation, nor for potential new investors since they will be deterred from subscription.

Q15. What is the anticipated impact from the introduction of the proposed Guidelines?

If the proposed Guidelines are implemented without substantial changes, we see the potential impact as creating further confusion for investors in Europe which products deliver sustainable outcomes given the interoperability issues, without providing any further support with addressing greenwashing risk in Europe. As we've mentioned in our response, we would like ESMA to delay the Guidelines until more clarity on the definition of "sustainable investment" and ESMA and the European Commission have worked together to resolve interoperability issues or consider either revising the Guidelines as per alternative proposals set above.

Nevertheless, if the guidelines were to be adopted without any of the changes we have proposed above, it may have the following unintended consequence:

- **Increasing the risk of greenwashing** as the thresholds are based on a concept not clearly defined.

- **Increasing the risk of "green-bleaching"** if the constraints imposed are too stringent and inadequate (PAB exclusions for example). Indeed, it may drive some asset managers to stay out of ESG strategies.

Low-risk bond funds that would not be able to use the word "sustainable", would lead to execution-only investors with a high sustainability preference to end up having a stronger equity exposure than they otherwise would have preferred, thereby having them take on more financial risk. This perceived availability of sustainable low-risk bonds-based funds also runs contrary to the very objectives of fostering the sustainable transition of the economy as the word "sustainable" cannot be used.

Furthermore, we anticipate **increased investor confusion** as well as a **continuing inconsistency** of the **industry approach** to designate products as making sustainable investments or promoting E/S characteristics.

It will also **add complexity** to how local rules would apply on top of the guidelines. We would also foresee additional costs to amend funds' names, disclosures, and rebranding of funds that currently have ESG fund names, primarily as a result of the minimum criteria proposed, as well as the sustainable investments requirement. Finally, in light of SFDR's complex implementation, we emphasize the importance of human capital in compliance projects when proposing new requirements.

Funds that currently would fall within the scope of the proposed guidelines but do not meet the thresholds, these funds would experience **additional costs** (e.g. transaction costs) in re-positioning their portfolio particularly when other funds are also doing the same.