

# Advice to ESMA

## SMSG advice to ESMA on ESMA's consultation on Guidelines on funds' names using ESG or sustainability-related terms ("naming" consultation)

### 1 Executive Summary

#### *Link to greenwashing consultation*

In the wake of the ESAs' consultation on greenwashing, ESMA consults on future Guidelines on funds' names using ESG or sustainability related terms. The SMSG finds that the two consultations are closely related while timelines as well as scope are different. The greenwashing consultation involves all three ESAs working on a 2-year timeline, while the "naming" consultation applies to funds only and have a timeline of less than one year. There is also a difference in mandate, the ESAs having received a formal mandate from the EC on the greenwashing theme while the funds' naming consultation is not based on such a formal mandate. That said the SMSG finds that many of the topics looked at in the greenwashing discussion fit very well also in the funds' naming discussion.

#### *Naming approach*

The SMSG considers that it is good that ESMA initiates a discussion about the name of products, as names are - especially for the retail market - a powerful marketing tool. Regrettably, too often the name may even be the only reference looked at, or the only information taken in by some investors. In any case, the SMSG is of the opinion that the name of a fund should not be misleading. There is also room to be clearer in the name – as part of a wider discussion on potentially misleading statements - subject to the consideration that in practice very little information can normally be conveyed by a name. In addition, legitimately, as for any other product, names need not use vocabulary directly connected to the fund's strategy or assets. The name is not necessarily connected to an asset management type of vocabulary.

#### *Quantitative threshold*

The SMSG is not convinced by the proposed quantitative threshold approach. Definitions of concepts as well as underlying data are not yet finalised. It may be confusing for investors to add a second threshold, i.e., the Sustainable Investment threshold. This quantitative proposal may thus miss its goal at this stage of development of the sustainable finance framework. Thus, the SMSG considers that a two-step approach (qualitative first and quantitative at a second stage) may be a more appropriate approach.

### *Threshold breaches*

The SMSG agrees with ESMA that temporary passive breaches should be corrected in the best interest of the unitholders. To avoid the need to define “technical” authorised breaches, the threshold calculation should not be done on the AUM/NAV of the fund, but on the exposure value of the investment portfolio (i.e., without ancillary liquid assets and EPMs) in a consistent way with the other fund ratios on, for instance, diversification or eligibility.

### *Exclusions*

ESMA proposes to require the Paris aligned benchmark (PAB) exclusions to all investments of ESG-named funds. The SMSG does not agree with ESMA on this point. First, all ESG funds do not follow a PAB objective. Second, excluding the energy sector (without discriminating among companies) amounts to an exclusion of transition financing, which is an important objective of the sustainable finance agenda, as this is where the most important efforts are needed to achieve real carbon reduction impact.

### *Indices*

The SMSG also raises the question of the probable divergence between fund names, in the remit of ESMA’s proposed guidelines, and index names. Indices are very often an investment objective reference for funds or a tracking reference (examples: “ESG World Leaders index” or “For Good World index”).

### *Link to existing strategies and transition investing*

The SMSG regrets that the consultation paper does not assess existing strategies, nor link the proposal to existing rule-based efforts included in some national regimes or labels.

There is a need of clarification regarding ESG investment strategies and processes. Current ESG strategies implemented by asset managers go much further and are more diverse than negative screening. The SMSG sees a role for ESMA in establishing a list of key ESG investment approaches/strategies with their corresponding characteristics.

The SMSG in its response presents (not exhaustively) existing criteria that can be used to have the right to use an ESG term in the name: thematic investing on an ESG theme, engagement strategies, relative rating improvement approach, relative selection approach, and KPI improvement. Strategies that constrain the portfolio’s investments on an ex-ante basis on sustainability aspects/factors should be recognised. Indeed, it should be evidenced that sustainability aspects/factors have been of decisive importance in the selection of assets for a significant part of the portfolio’s investments.

The SMSG is reluctant to establish thresholds at a stage where we do not have more clarity on whether the definitions include or do not include the transition. If “naming” compliant Art. 8

and 9 funds would no longer be allowed to invest in any transition investments in their portfolio, the SMSG wonders which will ultimately be the impact on the environment of the European sustainable finance agenda implementation?

SMSG members consider that, implicitly, the proposed approach relies too much on a static view of “green” or ESG funds. There is a risk that a portfolio that invests in a sector that needs to transition on a high impact scale (energy sector for instance) may not be compliant, whereas a portfolio invested in more neutral sectors would be compliant while having possibly considerably much less impact on the green deal objectives. The important financing needs for the ecological transition should be factored in in the ESMA’s final Guidelines.

## 2 Questions of the consultation

### Q1. Do you agree with the need to introduce quantitative thresholds to assess funds’ names?

The SMSG agrees with ESMA that names can be misleading at times and that the issue is relevant but has the following remarks and positions.

#### *Definitions*

The SMSG is not convinced by the proposed quantitative threshold approach for several reasons. One important impediment to this approach is the lack of clarity of the underlying rules: we lack, for example, common “ESG” and “sustainable investment” definitions and calibrations. The sustainable investment definition is not yet calibrated, and if for instance asset managers have different assessments on the transition, they may get to different outcomes for similar portfolios. “Retail” investors” will also likely be confused about the distinction, as proposed by ESMA, between “ESG- related words” and “sustainability related terms”.

#### *Data*

The SMSG is not convinced that we are currently at a stage where we are able to set quantitative thresholds. We still lack standardised issuer data, as the CSRD and the ESAP are not yet implemented. Quantitative thresholds require clear, common, and measurable underlying factors to be effective. If such factors are not in place, there is a risk that investors may be misled.

#### *Negative screening vs more positive and impactful ESG strategies / transition*

Quantitative thresholds seem to implicitly rely solely on - and therefore validate only – negative screening (exclusion) sustainable investment strategies. The SMSG in its reply to the ESA’s greenwashing consultation noted that this is merely one of the many sustainable investment

strategies used by asset managers. Moreover, it is the least effective approach compared to others such as the engagement, impact, thematic, and best in class strategies.

The SMSG understands that from a supervision point of view a quantitative threshold approach might seem a more simple, white-and-black solution than more elaborated alternative solutions. It would indeed be an easier to check solution. However, even if the proposal has some merits, in practice, the need of clarification of the underlying rules is a major issue.

In addition, SMSG members think that, implicitly, the proposal seems to rely too much on a static view of “green” or ESG funds. If the taxonomy alignment proportion is used to classify funds for instance, there is a risk that a portfolio that invests in a sector that needs to transition on a high impact scale (such as the energy sector) may not be compliant, whereas a portfolio invested in more neutral sectors would be compliant while having possibly considerably less impact on the green deal objectives. As the taxonomy has not been designed to be an investment approach, it has not addressed the financing needs for the ecological transition, which are huge and impactful. Transition probably needs to be considered in a forward-looking way, in the sense that for transition it is important to look at the change (and the rate of change) in a factor or a set of factors towards the objective/target and not only at the ‘greenness’ level at one point in time, which is a snapshot of the current level of ‘greenness’ as opposed to the change. The level of ‘greenness’ can be used to distinguish, with the appropriate definitions and data, between e.g. – ‘green’ vs. ‘brown’ investments.

There is a need of clarification regarding ESG investment strategies and processes. Current ESG strategies implemented by asset managers are much more diverse than “merely” negative screening. ESMA could make a list of key ESG investment approaches/strategies with their corresponding characteristics. Such clarifications are necessary as they can also help advisors to avoid a mismatch of expectations between what funds promise, and what investors expect them to do.

More generally, a quantitative threshold approach would seem to exclude most of the very needed transition investments and increase further the weight of e.g. the Big Tech companies<sup>1</sup>: it is not because some listed companies may display highly taxonomy-compliance that buying even more shares of those companies will contribute to the European green deal aiming at channelling massive private investment towards the transition to a climate-neutral economy. The SMSG is concerned that there could even be that investors are being misled if this quantitative threshold approach would be pursued.

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<sup>1</sup> For example, three big tech/financial services companies combined represent 10,3% of the “MSCI World ESG Leaders Index”, whereas they weight 5,1% in the MSCI World Index as of 30/12/2022, a good proxy for the worldwide stock market capitalisation.

Lastly, greenwashing being in essence misleading information related to ESG/sustainability matters, any quantified threshold approach applied to fund names would have to comply with existing EU investor rules on clear, fair and not misleading information, in particular art 44 of the delegated regulation (EU) 2017/565<sup>2</sup>.

Also for these reasons the SMSG is reluctant to establish thresholds before knowing with more clarity if the definitions include or do not include the transition. If “naming” compliant Art. 8 and 9 funds would no longer include transition investments in their portfolio, the SMSG questions what will be ultimately the impact on the environment of the European sustainable finance agenda implementation?

Regarding the proposed thresholds approach, the SMSG would also like to understand how this approach will match the ESMA/EC work (not yet finalised) on the Art. 8 and 9 minimum investment criteria - is the threshold meant to replace these criteria?

#### *Articulation with existing regimes and strategies*

The SMSG would also like to raise the question of the articulation with existing regimes. With a convergence objective in mind, the consultation does not explore current national regimes. The SMSG acknowledges the urgent need for ESMA to give guidance to NCAs that do not yet have a “naming” regime, or a regime based on minimum investment criteria for ESG funds. However, some NCAs, including France or Germany, have already or are about to establish national rules. France has imposed “naming” thresholds linked to the intensity of the ESG criteria used in the investment strategy. The SMSG considers that all market participants would benefit from gaining additional knowledge as to the NCAs’ agreement and engagement on this initiative, as well as on the freedom for each NCA to maintain or introduce their own preferred/appropriate criteria.

On a more general stance, the SMSG would like ESMA to assess what the impact would be for the fund ecosystem if it were to go from a more general ESG-rating selection approach or from an engagement strategy or label-based approach to a new type of approach based on a unique and different type of threshold. The SMSG is concerned that a new approach means that also fund producers will have to do again things that already exist, knowing that the real game changers around the availability of data and the finalisation of the taxonomy (including the social one) are still to come. In any case, it should be acknowledged that for the moment fund manufacturers have to work with what is there.

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<sup>2</sup> “It shall be accurate and in particular shall not emphasise any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks. It shall be sufficient for and presented in a way that is likely to be understood by the average member of the group to whom it is directed, or by whom it is likely to be received. It shall not disguise, diminish, or obscure important items, statements, or warnings.”

There are also practical questions regarding how ESMA defines what is an “E” or a “S” characteristic. How is this calculation to be done in practice? Will there be a need to classify each instrument and relate it to “E” or “S” or could the whole ESG portfolio’s objective be considered (like a minimal ESG rating/assessment or a relative approach to do better than the benchmark on a KPI or rating)?

#### *Threshold breaches*

The SMSG agrees with ESMA that “a temporary deviation from the thresholds, if the said deviation is not due to a deliberate choice of the asset manager, should be treated as a passive breach and corrected in the best interest of the unitholders.” Indeed, if ESMA proceeds with the proposal, it should be clearly stated that a portfolio value is not static and that passive breaches are to be corrected with a timing that considers the best interest of investors. In addition, ramp-up strategies (like private equity), formula funds, target date funds and other fund particularities should be accounted for in the threshold’s application date. Funds closed for subscriptions or funds that are not marketed any more at the application date of the Guidelines should not be in the scope.

To avoid the need to define “technical” authorised breaches, the threshold calculation should not be done on the AUM/NAV of the fund, but on the exposure value of the investment portfolio (i.e., without ancillary liquid assets and EPMs) in a consistent way with the other fund ratios relating to, for instance, diversification or eligibility.

#### *ESG terms*

The SMSG considers that a list of ESG terms would bring more clarity to all actors through the value chain and proposes that such a list be included in the guidelines. To reduce NCA divergence a non-exhaustive list should as a minimum be shared at the ESMA level with all NCAs.

#### *“What’s in a name?”*

ESMA’s consultation covers only questions on names. However, names are part of a larger set of documents that express a fund’s characteristics, including on ESG. Some local regulations are wider, like the French AMF doctrine that refers also to other kinds of information (Prospectus, KID, marketing documents). There is a risk that as ESMA focuses on names only, non-compliant funds continue to be sold as ESG funds despite a name change. ESMA is right in targeting the name, but should ultimately also look at the prospectus, the KID ESG statements etc. The SMSG generally supports that ESMA focuses on fund names as the name is too often the only thing some retail investors might be looking at but cautions that potential misleading wording can go beyond naming as the SMSG expressed in the advice on greenwashing. The goal would be to obtain in the end consistency between different investor material (and products) marketed to retail investors.

### *The way forward*

The SMSG agrees with ESMA that the issue is relevant and that non-misleading fund name information is important to investors. It is important to manage investors' expectations and be strict with regards to fund naming. Appropriate guidelines should be in place to support an investment suitable to the needs and preferences of that investor. This said, there are at present too many moving parts. There is first a need to learn more about the current situation, and to gain such knowledge we should mandate a review of the current names as presently used. As noted above a study should be carried out to see how ESG factors are incorporated and which the different ESG strategies are. On this basis a set of rules/options could be presented, building as much as possible on existing national regimes. The SMSG is of the opinion that it would not be advisable to "rush" with a one-size-fits-all threshold.

Taking due account of both the need for action and the current regulation-under-construction situation, the SMSG would advise ESMA to follow a two-step approach: first, define more qualitative guidelines in the period between now and full completion of the CSRD, ESRS<sup>3</sup> and ESAP<sup>4</sup>, while also clarifying definitions of concepts used under SFDR, and, second, carry out a revision of these guidelines with introduction of quantitative thresholds once data are available and the regulatory framework is completed.

In brief, the question arises whether thresholds solve the issue with fund names. The SMSG is of the opinion that there are still too many uncertainties to make thresholds an efficient measure as of today.

## **Q2. 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.**

The SMSG reminds that it is important to link the proposal to existing efforts in the field. The unique threshold proposed is difficult to assess as long as the underlying concepts are not clarified. More clarity on definitions and calibration on methodologies are needed if we want any threshold option to work.

The group would also like to comment on the calculation basis. To avoid the need to define "technical" authorised breaches, the threshold calculation should not be done on the AUM/NAV

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<sup>3</sup> European sustainability reporting standards

<sup>4</sup> ESAP – European Single Access Point – Companies in the EU have to publish certain information (financial statements, data on sustainable finance, etc.). Building on the 'European financial transparency gateway' project, this initiative will set up a single EU access point to financial and non-financial company information. Web portals or other means will give investors quick and easy access, without undue burden on companies. Some data will be available in machine-readable format, helping users search and compare data more easily.

of the fund. Indeed, any fund holds ancillary liquid assets (cash, deposits on sight, money market funds) for daily operations. There is no reason to compare a fund with more cash to another having less. The same logic applies to funds using EPMs (efficient portfolio techniques) to manage portfolio risks and operations (ex: FX hedging or broad index derivatives that are temporarily used to manage subscriptions). The calculation should be done on the exposure value of the investment portfolio (i.e., without ancillary liquid assets and EPMs) in a consistent way with the other fund ratios like diversification or eligibility.

If this is not possible within ESMA's current remit, then, until the exposure calculation is possible, the thresholds must take into account the investable universe after removing about 20% ancillary liquid assets – the rule in France and Luxembourg for instance, and about a similar proportion for EPMs.

Also, it would be advisable to assess how names are used, namely what ex ante rules are applied by fund managers to evidence the reality of the ESG management/engagement, so that to be able to come up with alternative proposals. For instance, the SMSG sees several existing criteria that can be used to have the right to use an ESG term in the name (not exhaustive):

- Thematic investing on an ESG theme: the fund aims to select investments that are participating or positively contributing to an ESG theme.
- Engagement strategies: the asset manager takes a position on ESG issues and demands that the targeted companies improve their practices over time (these requirements are formulated via a structured approach including direct dialogue with the company, voting and long-term monitoring). These strategies take time to implement and include escalation actions depending on each situation. Regarding the stewardship and voting policy for transition investing more particularly, the asset managers' policy encompasses voting at AGMs of the portfolio companies that need to transition, including on the ESG/sustainability related resolutions and in particular those aimed at accelerating the company's transition. The reason/strategy and results of these actions are disclosed in the annual report.
- Relative rating improvement approach: the fund aims at improving the average non-financial rating of the fund relative to the benchmark/investment universe (narrowly defined).
- Relative selection approach: the fund aims selecting the best issuers of the benchmark/investment universe (narrowly defined) based on their non-financial rating and/or excluding issuers on the basis of non-financial characteristics.
- KPI improvement: improving a/several KPI(s) on the portfolio over time or compared to the one(s) of the benchmark/investment universe.



- Other.

These funds have to make explicit in the prospectus their ex-ante (constraining) ESG securities selection strategy to be able to use an ESG name. Merely performing ESG integration is not sufficient: providing ESG ratings or analysis to investment managers without constraining the portfolio investments on an ex-ante basis on the sustainability aspects/factors is not significant enough as a commitment. To link with ESMA's proposal, the resulting investment portfolio that has been selected through the ESG filter (e.g., criteria/KPI/engagement) should cover a significant part of the portfolio. Indeed, it should be evidenced that the sustainability aspects/factors have been of decisive importance in the selection of assets for a significant part of the portfolio's investments.

**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.**

It is difficult to set a quantitative threshold on sustainable investments (SI) as of SFDR while definitions are not yet clarified and ESMA has not yet received the clarifications requested last year from the European Commission. For instance, one of the most impacting features is the fact that not all methodologies consider the whole company as a sustainable investment. Indeed, the % of SI is based on different methodologies, each asset manager having its own methodological points and calibrations. In addition, these are currently changing, calibrations are reviewed, as this is a new exercise for asset managers and works as an iterative process.

The SMSG thinks that accuracy is relevant to all questions linked to the calculation of thresholds, even more if this is not only a transparency issue but also an ex-ante management rule to implement and follow/check. A better approach may be to distinguish between “ESG” which can refer to all ESG characteristics and a more specific criteria that can be referred to as “sustainable”. This could be an additional threshold (level to be defined), a relative threshold (between the fund and its benchmark using the same SI methodology of the asset manager) or something else based on different criteria. “ESG” refers to sustainability-related topics and sub-topics as per the ESG categorisation of topics under CSRD and ESRS, while „sustainable” can be more seen as a characteristic of a product, service, or company, by describing its current state. With this perspective in mind, a fund manager can have an ESG-oriented strategy, or objectives, while a fund can be more or less sustainable. This is at meta-level, as it is difficult to assess to what extent a single company can be sustainable.

It is useful to mention also that the use of the word "sustainable" is very widespread today. Regarding retail investment for instance, several types of products may use the same word,

not only funds. For instance, notes sold to retail may use it or banking accounts. Regarding distribution, MiFID uses also "sustainable preferences" as vocable without linking it to the SFDR SI concept. There is no alignment of definition between the different pieces of regulation. This piecemeal approach leads to confusion of concepts. In the end, what it matters is that retail investors be protected. With this context in mind, the SMSG thus advises ESMA to weigh if the proposed partial linkage between the SFDR SI concept and proportion to the use of the "sustainable" word for European funds brings clarity or confusion to end users.

Market studies would show that 50% may not be attainable as less than 20% of current Art 8 funds would target more than 50% investment in sustainable investments. In practice, the application of a 50% threshold would potentially require a change in name for more than 80% or Art 8 funds that use sustainability-related terms in their name. Is the market wrong or is the rule too strict?

*Two ratios might be complex for investors.*

From an individual investor point of view, first a 80% and then another 50% threshold as set out in ESMA's proposal is very difficult to apprehend for individual investors. The SMSG considers that it to be important to have in mind the need to make life easier for investors. The effect of the guideline may be that investors and advisors may be lost on the way, as the rules become too complex.

*Art 8 and 9 need clarification*

The SMSG understands that ESMA is proposing rules for naming funds on top of the SFDR classification. In practice, the two sets of rules are interrelated. We do however not see that ESMA has a mandate to work directly on establish minimum criteria for Art 8 and 9 funds. It follows that there is some additional confusion in the market.

The SMSG agrees with ESMA that the current unclear situation on definitions and fund classifications (and downgrades/upgrades) are not sustainable and need action. However, setting rules on naming of funds is not starting from a white page. On the contrary, the proposal arrives in a market that already applies a given set of rules and already invests in research and data to implement ESG strategies that are already invested by retail and/or institutional clients. Individual potential abuse situations should be dealt with. Regarding setting rules for the entire fund market, the SMSG believes there is a need to take the necessary time to be more effective in the rule setting and achieving to prevent "greenwashing". If the necessary time is not taken to robustly define the framework and the underlying concepts, there is risk that we will make very little progress on greenwashing (50%/80%/X% "of what"?) The group is concerned that negative screening and similar approaches are envisaged in the proposal, at the same time as independent research shows these are the least effective approaches.

The SMSG is conscient that ESMA cannot change level 1. It is however possible to work at level 2 and level 3, by giving more guidance to asset managers and encourage the agenda transition. The SMSG believes that the agenda of supervisors should not only encompass investor protection, but also the effectiveness of sustainable finance, as an element of support of the financing of a sustainable economy.

Art 9 and 8 funds are already considered by investors as a classification, even if this is not the primary intention of the legislator (it was aimed as a transparency regime). In addition, if investors think that investing in Art 9 funds is more of a guarantee than investing in Art 8, they will continue the trend already observed and invest more in Art 9. If Art 9 funds are almost a “null” category, it may lead to a bubble in the few assets deemed eligible. This is why the SMSG is of the opinion that it is needed to clarify criteria for Art 9. When asset managers do not think they are on solid ground, they change classification, with puzzled investors as a result. For instance, in Q4 2022, about 40% of Art 9 funds changed classification for Art 8. In addition, if almost all funds are categorised as Art 8, even those that merely apply some company-wide sectoral or legal exclusions, the Art 8 classification greenwashing risks increases mechanically and may disappoint investors that would like to discriminate between different ESG intensities in their ex-ante management rules.

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

Yes, even if ESMA introduces this proposal based on thresholds, this represents only one option. The SMSG thinks there are alternative ways that are worth exploring.

Regarding the effects of any naming option, the SMSG thinks it would be useful to distinguish between transition investments and investments in companies that have already transitioned. For instance, companies transitioning from an oil and gas only model to a mixed model with renewables and with a phase out should be considered as eligible investments. Several metrics like turnover, CapEx, OpEx, net zero paths/plans, enabling activities are elements can be used to define transition investments.

In any case, thresholds may also be expressed as a KPI (not only as a proportion), or in terms of issuer number, or be implemented in relative terms (for instance, comparing a KPI in the fund with the benchmark/investment universe).

**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.**

Yes. Please refer to previous responses.

The SMSG would first ask ESMA to clarify and specify the minimal criteria needed for the eligibility of other investment approaches than negative screening. The SMSG thinks it is important to make sure that Art 8 and 9 funds, and especially Art 9 funds, help to convey investment flows towards the transition, as per the European Commission's sustainable finance agenda. If investments do not flow into the transition, the objective of sustainable finance to support the economy, all sectors included, to transition will not be achieved. For instance, if "transition" is in the name of a fund, it should be expected that the investments of the fund have a clear transition plan. In addition, there are currently initiatives that permit to assess the transition plans.

**Q6. 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.**

The SMSG completely disagrees with ESMA's proposal in this respect. Even if it may seem simple to pick these criteria, they are not relevant for the naming guidelines. The SMSG is of the opinion that it is excessive to ask all ESG funds to apply the Paris agreement exclusion to all their investments. These exclusions are crafted in the specific objective of a climate index that looks to be aligned to the 2015 Paris Climate Agreement objectives.

Aligning all ESG funds to these exclusions will exclude the energy sector, one of the sectors in urgent need of transition from fossil fuels towards low carbon energy. For instance, the transition from gas to wind energy takes time and companies will currently have blended activities. Excluding all of them without distinguishing between companies that do not make progress and companies that engage seriously on the reduction of GHG emissions goes against the objective of encouraging the renewable energy sector. Transitioning companies should have credible transition plans, for instance with verified science-based targets to be eligible as sustainable investments.

The SMSG deems this exclusion proposal as non-coherent with the European Commission's objectives in this matter. The SMSG proposes instead clarifying the criteria for other investment strategies than negative screening. Also, it is useful to factor in how Art 8 and 9 ESG funds would help the investment in the transition. ESMA should come up with concrete proposals on investment strategies definitions (e.g., thematic, engagement, impact, best in class/universe/effort, solidarity funds, green bond funds/sustainability linked bond funds) and think of how this proposal can align with existing regimes.

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

**a) Would you suggest the use of the notional value or the market value for the purpose of the calculation of the minimum proportion of investment?**

Regarding derivatives, the SMSG believes that there should be as much calculation consistency as possible between the areas of regulation (similarity of derivative treatment between financial and non-financial ratios).

The SMSG considers that derivatives should be considered in a consistent manner with the financial ratios. Currently, diversification ratios, concentration ratios, eligibility ratios are calculated and checked by the depositary at their exposure value. It means taking into account the delta equivalent exposure of the underlying asset of the derivative, as per CESR's guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788).

**b) Are there any other measures you would recommend for derivatives for the calculation of the minimum proportion of investments?**

The rule should be clear: derivatives that contribute to the ESG objective should be taken into account while efficient portfolio management techniques (EPMs) should be disregarded.

**Q8. 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.**

Consistency is desired in principle with indices, but it is not in ESMA's remit. The same difficulty applies for global indices. The SMSG acknowledges that ESMA is right in noticing the problem, however asking index providers to follow ESMA's rules is difficult to achieve in practice. The result may simply be that custom indices proliferate even more than today, that costs go up and that other products (like derivatives) can still reference the parent/main index versions. Questions may also arise in terms of unlevel playing field for EU domiciled funds in a global index market and even at some point of effects on the markets' efficiency.

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

There should be consistency with the financial treatment where the two investment replication techniques have the same effects. The SMSG does not see a distinction to make.

In this context it should be noted that a fund portfolio that is swapped against a fund's exposure is not a "collateral", it is the propriety of the fund. Collateral is what is received by the fund: all assets received in the context of OTC financial derivative transactions and other efficient portfolio management (EPM) techniques to cover the fund's counterparty risk.

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

The SMSG considers that the rule "say what you do and do what you say" applies also to "impact". Before introducing thresholds, the term "impact" should be defined, for instance by the 3 pillars widely recognised today: intention, additionality, measure. This step is needed as we lack a regulatory European-wide definition. An impact strategy goes beyond meeting some ESG criteria by making ex ante efforts to reinforce the ESG dynamic that is pursued by a fund.

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

The SMSG has above and do also here emphasise that the transition is where the most financing needs are which should be taken into account in Art 8 as well as Art 9 products. Rather than having a specific provision, strategies that invest in companies that engage in

transition with solid plans should be authorised to use ESG wordings in their name. The SMSG reminds that companies' plans will ultimately need to be certified and that information on transition plans under the CSRD framework will not be available before 2025. Each company in scope will then disclose its own plan, and the credibility and the quality of the plan is yet to be assessed in order for the information to be used by investment managers and other investors. Indeed, there should be clear and precise conditions in the transition plan and "engagement washing"<sup>5</sup> should be avoided. SRD2 engagement reports should show how actors are actively engaged with issuers. If a company has a transition plan (that should also contain KPIs), then the asset manager needs to have a strategy to accompany the company (dialogue) that can go up to proposing or supporting resolutions at AGMs.

**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?**

The SMSG considers that a sectoral level playing field is needed. As noted above, unless the ESAs agree on a coherent common approach, an unlevel playing field will exist between products. Key performance indicators may be different between sectors, but the same overarching rule should be applied by all ESAs.

**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.**

Mindful of the investor protection agenda, the SMSG considers that there is a need for an appropriate transitional period for existing funds. The length of such period depends on the final Guidelines that will be decided, and the efforts required to be made by market participants, their ecosystems, and regulators. Considering the different phases of managing such an implementation project (also keeping in mind that the European Commission might come out with an SI definition which could require additional implementation time), a transitional period of 6 months may be insufficient. In this case, it could be useful assessing if 12 months may be acceptable.

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<sup>5</sup> Engagement means developing a dialogue with companies which is a heavy and lengthy enterprise. Sending one letter to the CIO is a one-time action, it must be part of a larger stewardship strategy.

**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.**

In case the question relates to listed closed-ended funds, they should be in the scope. If the question relates to open ended funds that are closed to subscriptions, whatever the subscription/distribution channel, or are not marketed any more, they should not be in the scope. Open ended funds whose subscriptions have been terminated will no longer market the product, so applying these rules would not be proportionate.

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

The SMSG considers that if the Guidelines are adopted as such, there may be a serious impact by shifting further money towards the negative screening approaches only. The SMSG reiterates the need to ensure that positive screening strategies (e.g. transition, engagement, best in class, thematic, impact) are eligible and be included in the naming scope. The market estimates of the effect of the proposed Guidelines show that very few funds would be compliant with the 50% threshold or with the exclusions. On existing EU ESG funds, instead of targeting (as an example) about 80% in and 20% out, there seems that the effect would be the opposite case (less than 20% in).

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

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