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| 18 November 2022 |

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| Reply form for the Consultation Paper on Guidelines for the use of ESG or sustainability-related terms in funds’ names |
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| Date: 18 November 2022 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Consultation Paper on Guidelines for the use of ESG or sustainability-related terms in funds’ names published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered);
* do not remove the tags of type <ESMA\_QUESTION\_FUNA\_0> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

**Naming protocol**

In order to facilitate the handling of stakeholders’ responses please save your document using the following format:

ESMA\_CP\_FUNA\_NAMEOFCOMPANY\_REPLYFORM.

e.g. if the respondent were ABCD, the name of the reply form would be:

ESMA\_CP\_FUNA\_ABCD\_REPLYFORM

***Deadline***

Responses must reach us by 20 February 2022.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# General information about respondent

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| --- | --- |
| Name of the company / organisation | Federated Hermes Limited |
| Activity | Investment Services |
| Are you representing an association? |  |
| Country/Region | International |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_QUESTION\_FUNA\_0>

Federated Hermes very much appreciates the opportunity to provide our views on the Consultation. Federated Hermes is a global leader in active, responsible investment. We are guided by the conviction that responsible investing is the best way to create long-term, sustainable wealth for our clients and their beneficiaries. We provide specialized capabilities across equity, fixed income, and private markets, in addition to multi-asset strategies and proven liquidity-management solutions. Through our world-leading stewardship services, we engage companies on strategic and sustainability concerns to promote investors’ long-term performance and fiduciary interests. Our goals are to help individuals invest and retire better, to help clients achieve better risk adjusted returns, and where possible, to contribute to positive outcomes in the wider world.

We believe there are two mutually reinforcing strands of responsible investment management: responsible investment and responsible ownership. Together, these aim to generate sustainable wealth creation for the end beneficiary investors, encompassing investment returns and their social and environmental impact. This drives our governance structures – designed to put our clients and beneficiaries at the heart of everything we do – and our investment and engagement activities, through which we seek to deliver strong risk, adjusted returns and where possible, to contribute to positive outcomes in the wider world, consistent with client objectives and applicable requirements.

We support good and meaningful regulation of investment funds and their managers. We fully support ESMA’s goal to achieve greater supervisory convergence in the European Union (EU) and to combat greenwashing. However, we believe that before ESMA is in a position to ensure supervisory convergence on the use of ESG or sustainability-related terms in fund names, the co-legislators must first include in SFDR (or in another stand-alone Regulation) a requirement for such considerations that ESMA can then work on and provide guidance. Unfortunately, there is no reference to naming rules or conventions in SFDR for ESMA to develop guidelines, and as such the responsibility to ensure that funds domiciled in the EU which include either ESG or a sustainability-related term in their names are, and should continue to be, subject to Member State regulators who are already charged with ensuring that such names are not misleading.

Whilst it is of the utmost importance to protect EU investors against misleading promotion or unsubstantiated claims of ESG integration or sustainability in investment funds (i.e., greenwashing) it is also equally important to preserve the existing legislative process.

We would fully support a review by ESMA focused on supervisory convergence on the various Member States review of fund names, and how each jurisdiction determines that a particular name is not misleading, as an effort to increase regulatory convergence that is within ESMAs remit, once the co-legislatures provide an appropriate remit.

The EU has established itself as a global leader in sustainable regulation, being an early actor in having adopted several ESG related initiatives. It is critical that the EU mitigate greenwashing to the greatest extent possible in order to retain the confidence of global investors in EU funds.

As will be evident in our response, whilst we welcome the laudable objectives of the SFDR regulation, we have major concerns that an over prescriptive approach will be counterproductive. Further, despite this not being the co-legislators’ intention so far, asset managers are categorising funds for marketing purposes and, as a result, a prescriptive/quantitative approach may be increasing rather than reducing greenwashing.

In a much more qualitative approach of supervision, fund managers ought to be able to i) design their funds to meet the objectives and interests of investors; ii) describe in detail to investors and the regulator how fund managers intends to deliver on the investment objectives and which indicators should be used to measure the fund’s performance against its stated investment policy; and iii) name their funds in accordance to the demonstrated investment policy. It is then incumbent on the regulator to assess whether these three elements are coherent and to judge whether the fund manager is delivering in accordance with what has been articulated. In our view, such an approach would best protect investors from greenwashing. In this way the regulator will focus on holding fund managers accountable, avoid misleading behaviour and not encourage box-ticking compliance by being over prescriptive.

Notwithstanding these concerns, we have set-forth our thoughts on how a uniform regulatory requirement on the use of ESG or sustainability related terms could be adopted, should the European Commission decide to open the Level 1 text of SFDR or issue a new standalone legislative proposal in the attached Appendix A.

We very much appreciate your consideration of these very important points, and we will make ourselves available for any follow-up questions or discussions as you deem appropriate.

**PROCEDURAL CONCERNS**

First, the proposed guidelines are more akin to Regulatory Technical Standards (RTS) than either guidelines or recommendations. While we believe there is a need for clarification of definitions in SFDR and, as one of ESMA members noted (see AMF Proposal for minimum environmental standards for financial products belonging to the Art.9 and 8 categories of SFDR), probably a need for some thresholds for qualification, we do not believe that ESMA has authority under Article 16 of ESMA Regulation 1095/2010 to introduce such notions in the legislative landscape.

Second, although ESMA asserts these draft guidelines are developed under AIFMD and UCITSD only, they contradict the requirements of Regulation (EU) 2019/2088 on sustainability‐related disclosures in the financial services sector (SFDR) or the requirements of the Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the “Taxonomy Regulation”). Indeed, although these definitions are still missing in L1 and L2 texts, ESMA is encroaching into further defining, for instance, sustainable investments, ESG integration, promotion of ESG characteristics, transition, engagement, etc. This is an area of competence reserved for the co-legislators under legislative proposal by the European Commission (EC).

Third, greenwashing and misleading fund names are issues pertinent to investor protection and regulation of fund distribution, both of which are matters currently entrusted to the competence of individual Member State regulators. National Competent Authorities (NCAs) are best placed to review and approve fund names based on what is in a fund’s governing documents, their engagement and review of a fund managers policies, procedures, and practices, all of which are designed to ensure that fund names are not misleading.

Notwithstanding these procedural issues, we have set-forth our thoughts on how the EC could impose a uniform regulatory requirement on the use of ESG or sustainability related terms should the EC decide to open the Level 1 text of SFDR or issue a new standalone legislative proposal and provide ESMA with the requisite remit.

<ESMA\_QUESTION\_FUNA\_0>

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

<ESMA\_QUESTION\_FUNA\_1>

**No.** We do not agree that there is a *need* to introduce a quantitative threshold through ESMA guidelines as currently Member States are already reviewing fund names to ensure that any such names including ESG- or sustainability-related themes are not misleading. What is necessary is a greater focus on policing funds to ensure they are operating as disclosed and imposing penalties on those funds or managers determined to be greenwashing.

Introducing quantitative thresholds to assess fund names through ESMA guidelines, on the face of it, might look like one step toward better supervisory convergence, however, it negates the qualitative dimension of assessing whether a fund is green, ESG, sustainable, impacting, pushing for transition, engaging, etc.; as well as the qualitative assessment that a manager must conduct before investing in a specific asset and throughout the period a fund is holding an asset.

<ESMA\_QUESTION\_FUNA\_1>

1. : 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.

<ESMA\_QUESTION\_FUNA\_2>

**No**. There is considerable subjectivity and difficulty in evaluating whether a fund has or has not achieved an 80% or other level of threshold and as such this may lead to unintended consequences in terms of greenwashing and value to investors. Should ESMA continue considering an imposition of a threshold through ESMA guidelines, we would propose that it is paired with a qualitative assessment. In such circumstances an 80% threshold is at a level which would be appropriate though crucially depending on how reaching the 80% threshold is defined.

We caution, that such a threshold, especially as a stand-alone metric without a focus also on the qualitative aspects would be extremely difficult to implement and enforce, for several reasons:

1. Lack of clear and certain definition of ESG or impact-related notions in SFDR and TR. We note that Commissioner McGuiness informed the European Parliament that her services are working on a comprehensive assessment of the implementation of SFDR. In particular, the review will focus on how the regulation ensures legal certainty, also its usability, and its role in mitigating greenwashing;
2. Incorrect sequencing: ESMA and the other ESAs should further underline the urgency of getting clear definitions and legal certainty from the European Commission and the co-legislators on SFDR and TR concepts (e.g., sustainable investment, engagement, transition, impact, etc.). Only then, will ESMA be in a position of working on thresholds.
3. Uncertainty in the use of ESG in a fund name: ESMA states that “*if an investment fund has any ESG- […] related words in its name, a minimum proportion of 80% of its investments should be used to meet the environmental or social characteristics or sustainable investment objective*s”. ESMA ignores the “G” in ESG, which leads to the question of whether that “G” should count towards the percentage for the threshold. We believe it is no less relevant than E or S;
4. Inconsistency between these proposed thresholds and SFDR requirements: a fund with ESG or impact assets just under the threshold of 80% would not be allowed to use ESG-, or impact-related words in its name. However, such a fund could be classified as Article 8 fund under SFDR because it promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, and discloses these elements in the fund regulatory documentation and commercial documents;
5. Defining how the threshold should be met to satisfy ESG characteristics will need to be carefully determined so as not to favour one set of ESG behaviour over another. Would the threshold be calculated based on Net asset Value or sales? If sales, the threshold could cover level of product sales in line with the Taxonomy Regulation. Consideration, however, should also be given to, for example, employee and community relations or best practice governance. These are very difficult to define and measure and undoubtedly have qualitative aspects.
6. When does the “test” (threshold calculation) have to be performed if when investing or on an ongoing basis and how often? How should breaching the threshold be addressed? How and when to communicate such a change to investors and when should the regulator be notified?
7. How to ensure that all NCAs calculate the threshold in the same way? For instance, when implementing a threshold for the products, it is important that clarification is provided on how to treat securities that are used for efficient portfolio management (EPM). Any thresholds should take into account, depending on the type of product (as they all have different requirements on what % can be held in various types of securities), funds that hold positions in cash, cash-like instruments, index exposures for EPM and other derivatives (e.g., credit default swap with a short position on the underlying) and provide clarity on how these should be accounted for when calculating thresholds.
8. How to take account, depending on the type of product, of portfolio turnover and/or review time for existing holdings where its ESG assessment is being downgraded due to change in its approach to sustainability or incidents? For the latter, keeping fiduciary duty in mind, investment managers will need adequate time to reassess and exit at an appropriate time to ensure underlying investors are not negatively impacted.

All these questions need to be addressed through proper consultation.

As explained in response to Question 1, we reiterate that, should ESMA decide to set prescriptive guidelines on fund names, they should include both quantitative and qualitative aspects. Such an exercise is not numerically data driven but relies on analysing how well methodologies are incorporated into a process. We are concerned that a threshold-based approach on its own would lead to a “tick-the-box” exercise, where a much more qualitative analysis is required. If fund managers are required to show the depth and meaningfulness of the engagement techniques that they use, that will produce better results than a simple numeric box-ticking exercise.

<ESMA\_QUESTION\_FUNA\_2>

1. : 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.

<ESMA\_QUESTION\_FUNA\_3>

**No.** We do not support 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 through ESMA guidelines is not workable in the current state of SFDR. Besides, if an 80% threshold is adopted for ESG it should apply to any ESG or sustainability-related terms. There is no reason to provide a lower threshold for sustainability. Should ESMA continue considering an imposition of a threshold through ESMA guidelines, we would propose that it is paired with a qualitative assessment.

<ESMA\_QUESTION\_FUNA\_3>

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

<ESMA\_QUESTION\_FUNA\_4>

**No.** We do not support the inclusion of an 80% threshold mechanism through ESMA guidelines,

Should ESMA continue considering an imposition of an 80% threshold through ESMA guidelines, we would propose that it is paired with a qualitative assessment. As we note in Questions 2 and 3, reliance upon a quantitative threshold on its own, for the reasons noted would be very difficult. Therefore, a combined approach to assessing a fund’s name, looking at both quantitative and qualitative factors, with the ultimate determination left to the Member State regulators to prevent the use of misleading names is preferable.

<ESMA\_QUESTION\_FUNA\_4>

1. : 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.

<ESMA\_QUESTION\_FUNA\_5>

**No.** We do not support the inclusion of an 80% threshold mechanism through ESMA guidelines. Should ESMA continue considering an imposition of an 80% threshold through ESMA guidelines, we would propose that it is paired with a qualitative assessment. As we note in Questions 2 and 3, reliance upon a quantitative threshold on its own, for the reasons noted would be very difficult. Should ESMA develop guidelines, these must take into account the qualitative assessments which outline the processes of investing and engaging with portfolio companies.

<ESMA\_QUESTION\_FUNA\_5>

1. : 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.

<ESMA\_QUESTION\_FUNA\_6>

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<ESMA\_QUESTION\_FUNA\_6>

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

<ESMA\_QUESTION\_FUNA\_7>

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<ESMA\_QUESTION\_FUNA\_7>

1. 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?

<ESMA\_QUESTION\_FUNA\_1>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_FUNA\_1>

1. Are there any other measures you would recommend for derivatives for the calculation of the minimum proportion of investments?

<ESMA\_QUESTION\_FUNA\_2>

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<ESMA\_QUESTION\_FUNA\_2>

1. : 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.

<ESMA\_QUESTION\_FUNA\_8>

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<ESMA\_QUESTION\_FUNA\_8>

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

<ESMA\_QUESTION\_FUNA\_9>

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<ESMA\_QUESTION\_FUNA\_9>

1. : Do you agree of having specific provisions for “impact” or impact-related names in these Guidelines?

<ESMA\_QUESTION\_FUNA\_10>

**No.** We do not agree there should be provisions designed by ESMA for funds using the word “impact” or “impact investing” or any other impact-related term in their name in the existing legislative framework.

Unfortunately there is no clear and accepted definition of “impact investment”. We therefore reiterate that clarification is required first from EU legislators. Then, ESMA will be in a position to issue more fulsome interpretations and guidelines.

We stand ready to provide and discuss, with the European Commission and the two co-legislators, examples of industry-accepted frameworks in development at international level in the field of impact investing. For instance, the Operating Principles for Impact Management (Impact Principles), with 100+ signatories, are a widely accepted framework for investors for the design and implementation of their impact management systems, ensuring that impact considerations are integrated throughout the investment lifecycle.

<ESMA\_QUESTION\_FUNA\_10>

1. : Should there be specific provisions for “transition” or transition-related names in these Guidelines? If yes, what should they be?

<ESMA\_QUESTION\_FUNA\_11>

**Yes.** Federated Hermes firmly believes that EU sustainable finance regulations (at legislative level) should incorporate “transition”. We hope our recommendations assist policy makers in paving the way for a better and quicker recognition of “transition” investing; i.e., investing in companies that are not currently sustainable (under TR and SFDR definitions) but which through meaningful engagement, have the potential to transition to or enhance their sustainable operations, processes, and activities.

Should ESMA maintain these proposed guidelines, we suggest it should include a clear and concise statement that the use of the terms ESG and/or any sustainability-related terms include those assets in its quantitative thresholds that are, through existing or future engagement, could transition to or enhance their sustainable operations, processes, and activities. Any inclusion of transition assets by fund manager to meet a quantitative threshold should be supported by evidence, ex-ante, of the identification of a transition/improvement opportunity.

In the “transition” area, we reinforce our caution against a purely quantitative approach. The nature and measurement of engagement success is intrinsically qualitative. For example, the engagement objective milestone progress approach which Federated Hermes pioneered and launched back in 2009, whilst ostensibly quantitative and systematic, if considered solely in that way and without the qualitative evaluation of the objectives set and the progress made that we do, would lead to box-ticking not meaningful change.

Another example illustrating the need for a qualitative approach is that some fund manager would purport to offer a transition fund on the basis that the fund would deliver a year-on-year improvement in the portfolio WACI. At face value this could suggest the fund comprises a portfolio of companies improving their carbon intensity and transitioning to be Net-Zero aligned. With a purely quantitative measure however, the fund manager could tweak portfolio weightings to show a WACI reduction at fund level, while there is possibly no change in the absolute emissions associated with each of the portfolio companies.

A fund which incorporates “transition” or “improvement” should be able to: i) evidence to the NCA that the portfolio is constructed accordingly; ii) evidence that improvement or transition has been realised or may still be realised; and iii) evidence that proportionate engagement efforts have been made to achieve the improvement or transition. A combination of these points should enable such funds/financial products to be distinct from a ‘vanilla’ ESG-integrated or SFDR Article 8 product. As much as ESMA is looking to set a high bar and provide guidelines for regulators and the industry, the focus should be on quality of engagement combined with a commitment by the NCAs to thoroughly review a fund’s disclosure against its real-world performance, evaluate its supporting documentation, and when necessary, hold firms accountable for greenwashing.

We recommend that SFDR and other relevant sustainable finance regimes consider including a “transition” or “improvement” category to reflect funds which are seeking to improve the sustainability performance of its investees rather than simply have categories of funds which reflect how sustainable investees already are. It is incredibly important that the definition of “sustainable investments” for Article 8 and 9 funds, include investee companies that either i) have transition strategies; or ii) are identified by financial market participants as being entities that could improve their environmental and social characteristics through engagement and such investee companies are, as evidenced in a reasonable period of time, willing to engage and/or are engaging.

While investing in companies that are currently contributing to an environmental or social objective is an important element of “sustainable investment”, financing the transition of investee companies which are engageable or in the midst of transitioning, will be critical in delivering the EU Green Deal and the achievement of Net Zero. Enhancing the guidance on SFDR to reflect the benefits of engagement and transition should be promoted and rewarded.

<ESMA\_QUESTION\_FUNA\_11>

1. : The proposals in this consultation paper relates 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?

<ESMA\_QUESTION\_FUNA\_12>

**Yes**. To ensure a level playing field, minimize investor confusion, and prevent any regulatory arbitrage, any requirements on the use of ESG or sustainability-related names should apply to other sectors.

<ESMA\_QUESTION\_FUNA\_12>

1. : 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.

<ESMA\_QUESTION\_FUNA\_13>

**No**. Given the challenges involved in implementation, and the work required not only by fund managers but also the NCAs, we believe a transition period of at least 12 months is more appropriate for existing funds. We do believe a 6 month transition would be appropriate for any new funds.

<ESMA\_QUESTION\_FUNA\_13>

1. : 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.

<ESMA\_QUESTION\_FUNA\_14>

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<ESMA\_QUESTION\_FUNA\_14>

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

<ESMA\_QUESTION\_FUNA\_15>

Should ESMA adopt these guidelines as currently drafted, there would be substantial negative consequences, including:

* Adding confusion and uncertainty where the lack of definitions has just started being addressed and in a context where we understand the Commission might not provide the much-needed clarity by using of its power of interpretation but by suggesting SFDR should be reformed – a legislative file that might not start before early 2025;
* Imposing a tick-the-box exercise to fund managers and quantitative supervisory approach to NCAs, where a much more qualitative analysis is of paramount importance for the success of the EU sustainable finance regime;
* Unlike what ESMA states in its cost-benefit analysis – without any evidence- or data-based analysis -, imposing significant compliance costs for funds and fund managers who would have to reconsider all their fund and marketing documents.

<ESMA\_QUESTION\_FUNA\_15>

1. : What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

<ESMA\_QUESTION\_FUNA\_16>

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<ESMA\_QUESTION\_FUNA\_16>