Sustainability-Related Terms in EU and UK Funds' Names

There are various definitions of greenwashing, but in the EU the ESAs have provided a common understanding of what this means, being a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. [1]

The European Securities and Markets Authority (ESMA) and the UK's Financial Conduct Authority (FCA) have therefore taken action with the aim that fund managers are, amongst other things, acting honestly and fairly when marketing sustainable funds to investors.

However, ESMA and the UK FCA have taken different paths. In May 2024, ESMA published a final report regarding six new categories of sustainability-related terms for use in funds' names (**Guidelines**).[2] The Guidelines are intended to complement the EU's Sustainability Finance Disclosure Regulation (**SFDR**), which was published on 27 November 2019,[3] and is currently subject to an ongoing European Commission review.[4]

In the UK however, the FCA's Policy Statement on Sustainability Disclosure Requirements and Investment Labels regime (**SDR**), published in November 2023, establishes a general anti-greenwashing rule, four bespoke sustainability labels, disclosure requirements, and requirements for how to use sustainability-related terms in funds' naming and marketing.[5]

Thus, the first key difference between the two regimes is: ESMA groups sustainability-related terms into six broad categories (each with their own rules and expectations) and the FCA provides a set of rules for use of specific fund labels or sustainability-related terms in their names.

Managers operating in both the UK and EU – whether marketing the same funds to both UK and EU investors or marketing separate funds to each group – may benefit from understanding how the two fund naming regimes work, alongside where they differ.

ESMA's Guidelines on Funds' Names

ESMA's Guidelines introduces six categories of terms based on their relation to a particular theme: "Social", "Governance", "Transition", "Environmental", "Impact", and "Sustainability". The below table, summarised from the Guidelines, provides examples of each category and the respective regulatory requirements for fund managers to meet to use these terms:

Categories	Examples from Guidelines	Guideline requirements for category
"Social"-related terms	Any words giving the investor any impression of the promotion of social characteristics, e.g., 'social', 'equality', etc.	1. Meet 80% threshold of investments used to meet environmental, social, or sustainable investment objectives in accordance with the binding elements of the investment strategy, which are to be disclosed under CDR.[6] 2. Exclude investments into companies as per the Climate Transition Benchmarks.
"Governance"-related terms	Any words giving the investor any impression of a focus on governance, e.g. 'governance', 'controversies', etc.	(1 and 2 the same as Social above).
"Transition"-related terms	Any terms derived from the base word 'transition', e.g., 'transitioning', 'transitional' etc. and those terms deriving from 'improve', 'progress', 'evolution', 'transformation', 'net-zero' etc.	(1 and 2 the same as Social above). 3. Ensure investments used to meet the threshold are "on a clear and measurable path to social or environmental transition."
"Environmental"-related terms	Any words giving the investor any impression of the promotion of environmental characteristics, e.g. 'green', 'environmental', 'climate', etc. These terms may also include 'ESG' and 'SRI' abbreviations.	(1 the same as Social above). 2. Exclude investments into companies as per the EU Paris-aligned Benchmarks.
"Impact"-related terms	Any terms derived from the base word 'impact', e.g., 'impacting', 'impactful', etc.	(1 and 2 the same as Environmental above). 3. Ensure investments used to meet the threshold are "made with the objective to generate a positive and measurable social or environmental impact alongside a financial return."
"Sustainability"-related terms	Any terms only derived from the base word 'sustainable', e.g., 'sustainably', 'sustainability', etc.	(1 and 2 the same as Environmental above). 3. Commit to invest meaningfully in sustainable investments referred to in Article 2(17) of the SFDR.[7]
Where terms are combined, they apply cumulatively – apart from names which include terms in the "transition" or "sustainability" category, where other rules apply.[8]		

One of the requirements relating to the terms mentioned in the table above is that (as applicable) funds need to observe exclusions based on criteria found in either the Paris Aligned Benchmark (**PAB**) for most sustainability-related terms, or the Climate Transition Benchmark (**CTB**) for transition-related terms.

The CTB exclusions are, as per Article 12(1) of EU 2020/1818, any companies that are:

a) Involved in "any activities related to controversial weapons;"

b) Are involved in "the cultivation and production of tobacco;" or

c) Are found "in violation of the United Nations Global Compact (UNGC) principles of the Organization for Economic Cooperation and Development (OECD) Guidelines."[9]

The PAB exclusions are inclusive of the CTB exclusions, but also include companies that derive at least:

d) 1% of revenues from hard coal and lignite;

e) 10% of revenues from oil fuels;

f) 50% of revenues from gaseous fuels; or

g) 50% of revenues from "electricity generation with a GHG intensity of more than 100 g CO2 e/kWh."

ESMA's "Sustainability" category was a key area of industry feedback to the earlier consultation paper in November 2022.[10] In its initial draft of rules for funds' names, ESMA required that funds using terms in the Sustainability category have 50% of the fund invested in sustainable investments. This criteria was changed after the consultation, and now fund managers are instead required to invest meaningfully into, as per SFDR, assets which actively contribute to a sustainability objective or which invest into "human capital or economically or socially disadvantaged communities."

The FCA's Rules on Funds' Names

The FCA's anti-greenwashing rule (AGR) is one measure from the SDR policy statement and applies to all FCA-authorised firms that communicate to clients in the UK, or communicate (or approve for communication) a financial promotion to persons in the UK, whether or not they undertake in-scope sustainability business. Where FCA-authorised firms do so, and when doing so reference a product's or service's sustainability characteristics, then the AGR may apply.

Whilst the AGR will have broad application, the FCA has also introduced specific rules for funds' names which start to apply in H2 2024. For further information on products and firms in scope of the regime, see Chapter 10 of PS23/16.

Unlike ESMA's Guidelines however, the SDR provides two pathways to being able to use sustainability-related terms in a funds' name or marketing materials.

The first pathway is for a fund manager to opt into the FCA's fund labelling rules, which (apart from 'Impact' label, which can only be used with the Sustainability Impact label) gives fund managers the right to use certain prescribed sustainability-related terms in their funds' names.

For details on the FCA's sustainability labels and the specific criteria that in-scope funds must meet to use said labels, please refer to Trustee & Fiduciary Regulatory Insight's article titled 'UK FCA Confirm Sustainability Disclosure and Labelling Regime.'

If a fund manager opts not to use a sustainability label, there is a second pathway for fund managers to be able to use sustainability-related terms in their funds' naming. More details about these requirements – many of which reflect the initial requirements for sustainability labels – can be found in Trustee & Fiduciary Regulatory Insight's recent article mentioned above. However, even if a fund without a sustainability label meets the requirements, there are restrictions on the use of the terms 'sustainable,' 'sustainability,' or 'impact' as these are reserved for funds enrolled in the labeling scheme only.

As part of the second pathway, the requirement for funds to use sustainability-related terms in their names without using sustainability labels states that a given fund's sustainability characteristics should be "material to that product."[11] The FCA's rules do not give a specific definition of materiality but do provide, as an example, "that at least 70% of its assets have sustainability characteristics."[12]

There is one exception to these two pathways for funds' naming and marketing materials which include sustainability-related terms: firms may use these terms in contexts not related to the underlying sustainability characteristics of the fund.

Which funds fall under scope of the European and UK regulations?

The cost-benefit analysis included in Annex III on Page 43 of ESMA's Guidelines estimates that approximately 6,490 UCITS and AIF managers undertaking sustainability business fall under scope of its Guidelines, while the FCA estimates that 1,393 fund managers fall under scope of the fund labelling requirements.[13] However it's worth noting that the FCA's AGR – which also impacts funds' names in that they must be clear, fair, and not misleading and consistent with the sustainability characteristics of the product or service – is expected to apply to a wider population (estimated 45,608 firms) regardless of whether they are undertaking sustainability in-scope businesses (e.g. managing funds in scope of the SDR rules) or not.[14]

However, the definition of sustainability in-scope business (as it is used in the ESG Sourcebook) highlights another key difference between the ESMA and the FCA regimes – their scope. For example, in Europe, European Venture Capital Funds, European Social Entrepreneurship Funds, European Long Term Investment Funds, and Money Market Funds are all captured by ESMA's Guidelines. However, whilst the FCA SDR regime applies to certain UK UCITS and AIFs, the FCA excludes Social Entrepreneurship Funds and Registered Venture Capital Funds.

Likewise, after its consultation with industry participants and consumer advocates, the FCA agreed that closed-end funds (which made no further investments after 22 July 2013) should be exempt from the SDR regime. However, despite acknowledging similar concerns from its consultation, ESMA's Guidelines have no such exemption for closed funds.

On 23 April 2024, the FCA published a consultation paper on extending its regime to portfolio managers.[15] For more information about the scope of this proposal and its implementation timeline, refer to Trustee & Fiduciary Regulatory Insights' article titled 'UK FCA Proposes Extending SDR to Portfolio Management.'

Do the regulations apply to overseas funds?

The FCA is clear that SDR currently only applies to in-scope UK funds. However, the FCA has stated it will be working closely with HM Treasury (as this issue falls under their remit) to develop a plan to incorporate overseas funds into the regulation in the future.[16] This is currently expected in the second half of 2024, but may be delayed.

In the meantime, distributors of funds to retail investors in the UK must clearly display that overseas funds are not part of the UK's fund naming and labelling regime.

More clarity is needed on the EU's approach to overseas funds.

Are feeder funds in scope?

The FCA specifies that feeder funds can use sustainability labels only when the "purpose of the feeder is to reflect the sustainability objective of the master fund."[17]

However, feeder funds without sustainability labels can only "use the same sustainability-related terms in their name and marketing as their master fund," and only if they provide investors easy access to the master funds' disclosures.[18]

ESMA's Guidelines do not detail specific policies regarding feeder funds.

What should fund managers do if their fund uses an index as a benchmark?

ESMA and the FCA have similar approaches to funds which use an index as a benchmark. ESMA writes that funds should only use sustainability-related terms in their name if the fund meets the general and specific criteria to do so – regardless of whether it uses an index as a benchmark or not. Furthermore, Article 9 under the EU's SFDR is designed for funds where "an index has been designated as a reference benchmark."

The FCA writes that these funds should only use sustainability terms in their name if the firms can demonstrate that the indexes are in full compliance with SDR labeling and naming rules. The FCA does acknowledge that this rule means that either a) some firms will have to change the names of some of their index-tracking funds or b) fund managers will need to lobby index providers to ensure their indexes comply with SDR.

When do the regulations come into force?

ESMA's final report and Guidelines were published on 14 May 2024 – which automatically triggered the process of translating the report into the official EU languages. Once this process is completed, the rules will apply for all new funds after a further three months. Thus, the guidelines will apply to new funds no earlier than 14 August 2024. ESMA's Guidelines also detail an additional six-month extension for funds that already exist, giving fund managers to at least 14 February 2025 to comply.

The FCA's policy statement was published on 28 November 2023. The AGR came into force on and applies from 31 May 2024. Fund managers may start using the FCA's sustainability labels on 31 July 2024.

Once a fund manager starts to use sustainability labels, it must immediately comply with the FCA's rules on fund naming and marketing. On 2 December 2024, the FCA's rules on fund naming and marketing become universally applicable, regardless of whether a fund manager uses sustainability labels or not.

How will the regulators approach the minimum thresholds?

Both regulators have a minimum threshold as a key part of their naming and/or labelling regimes in some way. See the above sections 'ESMA's Guidelines on Funds' Names' and 'The FCA's Rules on Funds' Names' for more details.

One question brought up repeatedly in responses to earlier consultations with the regulators is what, if anything, can be excluded from these calculations? For example, some funds hold derivatives or cash for risk-mitigation purposes. ESMA's answer is that the 80% threshold will be derived from the firm's SFDR disclosures regarding the proportion of the fund that has sustainable characteristics.[19] Therefore, the decision to include any asset in the calculations will reflect the choices already made by the fund manager in their SFDR disclosures.

Similarly, the FCA is "not being prescriptive around how exposures should be calculated for the purposes of meeting any thresholds," asking fund managers instead to reflect the reality of their funds' investment objectives and portfolios in their disclosures.

Will the regulators punish passive breaches of the minimum thresholds?

ESMA and the FCA have expressed similar approaches to passive breaches. The FCA wrote that they "would ordinarily only expect minimal deviations from the 70% threshold."[20] ESMA has also acknowledged that small and/or temporary breaches of the 80% threshold should be treated as passive breaches.[21] However, they specify that these deviations must not be the result of the fund manager's deliberate choices.

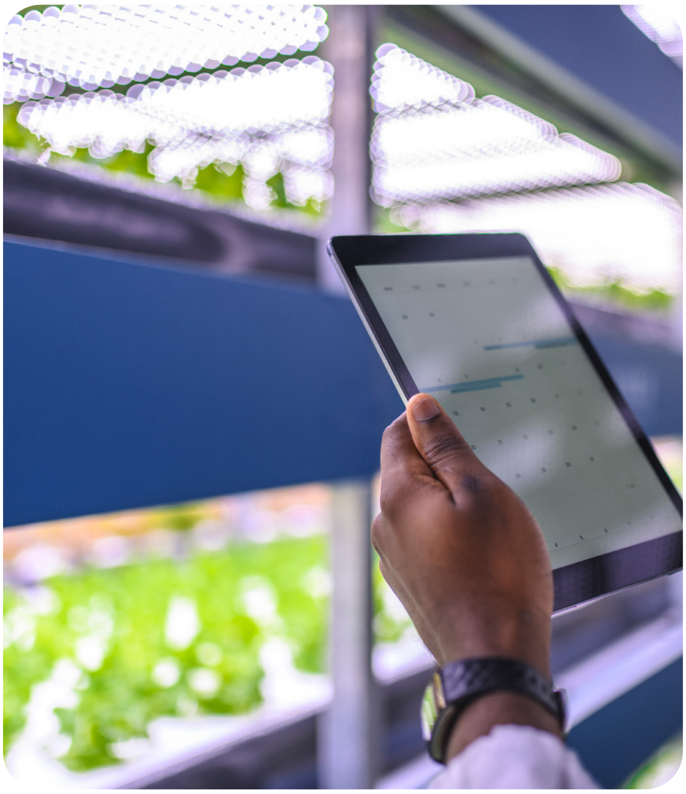
Next steps

Given that firms' review process for ensuring that UK funds are compliant with the UK SDR and labelling regime is likely still ongoing, in-scope firms may now have the additional task of reviewing their European fund range as well.

This will be against the backdrop of an evolving regulatory and legal regime as, since this article was written, other relevant papers have also been published such as the European Supervisory Authorities (ESAs) final reports on greenwashing in the financial sector.

In this case each ESA provides a stock take of the current supervisory response to greenwashing risks under their remit (ESMA, EIOPA, EBA) and notes that Member State competent authorities are already taking steps as regards the supervision of sustainability-related claims.

Then alongside the ESA's final reports on greenwashing, on 18 June 2024, they have also proposed improvements to the SFDR.[22]



[1] See https://www.esma.europa.eu/sites/default/files/2023-06/ESMA71-545613100-2323_ESAs_put_forward_common_understanding_of_greenwashing_and_warn_on_risks_-_Press_release.pdf

[2] See ESMA34-472-440 Final Report on the Guidelines on funds names (europa.eu)

[3] See Regulation – 2019/2088 – EN – sfdr – EUR-Lex (europa.eu)

[4] See https://finance.ec.europa.eu/news/financial-markets-commission-consults-sustainable-finance-disclosures-2023-09-14_en

[5] See PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

[6] See Annexes II and III of CDR (EU) 2022/1288

[7] See Regulation – 2019/2088 – SFDR Article 2(17)

[8] See ESMA 34-472-440 Page 56 Paragraphs 19 and 21

[9] See Delegated regulation – 2020/1818 – EN – EUR-Lex (europa.eu)

[10] See Consultation on Guidelines on funds' names using ESG or sustainability-related terms (europa.eu)

[11] See FCA 2023/39 Page 39 4.3.6(1)

[12] See FCA 2023/39 Page 39 4.3.6(1)

[13] See ESMA 34-472-449 Annex III Page 43

[14] See PS23/16 Page 81 Table 20

[15] See CP24/8: Extending the Sustainability Disclosure Requirements (SDR) regime to Portfolio Management (fca.org.uk)

[16] See PS23/16 Page 75 FCA's response to 'General feedback on benefits'

[17] See PS23/16 Page 65 FCA's Response to 'Feeder Funds'

[18] See PS23/16 Page 65 FCA's Response to 'Feeder Funds'

[19] See ESMA 34-472-440 Pages 17 and 18 ESMA's response to Q7

[20] See PS23/16 Page 104 Paragraph 41

[21] See ESMA 34-472-440 Page 57 Paragraph 22

[22] See https://www.esma.europa.eu/press-news/esma-news/esas-propose-improvements-sustainable-finance-disclosure-regulation

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