

ALERTS

ESG Update for Funds Offered in the EU: What's in a Name?

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Managers that offer ESG-focused funds to European investors should take note of the final “Guidelines on Funds’ Names Using ESG or Sustainability-related Terms” (“Guidelines”) published by the European Securities and Markets Authority (“ESMA”) on 14 May 2024.^[1] The Guidelines will affect funds established in the EU and, depending on the approach of the local EU member state regulators, are also likely to affect non-EU funds marketed in accordance with the EU national private placement regimes (“NPPRs”) established under the Alternative Investment Fund Managers Directive.

The Guidelines will not apply to non-EU funds that have not been notified for marketing in EU countries, such as when a fund is offered to a professional investor in the EU on the basis of a valid reverse solicitation. Equally, the Guidelines will not apply to funds marketed in the United Kingdom.

Managers of EU funds (both alternative investment funds (“AIFs”) and UCITS) and AIFs registered under NPPRs are already required to comply with Article 6 and, if applicable, Articles 8 or 9 of the EU Sustainable Finance Disclosure Regulation^[2] (“SFDR”) which set out pre-investment disclosure obligations related to sustainability. The Guidelines expand these disclosure obligations where the fund’s name contains any ESG, transition, impact or sustainability-related terms.

The stated objectives of the Guidelines are to protect EU investors from unsubstantiated or exaggerated sustainability claims and to provide clear and quantifiable criteria for fund managers to determine whether they can

use ESG or sustainability-related terms to promote their funds. The basic assumption of the Guidelines is that any fund that uses such terms in its name will either fall within the SFDR disclosure regime under Article 8 (as a fund promoting one or more environmental or social characteristics) or Article 9 (as a fund with a sustainable investment objective).

The Guidelines require EU regulators (that will commit to the Guidelines) to consider the conditions set out below in their supervisory approaches to funds throughout the life of the fund. A temporary deviation from the threshold and exclusions should be treated as a passive breach which the manager must correct in the best interests of investors, unless such a breach is deliberate.

Requirements for Funds With ESG or Sustainability-Related Names

The Guidelines will apply to any funds with environmental, social, governance, transition, impact or sustainability-related terms in their names. ESMA has provided the following definitions and examples of such names:

- Transition-related names are any terms derived from “transition” (such as “transitioning” “transitional”) or terms such as “improve”, “progress”, “evolution”, “transformation” or “net zero”.
- Environmental-related terms encompass any word that gives an investor an impression of the promotion of environmental characteristics, such as “green”, “environmental”, “climate”, “ESG” or “SRI”.
- Social terms include “social”, “equality” or similar.
- Governance-related terms are “governance”, “controversy” or any other term which gives an impression of a focus on governance.
- Impact-related names will include any word derived from “impact”, such as “impacting” or “impactful”.

Funds with “*transition*”, “*social*” or “*governance*”-related names should:

- Have 80 percent of their portfolio of investments meet, as applicable, the relevant environmental or social characteristics (within the meaning of Article 8 of SFDR) or sustainable investment objectives (within the meaning of Article 9 of SFDR); and

- Exclude investments in companies involved in: (i) any activities related to controversial weapons, (ii) cultivation and production of tobacco, and (iii) in companies that administrators of EU Paris-aligned Benchmarks exclude on the basis that they are in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises (collectively, the “Climate Transition Benchmark Exclusions”).[3]

Funds with “*environmental*” or “*impact*”-related terms in their name must also meet the above 80 percent investment proportion threshold and the above Climate Transition Benchmark Exclusions. In addition, these funds must also exclude investments in companies that derive (i) 1 percent or more of their revenues from exploration, mining, extraction, distribution or refining hard coal and lignite, (ii) 10 percent or more of their revenues from the exploration, extraction, distribution or refining of oil fuels, (iii) 50 percent or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels, or (iv) 50 percent or more of their revenues from electricity generation with a GHG intensity of more than 100g CO₂e/kWH (together with the Climate Transition Benchmark Exclusions, the “Paris-aligned Benchmark Exclusions”).[4]

Funds with “*sustainability*”-related terms in their name must (i) meet the above 80 percent investment threshold, (ii) excludes investments falling within the Paris-aligned Benchmark Exclusions; and (iii) commit to invest *meaningfully* in sustainable investments as referred to in Article 2(17) of SFDR. The term “meaningfully” has not been defined and no specific threshold of sustainable investments has been proposed.

Funds with “*transition*” or “*impact*”-related terms in their names should *additionally* ensure that investments that are used to meet the 80 percent threshold are on a “clear and measurable path to social or environmental transition or are made with the objective to generate a positive and measurable impact alongside a financial return”.

Funds with names combining multiple terms are subject to the above requirements cumulatively. The only exception is for “*transition*”-related terms where only the requirements applicable to “*transition*”, “*social*” and “*governance*” fund names apply.

Funds designating an index as a reference benchmark should only use the relevant ESG or sustainability names if the fund also satisfies the

guidelines associated with the name, as set out above.

All funds falling within the above categories must disclose the binding elements of their investment strategy using the pre-contractual disclosure templates set out in the Commission Delegated Regulation (EU) 2022/1288.[5]

Next Steps

The Guidelines will apply three months following their publication on ESMA's website in the official languages of EU member states. There will be a six-month transition period for existing funds. Any new funds established after the application date should apply the Guidelines immediately.

Authored by *Anna Maleva-Otto* and *Matthew Dow*.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] European Securities and Markets Authority, Final Report, Guidelines on funds' names using ESG or sustainability-related terms, 14 May 2024.

[2] Regulation (EU) 2019/2088.

[3] Articles 12(1)(a) to (c) of Commission Delegated Regulation (EU) 2020/1818.

[4] Articles 12(1)(a) to (g) of Commission Delegated Regulation (EU) 2020/1818.

[5] Annex II & III of the Commission Delegated Regulation (EU) 2022/1288

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Related People



**Anna
Maleva-Otto**
Partner
London



**Matthew
Dow**
Associate
London

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