European Securities and Markets Authority

Reply form for the Consultation Paper on Guidelines for the use of ESG or sustainability-related terms in funds' names

18 November 2022

European Securities and Markets Authority

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 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 under the headings 'Legal notice' and 'Data protection'.

General information about respondent

Name of the company / organisation	Morningstar
Activity	Other Financial service providers
Are you representing an association?	☐
Country/Region	International

Introduction

Please make your introductory comments below, if any:

<ESMA_QUESTION_FUNA_0>

From Morningstar Inc.

Ladies and Gentlemen,

Morningstar welcomes the opportunity to comment on ESMA's draft Guidelines on funds' names using ESG or sustainability-related terms. Morningstar is a leading provider of independent investment research and has a long history of advocating for transparency in global markets.

Morningstar brings a unique perspective to the questions posed in the proposal. As the world's largest provider of mutual fund data and ratings, we have a long history of advocating for transparency in global financial markets. Morningstar's mission is to empower investor success. We evaluate how funds perform along a variety of environmental, social, and governance, or ESG, factors, and analyse funds based on their ESG disclosures in regulatory filings, through data on fund manager stewardship activities like proxy voting, and based on their underlying holdings using Sustainalytics's company-level ESG Ratings that are aggregated up to the fund. Because we offer an extensive line of products for individual investors, professional financial advisors, and institutional clients, we have a broad view on the proposals and the possible effects of future final rules for investors.

<u>Executive summary</u>

We note that the guidelines would constitute a significant addition to SFDR, requiring most article 8 funds to go beyond the current transparency exercise and follow prescriptive portfolio composition requirements.

While in principle we are not opposed to setting minimum standards when certain terms are used in fund names, we believe the guidelines need to be refined and address the following points:

- **Definitions**: There is a need to further define what is considered an 'ESG-related term' versus a 'sustainability-related term' if the guidelines are to be applied as proposed. We recognize this may not be an easy task, but clarity is absolutely essential to ensure consistent application across the industry and to avoid undue greenwashing suspicions or accusations. Alternatively, we present two options below that could simplify the approach and remove the need for distinguishing between these two categories of terms.
- **Exclusions**: While minimum exclusions constitute a sensible safeguard from a retail investor point of view and are current practice for ESG funds, ESMA should carefully consider (1) the cumulative effects of these exclusions and (2) the risk of having discrepancies between EU Paris-Aligned Benchmark (PAB) exclusions and those required by national labels, resulting in a confusing landscape for retail investors.
- **80% portfolio threshold for funds using ESG-related terms**: We suggest that cash and other liquidity/hedging instruments should be excluded from the portfolio threshold calculation. Without this adjustment to the calculation, ESG funds not investing in listed equities or trying to serve conversative investors (i.e. from a risk appetite perspective) will find it difficult to meet the

requirement. Alternatively, ESMA could account for different fund liquidity profiles and lower the 80% threshold.

- **50% portfolio threshold for funds using sustainability-related terms:** We suggest waiting for the EC clarification[1] on the calculation of sustainable-investments (company threshold) to appropriately calibrate the portfolio threshold. In the absence of clarification, we suggest requiring funds to disclose in pre-contractual materials 'How sustainability is defined for this product?'. This would highlight to investors similarities or differences when considering and comparing products.

Alternative options for ESMA to consider:

(1) **Explore the option of minimum <u>transparency requirements</u> for each key category of terms (e.g. climate transition, impact).** For instance, funds using climate-related terms such as 'climate transition', 'climate change', 'climate impact' could disclose their portfolio carbon footprint or decarbonization target in line with trajectory of the Intergovernmental Panel on Climate Change's 1.5˚C scenario and net-zero ambitions by the year 2050. Transparency for funds using other terms could be enhanced by requiring funds to disclose the performance of relevant and selected key performance indicators versus their benchmark (e.g. SFDR Principal Adverse Impacts or SDGs Indicators).

(2) **<u>A label-type regime</u> whereby the interpretation of what pertains to 'ESG-related terms' versus 'sustainability-related terms' is not an issue anymore as fund managers would simply have to choose between three buckets or cease to use any 'ESG and sustainability-related terms':**
   - article 8 (80% ESG + exclusions)
   - article 8+(50% SI + exclusions)
   - article 9 (100% SI + exclusions)

Yours faithfully,

Arthur Carabia, Director, ESG policy research

<ESMA_QUESTION_FUNA_0>

[1] JC 2022 47 - Union law interpretation questions under SFDR (europa.eu)

Q1 : Do you agree with the need to introduce quantitative thresholds to assess funds' names?

<ESMA_QUESTION_FUNA_1>
In principle, we are not opposed to quantitative thresholds to the extent that they serve investors, constitute a reasonable bar to meet by fund managers, and are consistent with prudential and other sustainability related policies. The main goal should be to avoid greenwashing, not necessarily to change or upgrade practices.

EU PAB exclusions for funds using ESG or sustainability-related terms

Applying negative screens is a common feature of ESG products and would be therefore a reasonable expectation for funds using ESG-related terms in its name.

Fund industry readiness: Our data suggest that most article 8 funds are partially aligned with some of the EU PAB exclusions (when considered separately):
-About 76.5% have zero involvement in controversial weapons;
-About 83% have no involvement in companies that derive some revenues from tobacco manufacturing;
-About 85% have less than 1% exposure to companies deriving some revenues from thermal coal;
-About 85% have less than 10% exposure to companies deriving some revenues from fossil fuels;
It should be noted that this is only an approximative indication of current readiness. ESMA should consider other exclusions (electricity generation, OECD and UNGC) which we did not assess and most importantly the cumulative effect of these exclusions. If the current state of the fund industry is not aligned with the finalized Guidelines, there is a risk cause investor confusion, due to many funds changing their names or investment objectives, and potentially investor harm, due to unexpected losses as funds trade to align their portfolios with new standards.

Additional complexity with norm-based exclusions: While we support the exclusions based on OECD guidelines and UNGC principles, we want to highlight that these are more complex than the other product/activity-based exclusions proposed. These norm-based exclusions are subject to interpretation and may lead in some instances to different portfolio outcomes.

Interpretation questions: We note that ESMA is referring to paragraph 1 (exclusions) and 2 (Taxonomy DNHS) in its draft guidelines. If it is indeed ESMA's intention to include the Taxonomy DNHS, the minimum standards would be very difficult for most funds to meet.

Regulatory consistency: Finally, we would like to highlight that national labels may have different exclusions thresholds than the ones set in the EU PAB and that these discrepancies may be confusing to end investors (unless national labels swiftly adapt to meet the draft guidelines).
Novethic_Panorama_des_Labels_2022_Mai_Etude_ENG.pdf

Threshold of 80% of the minimum proportion of investments for the use of any ESG-related terms

It is unclear from the proposal if instruments held for liquidity management (cash, derivatives, MMFs) and hedging purposes (derivatives) would be included under the calculation of the minimum proportion of investments aligned with E/S characteristics. If these are included, this could have the unintended consequence of introducing a de facto limit on the liquidity pocket of 20% as there are no evident E/S lenses for some of these types of instruments. This limit could be an issue for certain funds (e.g. alternative assets) or client types (more risk averse) who want to consider E/S aspects but are faced with more stringent liquidity management processes. It may therefore be preferable to say that 100% of eligible investments of the fund need to be aligned with the E/S characteristics and scope out assets held for liquidity management/hedging purposes from the calculation.

Additional 50% minimum proportion of investments for the use of any sustainability-related ter

Upcoming regulatory development: Setting a strict 50% minimum portfolio threshold is premature at this stage as the ESAs and fund managers are still expecting clarification from the EC on the calculation of sustainable investments. The ability of these funds to meet the portfolio threshold will largely depend on this upcoming regulatory guidance. A revenue-weighted approach would make it impossible for article 9 funds to meet their 100% SI investment obligation and will most likely force the EC to opt for pass-or-fail approach. It is however very difficult to find a company threshold that would be relevant across industries and is perceived as sufficiently high by retail investors.

Current market practice: Most recent data that we have collected suggests that just over one fourth (27%) of Article 8 funds which report a minimum proportion of SI and with "sustainable" in their names would meet the 50% threshold. This excludes MMF, FoF and feeder funds and other "sustainability-related terms" that ESMA may want to capture. We note that fund managers using a pass-or-fail approach tend to use a relatively low company threshold (15-20%).

<ESMA_QUESTION_FUNA_1>

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.

<ESMA_QUESTION_FUNA_2>
It is unclear from the proposal if instruments held for liquidity management (cash, derivatives, MMFs) and hedging purposes (derivatives) would be included under the calculation of the minimum proportion of investments aligned with E/S characteristics. If these are included, this could have the unintended consequence of introducing a de facto limit on the liquidity pocket of 20% as there are no evident E/S lenses for some of these types of instruments (e.g. cash). This limit could be an issue for certain funds (alternative assets) or client types (more risk averse) who want to consider E/S aspects but are faced with more stringent liquidity management processes. It may therefore be preferable to say that 100% of eligible investments of the fund need to be aligned with the E/S characteristics and scope out assets held for liquidity management/hedging purposes from the calculation. Alternatively, ESMA could account for different fund liquidity profiles and lower the 80% threshold.

<ESMA_QUESTION_FUNA_2>

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.

<ESMA_QUESTION_FUNA_3>
Upcoming regulatory development: Setting a strict 50% minimum portfolio threshold is premature at this stage as the ESAs and fund managers are still expecting clarification from the EC on the calculation of sustainable investments. The ability of these funds to meet the portfolio threshold will largely depend on this upcoming regulatory guidance. A revenue-weighted approach would make it impossible for article 9 funds to meet their 100% SI investment obligation and will most likely force the EC to opt for pass-or-fail approach. It is however very difficult to find a company threshold that would be relevant across industries and is perceived as sufficiently high by retail investors.

Current market practices: Most recent data that we have collected suggests that just over one fourth (27%) of Article 8 funds which report a minimum proportion of SI and with "sustainable" in their names would meet the 50% threshold. This excludes MMF, FoF and feeder funds and other "sustainability-related terms" that ESMA may want to capture.

Interpretation questions: it is unclear to us what ESMA intends to consider as sustainability-related terms.

<ESMA_QUESTION_FUNA_3>

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

<ESMA_QUESTION_FUNA_4>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_4>

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

<ESMA_QUESTION_FUNA_5>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_5>

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.

<ESMA_QUESTION_FUNA_6>
Applying negative screens is a common feature of ESG products and would be therefore a reasonable expectation for funds using ESG-related terms in its name.

Fund industry readiness: Our data suggest that most article 8 funds are potentially aligned with some of the EU PAB exclusions (when considered separately):
-About 76.5% have zero involvement in controversial weapons;
-About 83% have no involvement in companies that derive some revenues from tobacco manufacturing;
-About 85% lave less than 1% exposure to companies deriving some revenues from thermal coal;
- About 85% lave less than 10% exposure to companies deriving some revenues from fossil fuels;
That being said this is only an approximative indication of current readiness. ESMA should consider other exclusions (electricity generation, OECD and UNGC) which we didn't not assess and most importantly the cumulative effect of these exclusions.

Norm-based exclusions: While we support the exclusions based on OECD guidelines and UNGC principles, we want to highlight that these are more complex than the other product/activity-based exclusions proposed. These norm-based exclusions are subject to interpretation and may lead in some instances to different portfolio outcomes.

Interpretation questions:

- We note that ESMA is referring to paragraph 1 (exclusions) and 2 (Taxonomy DNHS) in its draft guidelines. If it is indeed ESMA's intention to include the Taxonomy DNHS, the minimum standards would very difficult to meet by most funds.
- It's unclear what terms would pertain to ESG-related terms vs sustainability-related terms. This would need to be clearly disclosed by market participants.

Regulatory consistency: Finally, we would like to highlight that national labels may have different exclusions thresholds than the ones set in the EU PAB and that these discrepancies may be confusing to end investors.
Novethic_Panorama_des_Labels_2022_Mai_Etude_ENG.pdf

<ESMA_QUESTION_FUNA_6>

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

<ESMA_QUESTION_FUNA_7>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_7>

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?

<ESMA_QUESTION_FUNA_1>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_1>

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

<ESMA_QUESTION_FUNA_2>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_2>

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.

<ESMA_QUESTION_FUNA_8>
Yes, the rules should apply to both passive and active funds.
<ESMA_QUESTION_FUNA_8>

Q9 : 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>
No, both physical and synthetic replication should be allowed and treated the same way under the guidelines.
<ESMA_QUESTION_FUNA_9>

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

<ESMA_QUESTION_FUNA_10>
The draft guidelines inappropriately treat impact funds the same way than products with ESG characteristics. We are therefore not opposed to having specific qualitative provisions for impact-related names in the guidelines.

We note that funds investing in public equities using the term 'impact' in the fund would most likely not meet the impact definition used in page 11 of the consultation paper ('generate'). Equity managers may indeed select listed companies based on their alignment with impact objectives and frameworks (% of revenues alignment with UN's SDGs) but there impact does not necessarily have to be the outcome of an impact-oriented investment.

<ESMA_QUESTION_FUNA_10>

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

<ESMA_QUESTION_FUNA_11>
There might be merit in setting minimum transparency obligations for funds using climate-related terms such as 'climate transition', 'climate change', 'climate impact'. In this case the transparency obligation would be met by reporting the portfolios decarbonization metrics to ensure it is in line with trajectory of the Intergovernmental Panel on Climate Change's 1.5˚C scenario and net-zero ambitions by the year 2050.
<ESMA_QUESTION_FUNA_11>

Q12 : 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, we believe the ESAs should aim for a consistent approach across financial products covered under SFDR.
<ESMA_QUESTION_FUNA_12>

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.

<ESMA_QUESTION_FUNA_13>
It depends on the stringency and the granularity of the final guidelines. But in light of draft proposal, we would advise to ensure enough lead time (e.g. 12 months) to favour an orderly transition and avoid sudden portfolio rebalancing to meet the guidelines.
<ESMA_QUESTION_FUNA_13>

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.

<ESMA_QUESTION_FUNA_14>
Retail investors mainly invest via open-ended funds rather than via closed-ended funds. When they are investing via closed-end funds, retail investors tend to be exposed to alternative asset classes which are less liquid (typically real-estate). Portfolio shifts as a result of the guidelines could be costly for retail investors investing via closed-ended funds. Therefore it's best to apply the guidelines to closed-ended funds launched after the application date.

<ESMA_QUESTION_FUNA_14>

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

<ESMA_QUESTION_FUNA_15>
We anticipate that some funds will prefer to change their names but others will opt for portfolio adjustments to meet the guidelines. It would not be surprising to see some fund managers adjust their company threshold to meet the minimum portfolio threshold of sustainable investments (fund managers using a pass-or-fail approach tend to use a company threshold of 15-20%). One clear risk is to see diverging interpretations for the classification of terms between the ‘ESG’ category and the ‘Sustainable’ category.

<ESMA_QUESTION_FUNA_15>

Q16 : 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>
TYPE YOUR TEXT HERE
<ESMA_QUESTION_FUNA_16>