Investor Alert

A concise treatment of an emergent topic of special interest to our institutional investor clients.

Increased Regulatory Scrutiny of Fund Sustainability Labelling – EU and US Approaches

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EU and US regulators have expressed concerns that some fund managers have responded to growing investor interest in sustainable finance products by misleadingly applying sustainability-related terms in fund and product names.[i] The EU issued the first comprehensive regulatory treatment of how funds should be labelled to reflect the integration of sustainability factors in their portfolios. This treatment is embedded in the Sustainable Finance Disclosure Regulation (SFDR) and the proposed European Securities and Markets Authority (ESMA) Guidelines on fund names that include ESG or sustainability-related terms. The US now appears to be following suit in a manner more limited in scope, with its proposed Amendment to Rule 35d-1 Investment Company Act 1940 (the "Names Rule"). The table below summarizes the similarities and differences between these two regulatory approaches.

EU and US Approaches Compared

	The European Approach: SFDR and ESMA Guidelines on funds' names using ESG or sustainability-related terms	The (Proposed) US Approach: Amendment to the Names Rule (May 25, 2022)
Classification system	Funds must classify their strategies in three ways under the SFDR: • **Fund** does not integrate sustainability into its investment process, nor does it have ESG characteristics. (Article 6) • **Fund** "*promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made to follow good governance practices*." (Article 8) • **Fund** pursues an objective of sustainable investment.[ii] (Article 9) The proposed ESMA Guidelines do not allow a fund to use ESG-related terms in its name unless at least 80% of its investments are used to meet Article 8 or 9 criteria (the environmental or social characteristics or sustainable investment objectives, respectively). A fund is to be also required to allocate at least 50% from within this 80% threshold to 'sustainable investments' if it wants to use the term '*sustainable*' or any sustainability-related terms.[iii]	The amended Names Rule would allow funds who incorporate ESG factors in their investment strategies to classify themselves as one of the following: • **Integration funds**, which consider partially and (relatively) less significantly one or more ESG factors alongside more significant non-ESG factors in their investment decisions. Such funds would not be permitted to use ESG-related terms in their names. • **ESG-focused funds**, which mainly or significantly consider one or more ESG factors in selecting their investments. • **Impact funds**, which aim to attain a particular ESG impact(s). In the normal course of events,[iv] the Names Rule requires the funds using sustainability-related terms in their names to invest at least 80% of their assets in line with the investment focus suggested by the chosen name.

Applicability and deadline for compliance	The SFDR came into effect in March 2021. The period to submit responses to the ESMA Guidelines ended on 20 February, 2023. The issuance of the final Guidelines is expected to occur by the second or third quarter of 2023.[v] The Guidelines do not interfere with the application of the SFDR requirements, but rather complement them and build on its articles. The Guidelines will apply three months after the date of the publication of the guidelines on ESMA's website. However, there will be a transitional period of six months for those funds already existing before that publication date.	The comment period ended on 16 August, 2022. The SEC expects to adopt the amendments by Q4 2023. Fund managers would have one year to comply with the amendments after the date of the publication of the final amendments in the Federal Register.
Disclosure level	There are two levels of disclosures: entity and product levels. Level 1 (entity level) requires EU financial institutions (including those marketing to EU investors) to make *"principles-based disclosures"* on their ESG-related activity. Level 2 (product level) disclosures are more detailed, requiring many details that cover information on the environmental and/or social characteristics promoted or the sought-after sustainable investment objective, the binding elements of the investment strategy used to achieve these characteristics, or this sustainable investment objective and the size of investments allocated to "sustainable investments".	The SEC Proposal considers amending current required disclosures to have a similar entity/product level division as that adopted by the EU. The product level disclosures would require ESG-focused funds and impact funds to disclose more details, including information about the fund's ESG strategy, a description of how the fund incorporates ESG factors into its investment decisions, and how it engages with portfolio companies about ESG issues.

Impact of the EU Approach

Downgrading of Article 9 Funds; Slowdown in New ESG Funds

- In Q4 2022, around 40% of Article 9 funds were downgraded by asset managers to Article 8, representing EUR 175 billion in assets and causing a huge shrinkage in the market share of Article 9 passive funds from (24%) to (5%). This downgrade happened as a result of managers' preparation to comply with the SFDR Level 2's regulatory technical standards effective as of January 2023. These Standards require a detailed disclosure of information on the fund(s)' sustainability efforts and risks.
- Over 70% of Article 9 ETFs downgraded to Article 8.
- Around 50% of 838 investment funds examined in the Great Green Investment Investigation invest in "*grey*" assets with a link to fossil fuels or aviation. The investigation judged these funds by their own sustainability standard and evaluated their alignment with their announced goal(s).
- A slowdown in the creation of new ESG funds from scratch by 60% in 2022 compared to 2021.

DWS Investigation

- EU Member States' national competent authorities (NCAs) carry out the duty of overseeing the mitigation and management of ESG risks, including any misleading claims made. Such authorities look into greenwashing and false claims to check its accuracy. For instance, DWS Group was facing allegations regarding a potential use of misleading product names, particularly the label "ESG-integrated''. German regulator BaFin carried an investigation on a claim that around USD 900 billion of DWS' assets being ESG-aligned in the 2020 annual report was misleading. Just a year later, DWS included in its 2021 annual report that only EUR 115 billion are in ESG assets, which is far below the amount claimed in the 2020 report. Moreover, in December 2022, DWS downgraded 10 ETFS from Article 9 to Article 8.

What can Valoris help?

Valoris provides clients with customized advice in the development of sustainable finance products, including aligning fund names with investor expectations.

Our service offering for investors aligning with EU regulation	Our service offering for investors aligning with US regulation
For **Article 8 and 9 funds**, we: • Review and benchmark their internal investment and stewardship policies to verify that they meet the requirements for the fund name; • Review ESG-related data gathering, tools, analysis and outcomes, adjusted to each investment strategy/product; • Review the portfolio engagements and ESG data collection and disclosures, in particular website disclosure and PAI (principle adverse impact) statements; • Monitor and engage with portfolio companies around ESG and sustainability performance; • Review and benchmark how the fund manager ensures that the companies in which the investments are made follow good governance practices.	For **ESG-focused funds,** we**:** • Provide all the services offered for Article 8 and 9 funds (listed in the left side). For **Integration funds,** we**:** • Review RfPs and offering documents to ensure alignment with new regulatory requirements and investor expectations around ESG and sustainable investment; • Review investment strategies to ensure that they are in line with announced objectives/characteristics; • Assist in the preparation of disclosures on ESG and sustainable investing strategies and performance; • Develop and implement methodologies and tools to fully integrate consideration of ESG and sustainability factors in the investment processes; • Monitor and engage with portfolio companies around ESG and sustainability performance. For **Impact funds,** we**:** • Review and benchmark investment and impact strategies and objectives; • Review and document how and what impact data is gathered, analyzed and reflected in outcomes; • Review the portfolio engagements and impact-related data collection and disclosures; • Preparing the funds for external independent verification against recognized standards, such as the Operating Principles for Impact Management.

Notes

[i] Other regulators have taken action on the use of ESG-related terminology in fund names. The Monetary Authority of Singapore's 2022 Circular applies to any fund that uses or includes ESG factors as its key investment focus/strategy and represents *"itself as an ESG-focused scheme"*. Hong Kong's Securities and Futures Commission (SFC)'s 2021 Circular to management companies of SFC-authorized unit trusts and mutual funds - ESG funds provides guidance on the use of ESG or similar terms in a fund's name.

[ii] The proposed UK's Sustainability Disclosure Requirements (SDR)[ii] introduce three sustainable investment labels: sustainable focus, sustainable improvers, and sustainable impact.

[iii] These '*sustainable investments'* should be in accordance with the definition in Article 2 (17) of SFDR.

[iv] The SEC specifies in the Proposal the circumstances under which a fund may deviate from the (80%) requirement, such as market fluctuations or repositioning or liquidating a fund's assets with relation to a fund launch.

[v] ESMA is the EU's financial markets regulator and supervisor. It has prioritized oversight of ESG disclosures since 2019.

Contact Us

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