CLARITY AI

CLARITY AI RESEARCH, MAY 2024

Study: Implications of ESMA’s New Guidelines on Fund Names

In the first of a two-part series examining ESMA's name **rule** restricting the use of ESG and sustainability-related terms in funds' names, **Clarity AI research suggests that 44% - nearly half of the funds using environmental and impact terms - may need to change their name or divest assets.** In other words, the analysis shows that **these funds are invested in assets that breach the Paris-aligned benchmark (PaB) exclusionary criteria.**[1] Of those funds with investments in breach of PaB criteria, some 82% are Article 8 funds.

MAY 2024

Nearly half of the funds with environmental terms in their names may breach new EU regulations

— **Thomas Willman**, Regulatory Lead at Product Research & Innovation
— **Mouna Essakouti** Associate Manager of ESG Risk at Product Research & Innovation
— **Pablo Díaz-Varela Peña** Director of ESG Risk at Product Research & Innovation
— **Bruna Correa** Senior Data Scientist at Data Science

Asset managers will need to move fast: the guidelines were published on 14 May and will apply three months after their translation is published on ESMA's website. Existing funds will then have six months to make the necessary adjustments. In this first study, we analyzed funds that specifically use environmental (including broad ESG and sustainable terms)[2] and impact terms which are subject to applying the PaB exclusionary criteria related to exposure to certain sectors or revenue streams, such as fossil fuels.

We found that a large proportion of EU funds using these terms in their names may need to reevaluate the types of industries and revenue streams their products are exposed to. In the second part, to be released soon, we look into the criteria related to violations of United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

Due to the focused approach of this initial analysis (and a set of conservative assumptions on e.g. captured terms outlined below), we believe the true figure of funds in breach of the guidelines could be even higher than 44% and will elaborate more on this in the second part of this mini-series.

Introduction, background and overview

On 14 May 2024, ESMA finalized its long-awaited **guidelines** on funds' names using ESG or sustainability-related terms, commonly referred to as its fund "names rule". The guidelines, originally consulted in November 2022, introduce requirements on funds that use ESG or sustainability-related terms in their names. mongst other requirements, funds that use environmental and impact terms must ensure that their portfolio assets are not exposed to certain sectors via associated revenue, as stipulated by the Paris-aligned benchmark criteria.

Clarity AI research shows that nearly half of funds using environmental and impact terms may be invested in assets that breach the revenue thresholds across the (PaB) exclusionary criteria

1. See Commission **Delegated Regulation (EU) 2020/1818** Article 12 for list of exclusions .
2. In line with ESMA's interpretation, we included broad terms "ESG", "sustainable", "sustainability", "sustainably" as environmental terms, given they may give retail investors the impression a product has an environmental focus. We also included impact-related terms in the analysis as they are subject to the same PaB requirements

The ESMA fund names rule applies to any EU fund using an ESG or sustainability-related term in its name.[3] The rules vary depending on the term used, but broadly stipulate that any asset manager using a generic sustainability, environmental or impact term must ensure:

- A minimum of 80% of assets are used to meet the environmental and/or social characteristics or sustainable investment objectives of the fund.[4]
- No exposure to assets that breach the PaB exclusions.

The first of this two part series will examine (a), (b), (d), (e), (f), and (g), from the list of exclusions listed on the right column. The second article will cover (c).

In the first analysis of this two-part series, we examine the Paris-aligned benchmark exclusionary criteria related to exposures to controversial weapons, tobacco, fossil fuels, and companies whose revenue comes from intense energy generation.

To apply these exclusionary criteria thoroughly, it is important that asset managers understand the companies, industries and revenue streams they are exposed to. The analysis covers fully criteria (a), (b), (d), (e), (f) and (g):

- **(a)** companies involved in any activities related to controversial weapons;[5]
- **(b)** companies involved in the cultivation and production of tobacco;
- **(c)** companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite;
- **(e)** companies that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels;
- **(f)** companies that derive 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels;
- **(g)** companies that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO2 e/kWh.

Paris-aligned benchmark exclusions

a **Weapons**
companies involved in any activities related to controversial weapons.

b **Tobacco**
companies involved in the cultivation and production of tobacco.

c **UNGC and OECD**
companies that benchmark administrators find in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprise.

d **Coal and Lignite**
companies that derive 1% or more of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite.

e **Oil Fuels**
companies that derive 10% or more of their revenues from the exploration, extraction, distribution or refining of oil fuels.

f **Gaseous Fuels**
companies that derive 50% or more of their revenues from the exploration, extraction, manufacturing or distribution of gaseous fuels.

g **Electricity**
companies that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO2 e/kWh.

3. Clarity AI examined the terms that were captured as "environmental" related terms (including broad terms like "ESG" and "sustainability") and "impact"-related terms, to which the requirement to ensure assets are not in breach of the PaB exclusion criteria applies
4. Funds using "sustainable", "sustainability" or "sustainably" must also invest "meaningfully" in sustainable investments as defined by Article 2(17). Funds "impact"-related terms will need to ensure that investments are made with the intention to generate "measurable" and "positive" impact. And those using "transition"-related terms will need to show the investments are on a "clear" and "measurable" path to transition
5. We took a conservative approach to defining "activities" related to controversial weapons, not including financing activities (in line with a similar principal adverse impact indicator (PAI) in SFDR)

In Part 2, we will examine criteria (c), concerning companies in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.

Our expectation is that the 44% of funds potentially in breach of the PaB exclusions based on this first analysis will only increase when adding the additional criteria.

Research

ESMA only provided a partial list of captured terms as part of its consultation or final rule. Clarity AI therefore supplemented this list by undertaking a reverse lookup of EU funds in its universe containing terms that could be potentially captured. We considered only the top 25 most frequently used terms along with any explicitly mentioned by ESMA, before removing any social, governance and transition[6] related terms.

We took a narrow view of which terms could be considered environmental-related, to ensure our estimates remained conservative. We exclusively used English language terms in our sample, which covers the majority of funds in the EU.[7] We then took all funds that included those terms in their names and ran them through Clarity AI's Paris-aligned benchmark exclusion tool to determine which funds were exposed to companies in breach of the Paris-aligned benchmark exclusion criteria.

Result: What does the name rule mean for funds with ESG terms?

Leveraging Clarity AI's universe of more than 430,000 funds globally, we found 3,256 funds domiciled in the EU that have environmental and impact related terms in their names in English.[8] Of those 3,256 funds, the vast majority are Article 8 funds (74%) with Article 9 representing 19% and Article 6 just 7%.[9]

Figure 2: Funds that have environmental and impact related terms in their names

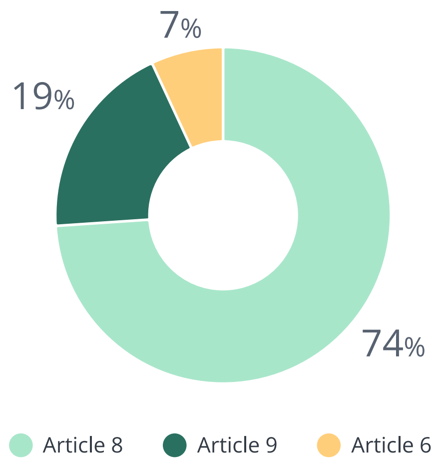

Figure 1: List of terms captured by the PaB exclusion criteria requirement

Examples provided in ESMA's paper

- Climate
- Environment
- Environmental
- Environmentally
- ESG
- Green
- Impact
- Impacting
- Impactful
- Sustainability
- Sustainable
- SRI (including "responsible")

Terms identified via Clarity AI universe

- Biodiversity
- Carbon
- Circular
- Clean
- PAB
- Paris-aligned
- Planet
- SDG
- Water

6. "Transition" and related terms were excluded from the analysis as the new guidelines apply differently to these terms. "Social" and "governance" related terms were also removed for the same reasons
7. Our research captures the majority of funds that exist in the EU market despite the language restriction given (1) we estimate more than 70% of funds in the EU use English language names, and (2) those using non English names will sometimes use English language ESG terms
8. ESMA's own impact assessment estimated the number of impacted funds to be 6,940. Our figure is lower since we focused on environmental terms only (not social, governance and transition terms)
9. These figures are in line with ESMA's own estimates which suggested Article 6 (6%), Article 8 (76%), and Article 9 (18%), based on their broader sample of 6,940 funds

Of the 3,000+ funds with environmental or impact related terms in their names, we found nearly half (44%) contained investments in companies that breach the Paris Aligned Benchmark criteria

In fact, we found that nearly a third of funds (28%) with environmental or impact related terms in their names have exposure to multiple companies in breach of the PaB exclusion criteria.

In its final guidance, ESMA noted that Article 8 funds would likely be the most impacted by the rules. They also mentioned that Article 6 funds impacted by the guidelines may have to re-classify to Article 8 to ensure they can hit the 80% threshold for promoting environmental or sustainable characteristics, or achieving sustainable investment objectives.

In terms of breaches of the PaB exclusionary criteria, looking by article, **we find nearly half (49%) of Article 8 funds with environmental or impact-related terms contain investments in companies with breaches**, and around a third of Article 6 (36%) and Article 9 (29%) funds.

The limits imposed on fossil fuel-related activities are a key driver of these breaches. However, breaches occur across the board, including exposure to tobacco production and controversial weapons. These breaches are not isolated, as many funds were individually invested in multiple companies that violated the exclusion criteria.

How can Clarity AI help

These results suggest that many captured funds will have to reconsider their usage of environmental and impact terms or divest from certain investments in order to comply with the new guidelines. In the second part of this mini-series, we will examine the exclusions related to breaches of global norms. We will see that these requirements add yet another layer of complexity to the implementation of ESMA's name rule and that the true figure may be higher than 44%.

Clarity AI leverages cutting-edge technology to provide sustainability-related insights to financial market participants. Our PaB exclusion tool allows you to quickly scan your portfolio for exposure to companies with PAB exclusion breaches. •

By exclusion we found that these funds were exposed to:

1,077
funds were exposed to companies active in oil fuels production above the 10% revenue threshold

875
funds were exposed to companies active in gas fuels production above the 50% revenue threshold

574
funds were exposed to companies active in thermal coal production above the 1% threshold

496
funds were exposed to companies directly involved in the production of controversial weapons

67
funds were exposed to companies generating electricity with an intensity above 100 g CO2 e/kWh

60
funds were exposed to companies involved in tobacco production

Learn more about our solutions
Contact us to learn more about our solutions and how we can assist you in meeting the new requirements.

10. We identify companies that derive more than 50% of their revenue from energy generation that is always above 100g CO2 e/kWh such as coal, biomass, and specific natural gas methods

About Clarity AI

Clarity AI is the leading sustainability tech company, leveraging advanced technology and AI to provide data-driven environmental and social insights to investors, corporates, governments, and consumers. AI has been at the core of Clarity AI's offering from the start, supporting a fully flexible set of data solutions, insights, analytics capabilities, and tools used for portfolio management, corporate research and engagement, benchmarking, regulatory reporting, online banking, and e-commerce.

Within the investment sector, Clarity AI serves a direct network of clients managing over $50 trillion in assets and includes firms like Invesco, Nordea, Lazard Asset Management, and Santander. Our strategic partnerships with financial institutions such as BlackRock, the London Stock Exchange Group (LSEG), BNP Paribas, Caceis, or SimCorp, allow thousands of users to access Clarity AI advanced data analytics capabilities through their usual investment platforms, ensuring a seamless workflow experience. Additionally, our partnerships with platforms like Diligent, boasting one million users, or Klarna, currently reaching over 150 million online buyers, benefit corporates and consumers alike. Clarity AI has offices in North America, Europe, and the Middle East.

For more information visit www.clarity.ai
Contact us at: insights@clarity.ai