INREV response to ESMA consultation on fund names

INREV

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Introduction

INREV welcomes the opportunity to provide feedback on ESMA's Consultation on Guidelines on funds' names using ESG or sustainability-related terms.

As ESMA is aware, the EU Commission initially framed the SFDR regulation for public finance markets. These markets represent approximately 90% of all investments and it therefore makes sense to make them the primary focus of the regulation. However, although only representing approximately 3% of total financial capital[1], the real estate market represents approximately 39% of total CO_2 emissions and 36% of energy use[2]. Real estate punches considerably above its weight in terms of the potential to achieve a regulatory impact that greatly accelerates the path to a more sustainable Europe. As such, the degree to which a regulation initially devised for public markets (that tend toward short-term trading horizons) remains a poor fit for private markets characterised by medium to longer term active management strategies, especially real estate, is of significant consequence.

The non-listed real estate investment industry already finds itself at a disadvantage when complying with SFDR and the Taxonomy given the imprecision and vagueness of existing definitions and the rather blunt nature of the current metrics set out in Level 2 regulations in relation to real estate as an asset class. Investment managers also find themselves at a disadvantage in relation to prospective sources of capital which wish to apply the disclosure regimes under Articles 8 and 9 of SFDR as "labels" for investment purposes, which must rightly be balanced against risks of data being misinterpreted and accusations of greenwashing.

Ideally, INREV would like to see a more comprehensive assessment of the implementation of the SFDR, with particular focus on the extent to which the usability of SFDR may be improved by having clearer definitions and more relevant metrics and labels applicable to unlisted real estate products. The guidelines on funds' names using ESG or sustainability-related terms could then build on this more comprehensive assessment. Nevertheless, as an interim measure (acknowledging it is for the Commission to commence such a comprehensive review), INREV broadly supports ESMA's targeted approach in proposing these guidelines and hopes that this will include careful consideration of the potential impact on managing non-listed real estate investment vehicles. For further discussion of this important topic, we urge ESMA to review the recently released INREV paper on the subject, which can be found here.

Optional application of proposed guidelines for investment products restricted to professional investors

As an overriding comment, we suggest ESMA consider making these guidelines optional in relation to any investment product which restricts investment to professional investors in the EU (defined as an

[1] Derived from McKinsey (2022) Private Markets Annual Review; Blackrock (2023) Private Markets Outlook
[2] https://www.weforum.org/agenda/2021/11/cop26-buildings-green-architecture-build-better-now-climate-change

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investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MIFID II)). While there will be undoubted pressure from potential investors for products to comply with the naming criteria in the guidelines, it would allow more sophisticated products (in particular in the "transition" section of the market which is so important to encourage from a public policy perspective) not to be corralled into naming conventions that might not be completely suitable and in a context where investors are sophisticated and will be conducting their own due diligence on the products.

Specific recommendations on ESMA's proposal

If ESMA accepts our recommendation to make the application of these guidelines on the use of ESG or sustainability-related terms in fund names optional for investment products that are restricted to professional investors and, even more so if ESMA does not accept our recommendation, we would propose several specific recommendations regarding the proposal which are set out in more detail in response to the consultation questions below.

<u>Exemption for closed-ended funds no longer open for marketing</u>

We would urge that the rules do not apply to closed-ended funds that are no longer open for marketing or admitting additional investors before the application date of the Guidelines, i.e., investors' exit will be at the end of fund life. These funds are not admitting additional investors following the application date of the guidelines and therefore present no risk that prospective investors might be misled by the name of the fund. Disclosure rules under SFDR would, of course, apply to these funds, which would help to address the risk of greenwashing through the application of periodic disclosure requirements. Such an exemption would avoid significant costs and disruption resulting from the change of name that yield no corresponding benefit in terms of investor protection.

We would welcome tailored rules for funds focusing on transitioning real estate assets from unsustainable to sustainable

One of the main challenges in Europe in relation to climate change mitigation is the insufficient rate of sustainable refurbishment (assessed at 1% per annum), which is recognised in the pan-European initiative "Renovation Wave". To reduce emissions by at least 55%, the EU renovation wave targets renovation of 35 million buildings. It is of critical importance that the regulatory environment supports financing of this undertaking.

An investment strategy focusing on this matter would be a value-add fund, which acquires "unsustainable" buildings and, within the period of approximately 3-5 years (depending on factors such as lease expiry, design and construction programme, planning and supply chain constraints, etc), renovates them to "sustainable". Once repositioned, the assets are sold to core funds. Thus, by definition, such a portfolio, which could make an extremely high contribution to climate change mitigation and pursue sustainable impact, would primarily hold unsustainable assets (waiting for or under refurbishment). The requirement to hold 50% of sustainable investments at all times in order to name such a fund in a way which describes its true purpose (sustainable refurbishment/ climate impact) would make it impossible. Therefore the rule as proposed could have a chilling effect on capital seeking to address climate change through real estate investment.

The same issue has already been recognised when it comes to SFDR Article 8/9 classification, where the same fund, for the same reasons, would not be allowed to disclose according to Article 9. The

naming convention compounds the issue by extending it to sustainable and impact terminology. Tailored rules for funds focused on transitioning real estate assets from unsustainable to sustainable, including the naming of such funds contemplated in the proposed guidelines should be created to address this highly undesirable effect.

Provide more clarity in relevant definitions

The pervasive lack of clarity in ESG and sustainability-related definitions in SFDR and the Taxonomy will carry into implementation of the proposed rules on fund names. As a result, compliance with the proposed numeric thresholds will be extremely difficult for many investment managers. While we do not object to numeric thresholds *per se*, they can only be implemented and complied with in practice when more clarity in the definitions applicable to them is provided. Furthermore, specifically what ESMA considers to be encompassed within "ESG and sustainability-related terms" is undesirably vague and additional clarity regarding what terms are covered is critically important.

We also highlight the definition of a "sustainable investment" as being too vague for real estate. Beyond the requirement for a sustainable investment not to be in an energy inefficient building (below EPC B or not compliant with NZEB) and not to be exposed to fossil fuel intensive activity, the definition is very unclear and virtually impossible to apply. Our engagement with members has shown that, as a result of this lack of clarity, the majority of real estate investors have opted to disclose a 0% allocation to sustainable investments – even if they are confident that their investment activity is resulting in positive sustainable outcomes. We do not believe that this lack of clarity is so acute a challenge for other asset classes – particularly public market investment products. Therefore, if the proposed rules on ESG and sustainability-related fund names go ahead, we consider that real estate investment products will be unduly penalised and there are unlikely to be many ESG or sustainability labelled real estate products.

Use of modifiers and qualifiers in fund names in conjunction with ESG or sustainability-related terms should be permitted

For real estate investment products with transition strategies focused on upgrading non-sustainable buildings to sustainable, which as noted above, are so critical for achieving net zero and Paris Agreement goals, the use of clear qualifiers or modifiers in conjunction with ESG or sustainability-related terms should be expressly allowed if tailored rules for real estate transition funds are not created.

For example, a fund named "Pan-European real estate redevelopment to sustainable fund" would not risk any confusion that the fund currently comprises even 50% sustainable investments.

Pre-contractual, website and periodic disclosure rules under SFDR fully apply to these funds, and they would therefore clearly explain the transition strategy and the achievements of goals over time to potential investors. In these examples, the use of "sustainable" or "impact" in the fund title should not be automatically prohibited if the fund falls below the threshold for sustainable investments, as the qualifier actually makes it much clearer to investors what the investment strategy is.

Responses to consultation questions:

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

In the absence of proposals for workable principles-based rules, we accept the proposed requirement to introduce quantitative thresholds to assess fund names, at least for funds open to retail investors.

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.

Although we accept the proposed requirement to introduce quantitative thresholds to assess fund names for funds open to retail investors, we believe that the proposed thresholds are too high and would suggest thresholds of 60% and 35% of 60% respectively.

First, it appears that the 80% and 50% thresholds are intended to be applied by reference to the value of investments made by the fund from time to time. This will be difficult to predict, and to satisfy, during the multi-year investment (or start-up period) phase of real estate funds and will be affected unpredictably by periodic valuations of investments. For example, the first investment made by a fund may be inconsistent with the environmental or social characteristics promoted, or (where relevant) the sustainable investment objectives in accordance with the binding elements of the investment strategy, even though all subsequent investments (exceeding 80% measured at the point of full deployment) may be aligned.

Second, similarly, the threshold will be difficult to satisfy during the multi-year divestment phase at the end of the life of the fund. We recommend that the guidelines be adapted so that the thresholds are applied by reference to "the start-up period" as opposed to "investments".

Third, we advocate that the measurement period for the calculation of the thresholds should be at the end of the investment period (rather than measurement on an on-going basis). Fund managers owe certain fiduciary obligations toward investors (including the duty to act in the best interests of investors) and in certain cases, such as redemption requests from open ended funds, honouring these obligations might result in the fund's asset allocation temporarily falling below thresholds related to the fund's name. It is important that managers maintain the discretion to make investment decisions in a way which is compliant with their wider duties and obligations.

In the light of the above, we have suggested amendments to the quantitative thresholds (paragraphs 16 and 17 in the proposed guidelines, Annex III to the Consultation Paper) as set out below.

We would like to draw ESMA's attention to the Public Hearing on 23 January 2023, during which the ESMA team indicated that the minimum proportion of 50% sustainable investments relate to the overall investments of the fund and not just the 80% and thus the consultation paper should be read as 50% of the investments of the fund should consist of sustainable investments within the meaning of Article 2(17) of the SFDR.

We consider that managers of many funds will find it difficult (if not impossible) to predict with any certainty their compliance with the quantitative thresholds proposed in paragraphs 16 and 17 of the draft proposed guidelines (Annex III to the Consultation Paper) as they will not be able to predict confidently the potential portfolio composition of the fund in order to measure and establish compliance with the proposed quantitative thresholds at the pre-contractual stage. Counterintuitively therefore, for such funds the introduction of quantitative thresholds may disincentivise managers from validly seeking to pursue strategies which "promote" E/S characteristics (or otherwise have a sustainable investment objective) and use an ESG or "sustainability" related term in their name, in

order to attract capital to be deployed towards pressing environmental or social need. For this reason, we propose that the thresholds should be lowered somewhat, to 60%, and 35% of 60%, respectively.

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.

As noted above, the use of clear qualifiers or modifiers in conjunction with ESG or sustainability-related terms should be expressly allowed. For example, a fund named "Pan-European real estate redevelopment to sustainable fund" would not risk any confusion that the fund currently comprises 50% sustainable investments. These funds are likely to be subject to the pre-contractual, website and periodic disclosure rules under SFDR, and they would therefore need to clearly explain the transition strategy and the achievements of goals over time to potential investors. In this example, the use of "sustainable" in the fund title should not be automatically prohibited if the fund falls below the threshold for sustainable investments, as the qualifier actually makes it much clearer to investors what the fund's investment strategy is.

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

As set out above, especially in the introduction and in our response to Question 2, the proposed guidelines, like SFDR, are not a good fit for actively managed portfolios and especially for assets that need to be transitioned form unsustainable to sustainable. While the risk of misleading investors through the use of ESG and sustainability-related terms in fund names may be a real concern for retail investors and therefore merit the mandatory application of the proposed guidelines, the application of the guidelines to funds open to investment only by institutional investors should be optional.

Even if they are adopted by funds open only to institutional investors, the use of qualifiers and modifiers attached to ESG or sustainability-related terms should be permitted. Finally, actively managed funds should only be required to comply with applicable thresholds after the investment or "start-up" period has closed, and there should be flexibility to deviate from those thresholds during the divestment period.

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.

Although we do not have an alternative proposal, we do not agree that the proposed thresholds are actually necessary or helpful for funds open only to investment by institutional investors. Enforcement of pre-marketing and periodic disclosure requirements in SFDR should be sufficient to achieve the supervisory aim of ensuring that ESG or sustainability-related names of funds are aligned with their investment strategy and objectives. As such, guidelines on names are unnecessary and confusing, as well as likely to disincentivise critically needed investment in sustainability.

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.

Exclusion criteria are incompatible with a strategy of actively managing real estate assets to transition them from “unsustainable” to “sustainable”. There is nothing inherently wrong with a building and it only needs to be renovated to become sustainable for it to make a meaningful contribution to achieving the Paris Agreement net-zero carbon goals. We note that, in any case, Article 8 products are subject to minimum safeguards under Article 8 of the SFDR (i.e. that investee companies follow good governance practices) and sustainable investments are already required to comply with the safeguards in the SFDR DNSH test, and so further safeguards are not necessary.

Notwithstanding the above, to the extent that additional safeguards are imposed through guidelines on fund names using ESG or sustainability-related terms, as we noted in the introduction and in response to Question 4, we believe these guidelines should be optional in relation to any investment product which restricts investment to professional investors in the EU (defined as an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments (MIFID II)).

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

We take no position on this issue or the sub-issues a) and b) below.

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?

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

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.

We take no position on this issue.

Q9. Would you make a distinction between physical and synthetic replication, for example in relation to the collateral held, of an index?

We take no position on this issue.

Q10. Do you agree of having specific provisions for “impact” or impact-related names in these Guidelines?

Impact investing is an investment style rather than an investment into specific types of assets and therefore the application of quantitative thresholds would be difficult in practice. There are frameworks such as the Global Impact Investing Network (GIIN) and the Impact Management Project which set out clear principles for Impact Investment. Examples of relevant factors for identifying impact funds include: 1) whether there are any impact frameworks the organisation aligns to? (e.g. the GIIN, which are linked to INREV DDQ 3.8.1 and 3.8.7); 2) how the intended impact will be generated; 3) who or which groups of people or ecosystems are benefiting from the impact strategy of the vehicle; 4) what is the additionality the fund is intending to create a positive impact through with its investments and how will the additionality be generated and assured; 5) how the impact will be measured (i.e. internally, independent third party, etc.) and what key performance metrics will be used to measure

intended impact; and 6) how the strategy differs as an ‘Impact Strategy’ from other strategies in the organisation investing in similar locations/ sectors.

Requirements for products with Impact related names could therefore be that these products must explain how they are aligned with a relevant Impact Investing framework, or that they must spell out in the fund documentation how they will deliver on the Impact Investment key concepts of Intentionality, Additionality and Measurability. Given the wide range of assets that impact investment strategies invest into, it is difficult to see how minimum thresholds can be applied to this investment style – a narrative approach to setting out how impact will be delivered would be preferable.

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

We consider that tailored rules for funds focused on transitioning real estate assets from unsustainable to sustainable, including in relation to the naming of such funds, should be created.

As we noted in the introduction, one of the main challenges in Europe in climate change mitigation is the insufficient rate of sustainable refurbishment (assessed at 1% per annum), which is recognised in the pan-European initiative “Renovation Wave”. To reduce emissions by at least 55% EU renovation wave targets renovation of 35 million buildings. It is of critical importance that the regulatory environment supports financing of this undertaking.

An investment strategy focusing on this matter would be a value-add fund, which acquires “unsustainable" buildings, and within the period of approximately 3-5 years (depending on factors such as lease expiry, design and construction programme, planning and supply chain constraints, etc). Once repositioned, the assets are sold to core funds. Thus, by definition, such a portfolio, which would make an extremely high contribution to climate change mitigation and pursue sustainable impact, would primarily hold unsustainable assets (waiting for or under refurbishment). The requirement, to hold 50% of sustainable investments at all times, for naming such a fund in such a way to describe its true purpose (sustainable refurbishment/ climate impact) would make it impossible. Therefore the rule as proposed would gave a chilling effect on capital seeking to address climate change through real estate investment. There are other investment strategies where the same issue would arise.

The same issue is already recognised when it comes to the SFDR Article 8/9 classification, where the same fund, for the same reasons, would not be permitted to disclose according to Article 9. The naming convention compounds the issue by extending it to sustainable and impact terminology. Tailored rules for funds focused on transitioning real estate assets from unsustainable to sustainable, including the naming of such funds, would help to address this highly undesirable effect. We would repeat our recommendation in the introduction that ESMA review the recently released INREV paper on the subject, which can be found here.

Q12. The proposals in this consultation paper relate 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?

In principle, we believe in a level playing field; however, in practice the impact of general, widely applicable proposals can vary considerably between different asset classes, strategies and management styles. As a result, a “level playing field” can quickly become a “one size fits all” regulation not fit for purpose for some sectors, even if perfectly justifiable for others. Therefore,

proposals advocating a level playing field should be very carefully considered to determine whether they might risk any unintended consequences.

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.

A 6-month transition period is far too short to be able to rename funds whose names do not comply with the guidelines. The time required (as well as the cost) would be significantly higher than the proposal seems to anticipate, and we therefore believe that a transition period of 24 months is warranted. Furthermore, as we note in our response to Question 14, we believe that closed-ended funds that are no longer being marketed or open for subscription before the application date of the guidelines should not be within the scope of the name-related provisions.

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.

As noted above, we would strongly recommend that the rules not apply to closed-ended funds that are no longer being marketed or open for subscription before the application date of the guidelines, i.e., investors' exit will be at the end of fund life. These funds are not admitting additional investors and therefore present no risk that potential investors might be misled by the name of the fund. Disclosure rules under SFDR would, of course, apply to these funds, which would address the risk of greenwashing through application of periodic disclosures requirements.

As we note in our response to Question 16, a “simple” fund name change is, in reality, anything but simple. It is an enormously burdensome process requiring notification to fund investors, changes to scores of documents such as the LPA, pitch books and other marketing materials, notification to regulators in jurisdictions where the funds are marketed, which costs both time and money. An exemption for closed-ended funds that are no longer being marketed or open for subscription before the application date of the guidelines would avoid significant costs and disruption in changing names that yield no corresponding benefit in terms of investor protection.

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

If no suggested changes are adopted, the impacts of the guidelines could be extremely harmful and significantly inhibit investment in real estate transition efforts as noted in the introduction and in our responses to several questions. Furthermore, we are concerned that the outcome of the wider SFDR review currently taking place could have an impact on these guidelines and make the anticipated benefits of this proposal highly counter-productive relative to its costs.

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.

A “simple” fund name change is, in reality, anything but simple. It is an enormously burdensome process requiring notification to fund investors, changes to scores of documents such as the LPA, pitch books and other marketing materials, notification to regulators in jurisdictions where the funds are marketed, which costs both time and money. As we note in our response to Question 14, to require this, especially for closed end funds no longer open to investment would entail significant costs and disruption that yield no corresponding benefit in terms of investor protection.