

## “Fat-Free” ESG: SEC Proposes Rule Changes Related to Fund Names and Fund and Adviser Disclosure Related to ESG Investment Strategies

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### Introduction

On May 25, 2022, the U.S. Securities and Exchange Commission (SEC), in 3-1 votes,<sup>1</sup> proposed (1) amendments to Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940 (the Names Rule Proposal)<sup>2</sup> and (2) disclosure requirements for registered investment funds and investment advisers related to environmental, social and governance (ESG) investment strategies (the ESG Proposal).<sup>3</sup> The Names Rule Proposal would expand the scope of terms subject to the Names Rule to include those that suggest that a fund focuses on investments that have, or investments whose issuers have, particular characteristics, would set limitations on the ability of a fund to depart from its investment policy under the Names Rule, and would modify certain other requirements of the Rule. The ESG Proposal mandates certain prospectus and/or annual report disclosure for investment companies and Form ADV disclosure for investment advisers that consider ESG as a part of their investment process. The SEC generally proposes a one-year transition period to come into compliance with the rules if adopted.<sup>4</sup> Public comments on the Names Rule Proposal and the ESG Proposal must be received 60 days after publication of each Proposal in the Federal Register.

### Summary of the Names Rule Proposal

The SEC indicates that the Names Rule Proposal is designed with the recognition that the name of a registered investment company or business development company (BDC) (and collectively, fund) can be used as a marketing tool and can have a significant impact on an investor's decision to invest.

### *The Names Rule Proposal Significantly Expands the Scope of Terms Subject to the Names Rule*

Currently, funds are required to adopt an investment policy under the Names Rule (a Names Rule Policy) when any term in the fund's name connotes a particular type of investment, but not when a term connotes an investment strategy. The Names Rule Proposal significantly expands this requirement to include any term in a fund's name that suggests a focus in investments that have, or investments whose issuers have, “particular characteristics.” If adopted, the Names Rule Proposal would require fund names including terms such as “growth,” “value,” or ESG-related terminology to adopt a Names Rule Policy. The Names

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<sup>1</sup> Commissioner Peirce dissented from both proposals. With respect to the Names Rule Proposal, Commissioner Peirce stated, among other objections, that the application of the Names Rule to terms such as ESG, growth, or value would be subjective and that the Names Rule as proposed would provide undue constraints on investment companies. Hester M. Peirce, Commissioner, SEC, [Statement on Investment Company Names](#) (March 25, 2022). Commissioner Peirce objected to the ESG Proposal, stating, among other objections, that the SEC already has a solution to prevent misleading disclosure, that the ESG Proposal is too inflexible, and that investment companies do not have the data necessary to make certain required disclosures. Hester M. Peirce, Commissioner, SEC, [Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies](#) (March 25, 2022) (Statement).

<sup>2</sup> [Investment Company Names](#), Release No. IC-34593 (March 25, 2022).

<sup>3</sup> [Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices](#), Release Nos. IA-6034 and IC-34594 (March 25, 2022).

<sup>4</sup> Funds would have 18 months to come into compliance with the shareholder report disclosure requirements of the ESG Proposal.

Rule Proposal would require Names Rule Policies to be fundamental for unlisted closed-end funds and BDCs, meaning they could be changed only with shareholder approval. Further, the Names Rule Proposal would codify past SEC guidance that compliance with the Names Rule does not mean that a fund's name is necessarily not misleading.

| Examples of Terms Requiring a Names Rule Policy under the Names Rule Proposal                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Examples of Terms <u>Not</u> Requiring a Names Rule Policy under the Names Rule Proposal                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>▪ Types of investments, such as: <ul style="list-style-type: none"> <li>▪ Equity/fixed income</li> <li>▪ Large-cap</li> </ul> </li> <li>▪ Industries or groups of industries, such as: <ul style="list-style-type: none"> <li>▪ Technology</li> </ul> </li> <li>▪ Specific types of tax treatment, such as: <ul style="list-style-type: none"> <li>▪ Tax-exempt</li> <li>▪ Municipal</li> </ul> </li> <li>▪ Particular countries or geographic regions, such as: <ul style="list-style-type: none"> <li>▪ Latin America</li> <li>▪ China</li> </ul> </li> <li>▪ <b>New:</b> Types of investment focus, such as: <ul style="list-style-type: none"> <li>▪ Growth or value</li> <li>▪ ESG-related terms<sup>5</sup></li> <li>▪ Global or international</li> <li>▪ Income</li> <li>▪ Intermediate-term bond</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ Characteristics of the fund's overall portfolio, such as: <ul style="list-style-type: none"> <li>▪ Balanced</li> <li>▪ Terms indicating that a fund seeks to achieve a certain portfolio "duration"</li> </ul> </li> <li>▪ A particular investment technique, such as: <ul style="list-style-type: none"> <li>▪ Long/short</li> </ul> </li> <li>▪ A possible result to be achieved, such as: <ul style="list-style-type: none"> <li>▪ Real Return<sup>6</sup></li> </ul> </li> <li>▪ Retirement target dates</li> </ul> |

***The Use of ESG-related Terms in the Names of Funds Would Be Per Se Misleading*** The Names Rule Proposal and the ESG Proposal define an ESG Integration Fund as a fund that considers one or more ESG factors alongside other non-ESG factors, where the ESG factors are no more significant than other factors in the investment selection process. The Names Rule Proposal would consider the use of ESG terms (such as "sustainable") in an ESG Integration Fund's name to be materially deceptive and misleading. In particular, the SEC stated that: "Because funds' names necessitate brevity, the inclusion of ESG terminology in their names would be materially deceptive and misleading unless a fund prioritizes those ESG considerations that their names suggest, as contrasted to funds that analyze ESG factors only as part of a broader investment selection process."<sup>7</sup>

***The Names Rule Proposal Would Specify When a Fund Can Depart From Its Names Rule Policy*** Currently, the Names Rule requires an investment company to comply with its Names Rule Policy under "normal circumstances." The Names Rule Proposal would limit the circumstances under which a fund could temporarily depart from its Names Rule Policy: (1) as a result of market fluctuations or other circumstances where the temporary departure is not caused by the investment company's purchase or sale of as security or the investment company's entering into or exiting an investment; (2) to address unusually large cash inflows or unusually large redemptions; (3) to take a position in cash, cash equivalents, or government securities to avoid a loss in response to adverse market, economic, political, or other conditions or (4) to reposition or liquidate a fund's assets in connection with a reorganization, to launch the fund, or when notice of a change in the fund's 80% investment policy has been provided to fund shareholders at least 60 days before the change pursuant to the rule. Such departures generally would

<sup>5</sup> ESG-related terms would include terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact" or "good governance."

<sup>6</sup> The SEC indicates that a name including the term "real return," unlike "income," does not suggest an investment focus or particular characteristics, but rather "indicates the fund's objectives but without specifying the fund's investments or intended investments." See Names Rule Proposal, *supra* note 2, at 24-25.

<sup>7</sup> See Names Rule Proposal, *supra* note 2, at 84.

be limited to 30 days, and a fund would be required to come back into compliance as soon as reasonably practicable.<sup>8</sup>

#### ***Derivatives Must Be Valued Using Notional Value for Purposes of the Names Rule Policy***

The Names Rule Proposal would require that funds use a derivative instrument's notional amount for purposes of determining the fund's compliance with its Names Rule Policy, as opposed to the derivative instrument's market value. The Names Rule Proposal would allow a fund to include derivatives with exposure to one or more market risk factors associated with its name (in addition to derivatives providing exposure to the terms in the fund name). This change would, for example, allow a foreign equity fund to include certain derivatives designed to hedge currency risk in calculating compliance with its Names Rule Policy.

#### ***Disclosure***

- The Names Rule Proposal would require a fund to define in its prospectus the terms used in its name, as well as the criteria that the fund uses to select the investments described by those terms. Those definitions must be consistent with their plain English meanings and their established industry use.
- The Names Rule Proposal would clarify that funds that otherwise use electronic delivery are permitted to electronically deliver notices of changes to a Names Rule Policy.
- For the third month of each quarter, a fund that has adopted a Names Rule Policy would be required to disclose on Form N-PORT the percentage of investments invested in compliance with its Names Rule Policy and the number of days over the last month that the fund was out of compliance with such Policy. Funds also will be required to indicate with respect to each investment whether the fund counts such investment in compliance with its Names Rule Policy.
- The Names Rule Proposal also sets forth recordkeeping requirements for funds that adopt a Names Rule Policy. For funds that do not adopt a Names Rule Policy, the fund must keep a written analysis regarding the determination by the fund's board of directors (Board) that the fund did not need to adopt a Names Rule Policy.

#### ***Summary of the ESG Proposal***

The SEC indicates that the ESG Proposal is intended to provide consistent, comparable and reliable information for investors concerning funds' and advisers' incorporation of ESG factors.

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<sup>8</sup> A fund could depart for 180 days in connection with a fund launch, and there would be no specified time period in connection with a reorganization.

### *Fund Disclosure*

The ESG Proposal establishes a framework for three classifications of ESG funds that would be subject to varying disclosure requirements:

|                             |                                                                                                                                                                                                                           |
|-----------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>ESG Integration Fund</b> | considers one or more ESG factors as a part of its investment process, but such factors generally do not take precedence over other factors like earnings or macroeconomic trends when making investment decisions        |
| <b>ESG-Focused Fund</b>     | is a fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its engagement strategy with the companies in which it invests <sup>9</sup> |
| <b>ESG Impact Fund</b>      | a sub-set of the ESG-Focused Funds, makes investment decisions to “drive specific and measurable environmental, social or governance outcomes”                                                                            |

In particular, an ESG Integration Fund generally would be required to include a brief description in its summary prospectus and a more detailed description in its prospectus regarding how it incorporates ESG into its investment process. An ESG-Focused Fund generally would be required to include a prescribed ESG overview table in its summary prospectus, a more detailed description in its prospectus (including information on any screens, internal or external methodologies and any engagement strategies) and information regarding the fund’s achievement of its particular ESG goals (including as relevant detailed information on proxy voting, meetings with issuers and greenhouse gas (GHG) emissions data) in its annual report. An ESG Impact Fund generally would be subject to the disclosure required of an ESG-Focused Fund and, in addition, would be required in its annual report to disclose information on the fund’s progress towards achieving its ESG goals, including qualitative and quantitative data. An overview of the proposed disclosure requirements for each category of ESG fund in each filing can be found [here](#).

Funds also would be required to disclose on Form N-CEN their ESG classification, the ESG factor(s) they consider (*e.g.*, E, S and/or G), and the method they use to implement their ESG strategy. Funds also would be required to disclose information on any ESG providers used in implementing the funds’ investment strategy and whether the fund follows any third-party ESG frameworks. One proposed amendment to Form N-CEN would apply to **all** index funds, regardless of whether the fund is classified as an ESG fund: all index funds would be required to disclose identifying information on the index that they track.

### *Adviser Disclosure*

The ESG Proposal also would require registered investment advisers that consider ESG factors as part of their advisory business to make certain ESG-related disclosures on their Form ADV brochures. Investment advisers would be required to include a description of the ESG factor or factors the adviser considers for each significant investment strategy or method of analysis (including how it incorporates carbon emissions when making investment recommendations); information on any material relationship or arrangement with an ESG consultant or service provider; a description of which ESG factors the adviser considers in voting client securities and how the adviser considers them and a description of the ESG factors considered in any wrap fee programs.

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<sup>9</sup> ESG-Focused Funds would include funds that (1) track an ESG-focused index, (2) funds that include or exclude investments based on ESG factors as a primary investment consideration, (3) funds that have a policy to vote proxies or engage with the management of its portfolio companies as a *significant* means of implementing its ESG strategy and (4) funds with a name or advertisements that suggest that ESG-related factors are a significant consideration for the fund. The ESG Proposal notes that, although a determination of whether a fund’s proxy voting or engagement is a significant portion of its strategy would depend on the facts and circumstances, a fund that regularly and proactively votes proxies or engages with issuers on ESG issues to advance one or more particular ESG goals that the fund has identified in advance would be significant.

Advisers, including exempt reporting advisers, also would be required to disclose certain information on Form ADV Part 1, including census data about whether the adviser: (1) acts as or has related persons that act as ESG service providers, (2) considers ESG factors and (3) uses any third-party ESG frameworks or ESG service providers.

### Compliance

While the ESG Proposal does not require funds and investment advisers to adopt specific ESG compliance policies and procedures, the Proposal states that policies and procedures should address the accuracy of ESG-related disclosures and portfolio management processes to ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the fund or adviser. The ESG Proposal provides several examples of policies and procedures that should be adopted based on a fund's or adviser's ESG practices (e.g., if a fund discloses to investors that it adheres to a particular global ESG framework, its policies and procedures should include controls designed to ensure that the fund is managed in accordance with that framework).

### Key Takeaways

- The Names Rule Proposal would represent a significant expansion of terms requiring a Names Rule Policy and, combined with the proposed restrictions on departures from a Names Rule Policy, could hamper a portfolio manager's ability to manage its investments in a manner it believes to be in the clients' best interest. Asset managers should consider whether current fund names would require a new Names Rule Policy and whether any funds that would be considered Integration Funds contain what would be impermissible ESG-related terms.
- The ESG Proposal's classification and definition of the types of ESG funds are inconsistent with other regulatory regimes<sup>10</sup> as well as some industry classification schemes. As a result, the same or similar investment strategies may require materially different disclosure to investors in different jurisdictions, creating complexity and inefficiency for asset managers that manage U.S. and non-U.S. funds.
- Unlike the SEC proposal for public company and certain foreign private issuers,<sup>11</sup> the ESG Proposal does not include a safe harbor from liability or any exemptions with respect to the required reporting of portfolio company GHG metrics.<sup>12</sup> Thus, asset managers could be subject to disclosure liability related to data that public companies are not required to provide or for which public companies enjoy safe harbors from liability.
- The ESG Proposal would require details in an ESG-Focused Fund's annual report relating to proxy voting and engagement, which may lead to greater investor confusion. In particular, the SEC indicates that an ESG-Focused Fund should not consider itself to be engaged "significantly" in an ESG strategy through its proxy voting if it "simply" uses its proxy votes to vote on ESG issues. Rather, the SEC suggests that a fund engages "significantly" through its proxy voting only when it employs certain activist strategies.<sup>13</sup>

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<sup>10</sup> In particular, the categorization and definitions are inconsistent with the European Sustainable Finance Disclosure Regulation as well as the proposed United Kingdom Sustainability Disclosure Requirements.

<sup>11</sup> [The Enhancement and Standardization of Climate-Related Disclosures for Investors](#), Release Nos. 33-11042; 34-94478 (March 21, 2022) (Issuer Proposal).

<sup>12</sup> The ESG Proposal would require ESG-Focused Funds to include in their annual reports GHG information of each portfolio company in which they invest by using a publicly available source of information or, if such information is unavailable, by making a "good faith estimate" of the portfolio company's emissions. The ESG Proposal recognizes that such good faith estimates will be based on different underlying methodologies and assumptions and may produce inconsistent results, but it stops short of providing any safe harbor.

<sup>13</sup> See ESG Proposal, *supra* note 3, at 61-62 (providing as an example of "significant" use a fund that runs a proxy campaign to change the board of a portfolio company to further its ESG goals). Similarly, the ESG Proposal's discussion of engagement led Commissioner Peirce to state: "Conducting a few earnest meetings during which ESG issues are raised will not do; to count for

- Both the Names Rule Proposal and the ESG Proposal emphasize that compliance policies and procedures should include specific and detailed policies and procedures addressing compliance with the rules, and the Proposals are quite prescriptive. This contrasts with the original compliance rule, which generally listed only the types of issues an adviser's policies and procedures should include at a high level and only included detail regarding certain fundamental fund issues (*e.g.*, valuation).
- Unlike the Issuer Proposal,<sup>14</sup> there is no suggestion that Boards should have particular ESG expertise. However, if adopted as proposed, Boards will be required to approve ESG-related filings and compliance policies and procedures that will contain detailed ESG-related information.

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purposes of the rule, such engagements must be 'part of an ongoing dialogue with the issuer regarding this goal.' More to the point, an ESG-Focused fund that implements its investment strategy via 'ESG engagement meetings' not only must advocate 'for one or more specific ESG goals to be accomplished over a given time period,' the progress toward achieving those goals must be 'measurable.'" See Statement, *supra* note 1.

<sup>14</sup> See Issuer Proposal, *supra* note 10 at fn. 277 and accompanying text (would require disclosure of whether any member of a registrant's board of directors has expertise in climate-related risks, with the disclosure required in sufficient detail to fully describe the nature of the expertise).