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IN FOCUS

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Environmental, Social, and Governance Funds: SEC Proposed Names Rule Reform

On May 25, 2022, the Securities and Exchange Commission (SEC) commissioners voted 3-1 to officially propose amendments to its "Names Rule" governing certain investment fund names. The proposed rulemaking is in response to concerns that the relationship between environmental, social, and governance (ESG) funds names and their actual investment strategies was potentially confusing or misleading. This In Focus covers background on this policy issue, features of the proposed rule, and arguments made for and against the changes.

Background

ESG funds are portfolios of equities and/or bonds, typically in the form of mutual funds, for which ESG factors have been considered in the investment process. Investor interest in such funds has grown considerably over the years. For example, according to Morningstar, which tracks fund data, domestic ESG funds had $357 billion in assets at the end of 2021, greater than four times the total amount held three years earlier.

For years, various outside observers and officials at the SEC, which regulates funds primarily through the Investment Company Act of 1940 and the Investment Advisers Act of 1940 (P.L 76-768; both are found in different titles in the same act), have raised concerns over their perceptions of confusing relationships between some fund names, especially environmentally oriented ones, and the fund's investments strategies.

Fund naming is largely governed by the "Names Rule" (Rule 35d-1 pursuant to the Investment Company Act) adopted by the SEC in 2001, which requires that at least 80% of the assets of an SEC-registered investment company or a business development company (BDC, a type of fund that invests in small and medium-sized companies and distressed firms) with a name that suggests that it focuses on particular types of investment (e.g., industries, nations, regions) must be invested in that type of asset. Reportedly, the SEC staff have often taken an approach in which terms such as *ESG* or *sustainable* in a fund name trigger the rule's requirement.

In March 2020, the SEC staff issued a request for comment on whether the existing requirements are effective, including for funds that contain terms such as *ESG* or *sustainable*, and help ensure that investors are not misled by fund names. It noted that a major concern is whether an ESG label refers to a "strategy," where the Names Rule is not applicable, or a "specific type of investment," where the Names Rule does apply. It also described a competitive market environment that may incentivize fund asset managers to use fund names to differentiate new fund offerings but may be inconsistent with the Names Rule. Various observers think that this scenario has encouraged fund "greenwashing," when a fund overstates the ESG attributes of its investments.

May 2022 Proposed Rule

As mentioned above, the agency proposed amendments to the Names Rule in May 2022 meant to modernize the prevailing fund naming convention. (On the same day, the SEC also voted to propose a complementary rulemaking that would require enhanced fund disclosures for ESG-oriented funds, which, it is hoped, will enable the ESG funds to be more transparent, potentially reducing the incidence of greenwashing.) If adopted as proposed, the reform would require SEC-registered funds to reassess their fund names, investment policies mandated under the Names Rule, and related fund prospectus disclosures. In proposing the reform, the agency argued, "Under certain circumstances, the current structure of the rule also may permit funds to depart from the investment focus suggested by their name over time, which can deprive investors of the protections of the rule…. The rule also is not currently well-suited to address ways in which the fund industry has evolved since its adoption." Major parts of the proposal include:

Modernization of the 80% investment policy requirement. At present, the Names Rule directs funds with certain names to invest 80% of their assets in the investments suggested by their names. The proposal would expand this requirement to any fund name that suggests a focuses on investments that have, or investments whose issuers have, particular characteristics. An example would be fund names with terms such as *growth* or *value* and those indicating that the fund's investment decisions incorporate one or more ESG factors. The proposal would also require a fund that holds derivatives to use their notional values, not their market values, in determining fund compliance with the Name Rule.

Temporary departures from a fund's 80% investment policy. The proposal denotes the unique circumstances under which a fund may depart from the 80% investment policy, including sudden changes in market value of its underlying investments. Specific time frames for when such funds must return to the 80% investment policy regime would also be delineated.

Unlisted closed-end funds and BDCs. The proposal would prohibit a registered closed-end fund (a type of mutual fund whose shares can be purchased and sold on a stock exchange) or a BDC whose shares are not listed on a

national securities exchange from changing its 80% investment policy unless fund shareholders vote to do so.

Enhanced prospectus disclosure, reporting, and recordkeeping. The proposal would include a number of amendments to provide enhanced information to investors and the SEC on how fund names track their investments. Among them, a fund's prospectus disclosure would define the terms used in the fund's name. Also, amendments to Form N-PORT, a monthly SEC fund reporting protocol, would require greater transparency on how the fund's investments match the fund's investment focus. In addition, funds would be required to keep certain records on how they comply with the rule or the rationale behind why they have determined that they are not subject to it.

Materially deceptive and misleading use of ESG terminology. Under the proposal, an integration fund, a fund that considers ESG factors alongside but more than other non-ESG factors in its investment decisionmaking, would not be allowed to use *ESG* or similar terminology in its name. Doing so would be defined to be either materially deceptive or misleading.

Selected Supportive Arguments

Groups supporting the proposal include the North American Securities Administrators Association (a state and provincial securities regulator group), the Consumer Federation of America (a consumer advocacy group), Public Citizen (a social justice group), and various environmental activists, among others. They assert:

- Some funds have reportedly claimed that the current Names Rule does not apply to them, while outside observers claim that it does. Broadening the scope of the Names Rule would provide clarity in these cases.
- A large number of funds have names that incorporate terms such as *growth*, *value*, or *sustainable* and may not be subject to the Names Rule. Under the proposal, such funds would be subject to the rule, which would enable them to better communicate that they have investment concentrations that are consistent with the characteristics suggested by their names.
- Currently, funds generally have significant discretion to determine when market conditions are "not normal," allowing them to depart from compliance with the Names Rule for an indeterminate period of time. By specifying the circumstances under which a fund can temporarily depart and imposing a 30-day time limit on such departures, the proposal would result in more alignment between a fund's name and investments over longer time periods.
- The proposal would require funds that use derivatives instruments to report on the notional (as opposed to the market value) of the derivatives, as is often currently the case. This better aligns with the fact that for most types of derivatives instruments, the notional value generally serves as a measure of a fund's investment exposure to such underlying reference assets.

Selected Critical Arguments

Groups criticizing the proposal include the Heritage Foundation (a think tank), the U.S. Chamber of Commerce (a business trade group), the Investment Company Institute (a mutual fund trade group), the Securities Industry and Financial Markets Association (a brokerage trade group), and the CFA Institute (an association of financial professionals), among others. They assert:

- Terms such as *ESG* and *sustainable* in fund names should not be included in the Names Rule in the first place, as they depict investment strategies, not investment types.
- The proposal places excessive emphasis on the salience of fund names, implying that investors can rely heavily on funds' names when they make investment decisions, thus minimizing other available investor information, including fund prospectuses, which detail fund investment objectives, strategies, and historical performance.
- Applying the 80% investment policy requirement to funds whose names suggest a focus on investments with "particular characteristics" will problematically involve subjective judgments. Given the expansiveness of terms such as *ESG*, *growth*, and *value*, it will be challenging for funds to implement the proposal and for the SEC to enforce it.
- By restricting the time in which a fund could depart from the 80% investment policy rule during episodes of persistent market volatility, the proposal would place greater limits on a fund's ability to respond to those market conditions by changing its portfolio mix to benefit its shareholders.
- Combined with the SEC's proposed May 2022 enhanced fund disclosures for ESG-oriented funds, the proposal's prohibition on integration funds' use of *ESG* in their names could have unintended consequences. While facing more pronounced disclosure requirements, the funds would not be able to use ESG-based names to relay to investors that they have integrated ESG factors.
- Valuing a fund's derivative assets at market value, as is done now, provides more useful information than does the proposal's notional value requirement, because market values tend to generally provide more accuracy, timeliness, and comparability.

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