

# SEC Proposes Fund Names Rule Amendments and Rules Governing ESG Investment Disclosures

## WRITTEN BY

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In two separate May 25 releases, the U.S. Securities and Exchange Commission (SEC) proposed amendments to (1) Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940 (Investment Company Act) and (2) rules and disclosure forms concerning funds' and advisers' incorporation of environmental, social, and governance (ESG) factors. The final rules, if adopted, would make investment companies and advisers subject to tighter standards regarding how funds are named and how ESG factors are disclosed.

## Amendments to the Fund Names Rule

Adopted in 2001, the Names Rule mandates that a fund's name does not misrepresent the fund's investments and risks and that investors' assets in funds are invested in accordance with their reasonable expectations based on a fund's name. The proposed amendments come nearly a year after Chair Gary Gensler, in [prepared remarks](#) before the Asset Management Advisory Committee, compared investment fund names to a fat-free milk nutrition label, expressing his concerns that it's more challenging to determine what a "green" or "sustainable" fund is invested in than to determine how many grams of fat are on a nutrition label. Building off those concerns, the SEC's proposal would, among other changes, do the following:

- Expand the 80% investment policy requirement to apply to any fund name with terms suggesting that the fund focuses on investments that have particular characteristics (e.g., fund names with terms, such as "growth" or "value" and those indicating that the fund's investment decisions incorporate ESG factors);
- Prohibit a fund that considers ESG factors alongside but not more centrally than other non-ESG factors in its investment decisions (i.e., Integration Funds) from using ESG or similar terminology in its name, which practice would be defined to be materially deceptive and misleading;
- Require fund prospectus disclosure that defined the terms used in a fund's name and amend Form N-PORT to require greater transparency on how fund investment selection methods match the investment name focus that the fund's name suggests; and
- Prohibit a registered closed-end fund or business development company (BDC) with shares not listed on a national securities exchange from changing its 80% investment policy without a shareholder vote.

## Amendments to Rules and Disclosure Forms Concerning ESG Investments

The proposed amendments to rules and forms under both the Investment Advisers Act of 1940 and the Investment Company Act would require registered investment advisers, certain registration-exempt advisers, registered investment companies, and BDCs to provide additional information regarding their ESG investment practices. The proposed amendments, which Chair Gensler stated would enable investors “to drill down to see what’s under the hood of [ESG] strategies,” include the following changes to promote consistent and reliable information for investors:

- Require funds that consider ESG factors in their investment process to disclose additional information regarding their strategy, which amount of disclosure depends on how central ESG factors are to a fund’s strategy. The proposal specifically identifies three types of ESG funds — Integration Funds, ESG-Focused Funds, and Impact Funds.
  - Integration Funds would be required to describe how ESG factors are incorporated into their investment process.
  - ESG-Focused Funds (*i.e.*, funds for which ESG factors are a significant or main consideration) would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
  - Impact funds (*i.e.*, a subset of ESG-Focused Funds that seek to achieve a particular ESG impact) would be required to disclose how they measure progress on their objectives.
- Require funds that use proxy voting or engagement with issuers as “significant means” of implementing their ESG strategy to provide additional information about their proxy voting or ESG engagements.
- Require ESG-Focused Funds that consider environmental factors in their investment strategies to disclose additional information regarding the greenhouse gas (GHG) emissions associated with their investments (*e.g.*, carbon footprint and weighted average carbon intensity of their portfolio). Integration Funds that consider GHG emissions would be required to disclose information about how they consider GHG emissions, including the methodologies and data sources the fund relies on.

These proposed rules and enhanced reporting requirements will show up in a number of forms, outlined below:

- **Prospectus ESG Disclosure Enhancements.** A registered fund would be required to provide investors with specific information about the fund’s implementation of ESG factors in the fund’s principal investment strategies. The level of detail required in the fund’s prospectus would depend on the level the fund considers ESG factors in its investment process, with a layered disclosure approach: (1) *Open-End Funds* would only need to provide an overview of their ESG strategy in the summary section of the prospectus, with more detail in the statutory prospectus; (2) *Integration Funds* would provide a more limited disclosure, “summarizing in a few sentences” the ESG factors it considers and incorporates into its investment strategy; (3) *ESG-Focused Funds* (with Impact Funds as a subset of ESG-Focused Funds) would be required to provide specific and detailed disclosures concerning how the fund focuses on ESG factors in its investment strategy; and (4) *Impact Funds* would be required to provide the disclosures that an ESG-Focused Fund would provide, while additionally providing an overview of the impact(s) the fund is seeking to achieve and the manner in which it is seeking to

achieve said impact(s).

- **Form N-CEN.** Proposed Item C.3(j) would require ESG funds to report, among other things: (1) the type of strategy employed (Integration, ESG-Focus, or Impact); (2) the ESG factor(s) it considers; and (3) the method(s) it uses to implement its ESG strategy. Additionally, registered funds would be required to disclose whether they consider ESG-related information or scores provided by ESG providers, and if so, to provide the legal name and legal entity identifier of each provider. The proposed amendment to Form N-CEN would also require a fund to report whether or not the fund follows any third-party ESG frameworks in its investment strategies, and if so, to provide the full name of such frameworks.
- **Form ADV Part 1A.** The amendment would require information about advisers' uses of ESG factors for their separately managed account clients and reported private funds. Registered advisers would be required to disclose their use of ESG factors and any third-party ESG frameworks used in connection with their advisory services. Both registered and exempt advisers would be required to provide information on whether they conduct other business activities as ESG service providers or consultants or have any related persons that are third-party ESG service providers or consultants.
- **Form ADV Part 2A.** The amendment would require registered investment advisers that consider ESG-related factors in their investment strategy to include information about their ESG practices. Specifically: (1) a description of the ESG factor(s) considered and the method of implementation into the adviser's investment strategy; (2) an explanation of whether and how the adviser employs ESG integration, ESG-focused strategies, or ESG impact strategies; (3) a description of any ESG strategy, criteria, or methodology employed in investment evaluation or selection, if applicable; (4) a description of any relationship or arrangement that is material to the adviser's business or clients that the adviser or its management persons have with any related person that is an ESG consultant or ESG service provider; (5) for advisers with specific voting policies or procedures that include one or more ESG considerations, a description of the ESG factors considered, and how they consider them; and (6) for advisers that sponsor wrap fee programs, a description of the ESG factors they consider and how they incorporate such factors under each program, an explanation of whether they review, or whether a third party reviews, portfolio managers' application of relevant ESG factors and the nature of such review, or an affirmative statement that no such review occurs and an explanation of any limitations on calculation, assessment, or presentation of ESG factors as a result.

This proposal comes on the heels of a [\\$1.5 million penalty](#) assessed against an investment adviser for alleged misstatements and omissions about its ESG considerations in making investment decisions for certain mutual funds that it managed.

Each proposal passed on a 3-1 vote. As with the [March 21 climate-related disclosures proposal](#) for registrants, Commissioner Peirce opposed both proposals, which she characterized as overly prescriptive and burdensome on funds and fund managers.

The public comment period for both proposals will remain open for 60 days following their publication in the *Federal Register*.

The Names Rule proposal and ESG disclosures proposal are available [here](#) and [here](#), respectively.

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