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Everyone Has an Opinion: Comments on Proposed ESG and Names Rule Reforms and Forecasting the Final Rules

By Keri E. Riemer and Jon-Luc Dupuy

On May 25, 2022, the Securities and Exchange Commission (SEC or the Commission) proposed two amendments to rules and reporting forms that, if adopted as proposed, would have a tremendous impact on investment companies registered under the Investment Company Act of 1940, as amended (the 1940 Act) and companies that elect to be treated as business development companies (BDCs, and together with registered investment companies, funds) under the 1940 Act. In the first proposal (the ESG Proposal), the SEC seeks to, among other things, create a classification system for funds that incorporates environmental, social, and governance (ESG) factors into their investment selection process and provide investors with additional information about such funds' use of ESG factors, including certain greenhouse gas (GHG) emissions disclosures. In the second proposal (the Names Rule Proposal),[1] the SEC seeks to significantly expand the scope of terms that it considers materially deceptive and misleading in the name of a fund where there is no corresponding policy to invest at least 80 percent of the value of the fund's net assets, plus the amount of any borrowings for investment purposes, in the manner suggested by the fund's name (80% Policy). If adopted without modification, the amendments would affect funds in the following ways:

- Modify prospectus and shareholder report disclosure requirements for all funds and BDCs engaged in ESG investing to elicit additional information regarding funds' ESG investment approaches.
- Amend Rule 35d-1 under the 1940 Act (the Names Rule) expanding the scope of names covered by that rule to include terms suggesting that a fund focuses in "investments that have, or whose issuers have, particular characteristics" including names that indicate ESG-related investment strategies, such as "sustainable" or "green."

The SEC requested that comments on the proposals be submitted by August 16, 2022. The SEC has expressed that it considers the "public's input" on proposed rules in its final rulemaking process.[2] Accordingly, it follows that if significant members of the affected investment community (in this case, fund complexes with substantial shareholder assets under management, the investment advisers to such fund complexes, and organizations representing the fund industry (collectively, Commenters)) communicate the same or substantially similar messages regarding certain operational or compliance challenges imposed by a proposed rule or other criticism, or suggest the same or a substantially similar alternative to a proposal, the SEC should consider those expressions and seek to incorporate them, or otherwise respond to the concerns raised, in the final rule. However, the SEC is not explicitly required to adopt Commenters' suggestions or modify the rules as proposed despite industry criticism.

In this article, we summarize common concerns and suggestions submitted by Commenters. We also discuss how the SEC may ultimately craft final rules designed to respond to such input.

Comments on the ESG Proposal

The multitude of proposed ESG-related disclosure and reporting requirements for funds focus on prospectuses, annual shareholder reports, and Form N-CEN, and the type of disclosures and level of detail required depend on the extent to which a fund considers ESG factors in its investment selection processes. To facilitate the implementation of and compliance with the proposed requirements, the SEC proposed a new fund taxonomy consisting of three categories of ESG funds, each of which has certain disclosure requirements:

1. *Integration Funds*, which are funds that "consider" one or more ESG factors along with other non-ESG factors in their investment decisions, but for which the ESG factors are generally not more significant than other factors in the investment selection process. Such funds would be required to describe how they incorporate ESG factors into their investment selection processes and how such ESG factors are considered alongside other factors.
2. *ESG-Focused Funds*, which are funds that focus on one or more ESG factors by using them as a "significant" or "main" consideration in selecting investments or in their engagement strategy with portfolio companies in which they invest, and they would include funds that track an ESG-focused index, funds that apply an inclusionary or exclusionary screen based on ESG factors, and funds that have a policy of voting their proxies and engaging with the management of their portfolio companies to encourage ESG practices or outcomes. Such funds would be required to provide more detailed disclosure than Integration Funds, including by completing a "check box" format "ESG Strategy Overview Table" that solicits information about the strategies employed (for example, tracking an ESG index, applying an exclusionary screen, engaging with portfolio company management), as well as narrative descriptions of related topics with more detailed information.
3. *Impact Funds*, which are ESG-Focused Funds that seek to achieve one or more specific ESG impacts (for example, a fund that invests with the goal of seeking capital appreciation while also furthering the fund's stated goal of financing the construction of affordable housing units or promoting the availability of clean water). Such funds would be required to make the same disclosures as all ESG-Focused Funds, as well as disclose in their investment objectives the ESG impact the funds seek to generate and information about, among other things, how the funds measure progress toward that stated impact.

One of the most substantial proposed disclosure requirements relates to GHG emissions metrics. For example, if the ESG Proposal is adopted as proposed, all ESG-Focused Funds that indicate that they consider environmental factors (unless such funds explicitly disclose that they do not consider companies' GHG emissions when making investments) would be required to disclose their portfolios' carbon footprint and the weighted average carbon intensity (WACI), each of which is based in part on portfolio companies' Scope 1 and Scope 2 emissions.[3] In addition, if these funds hold investments in portfolio companies that disclose their Scope 3 emissions and such Scope 3 emissions are publicly available, the funds must disclose the Scope 3 emissions associated with their portfolios.[4] It is not just ESG-Focused Funds that would need to make GHG emissions-related disclosures; Integration Funds that consider GHG emissions as one ESG factor in their investment selection process would be required to describe how the funds consider the GHG emissions of their portfolio holdings, including a description of the methodology that the funds use as part of their consideration.

The SEC proposed a 12-month period for compliance with the requirements, except that the compliance period for the new Form N-CSR requirements would be 18 months.

Although the ESG Proposal includes a number of additional proposed disclosures, many Commenters focused their attention—and raised common concerns—regarding (1) the definitions of "Integration Fund" and "ESG-Focused Fund," (2) proxy voting and engagement strategy disclosures, (3) GHG emission disclosures and liability arising from the use of third-party data, and (4) the compliance period.

Proposed Definition of Integration Fund is Overly Broad and Could Impose Disclosure Requirements on Most (if Not All) Funds

Commenters stressed that most, if not all, funds likely at least "consider" one or more ESG factors in their investment decisionmaking process, potentially from a financial perspective rather than with an intentional ESG-related view (for example, a fund considering investing in a juice company may consider the availability of clean water, but only with respect to the potential appreciation of the fund's investment). In light of this overly inclusive definition, most funds would need to comply with the final disclosure requirements for such funds. This, in turn, could lead to investor confusion and inaccurately present some funds as ESG funds when they do not intend or seek to be and do not market themselves as such. Commenters conveyed that obligating each fund that simply "considers" even one ESG factor—regardless of the purpose of that consideration or the degree to which ESG factors are incorporated into the fund's investment process—would highlight ESG factors (and in some cases, GHG emissions) in disclosures, potentially elevating the importance of such factors above those that are more significant to the fund when making investment decisions. This potentially inappropriate emphasis increases the risk of misleading investors and the appearance of greenwashing.

In light of these concerns, many Commenters urged the SEC to eliminate entirely the proposed "Integration Fund" category. However, the SEC may be reluctant to completely abandon the "Integration Fund" concept and the proposed disclosure requirements thereof; the SEC expressed in the release relating to the proposed reforms[5] that investors should be provided standardized ESG-related information that will help them compare various funds and that investors have requested more information about funds' consideration of GHG emissions. As an alternative to complete elimination of the Integration Fund category and associated disclosure requirements, the SEC could respond to concerns raised by Commenters by, for example, limiting the specific ESG disclosure requirements to only those Integration Funds that market themselves as employing ESG investment strategies. The SEC could also narrow the definition of "Integration Fund," such as by limiting it to funds for which consideration of environmental or social factors are elevated above certain other factors in the funds' investment decisionmaking process. Such modifications could help mitigate the risk of greenwashing and investor confusion.

Proposed Proxy Voting and Engagement-Related Disclosures Inappropriately Emphasize Quantity of Meetings and Would Impose Substantial Compliance Challenges

Under the ESG Proposal, ESG-Focused Funds indicating that they use proxy voting or engagement as a significant means of implementing their ESG strategy would be required to disclose, respectively, the percentage of ESG voting matters for which the funds voted in furtherance of the initiative, as well as certain metrics regarding ESG engagement activities, including the number or percentage of issuers with which the funds held "ESG engagement meetings"[6] and the total number of ESG engagement meetings held.

Commenters flagged a number of flaws with respect to these proposed requirements. For example, with respect to the proposed proxy voting disclosures, some Commenters noted that many management proposals addressing governance matters could be considered "ESG voting matters." In addition, the proposed disclosure requirement seems to indicate—potentially incorrectly—that the percentage of ESG voting matters supported by a fund demonstrates the extent to which the fund adheres to its ESG strategies. In some cases, a fund may vote against a proposal for reasons unrelated to its ESG strategies. Accordingly, these Commenters noted that the information produced, which could require substantial time, was unlikely to be informative for investors.

Similarly, many Commenters expressed concern that the proposed disclosure requirements relating to engagement activities would inaccurately suggest that the number of engagement meetings, rather than the quality or nature of engagement, is the appropriate metric on which to assess a fund's commitment to, or skillfulness in, engagement. Some Commenters suggested that the disclosure requirement could encourage funds to prioritize quantity (rather than the quality) of engagement meetings and, as a result, increase the risk of greenwashing. Commenters noted that the inappropriate granular focus on the number of meetings as a signal of success, combined with the unfitting message regarding the funds' engagement strategies that likely would be conveyed, would cause the disclosure to be potentially misleading and not particularly useful to investors. Some Commenters also stressed that the compliance burdens associated with satisfying the proposed disclosure requirements would be significant, in part because engagements generally occur at the adviser level rather than the fund level and because fund holdings in a particular issuer can change over time.

Some Commenters recommended that these proposed disclosure requirements be eliminated from the final rule to avoid the potential investor confusion described above. Although we expect the SEC to retain some form of disclosure requirement regarding proxy voting and engagement, it could potentially respond to Commenters' concerns by modifying the proposal. For example, the SEC could substitute the quantitative metrics requirement with a requirement that funds describe, in narrative format, their proxy voting and engagement activities and how they reflect the funds' ESG strategies.

Proposed GHG Emissions Disclosure Requirements Pose a Multitude of Challenges and Concerns for Funds, Including Risk of Private Litigation, While Potentially Confusing Investors

Many Commenters highlighted that the proposed GHG emissions disclosures would present a number of concerns and risks for funds, without providing any meaningful benefit to, and potentially misleading, investors. Some Commenters noted that the proposed GHG emissions reporting obligations are sufficiently broad as to require funds that do not have a principal investment strategy focusing on GHG emissions reduction to comply with the requirements. For example, an ESG-Focused Fund that considers GHG emissions for a limited number of its holdings would be required to report aggregated GHG emissions data for all of its holdings, even if the fund does not have a principal investment strategy tied to reducing GHG emissions. In addition, the over-inclusiveness of the reporting requirement could cause investors to incorrectly believe that the proposed carbon footprint and WACI are the most significant indicators of how "green" a fund is. This, in turn, could cause investors to be misled. For example, a fund may employ an investment strategy to invest in companies that seek to reduce GHG emissions over time or invest in startup companies intending to produce parts for electric vehicles that have not yet fully established their operations. In such an instance, the fund's carbon footprint and WACI may not, at the time of disclosure, appear low to investors, and it could inappropriately convey that the fund is not actually "green." In addition, some Commenters relayed that the disclosures could imply that a fund is focused on GHG reduction when in fact GHG emissions are not even a material consideration for the fund (which is actually focused on other environmental considerations).

Many Commenters expressed concern that the proposed disclosure requirements would obligate certain funds to provide, in a regulatory report, metrics necessarily derived from data from portfolio companies that are not currently obligated to report their own emissions data. This could subject the reporting funds to private litigation risk related to the accuracy of the aggregated GHG emissions data based on information from third-party sources. Accordingly, these Commenters urged the SEC to provide funds with a safe harbor from liability relating to the accuracy or reliability of reporting metrics for GHG emissions that are dependent on third-party data. Some Commenters suggested that the safe harbor could be tied to good faith, such as by providing that the carbon footprint and WACI calculations would be deemed not to be fraudulent unless it is shown that the calculations were made without a reasonable basis or were calculated other than in good faith.

Commenters also pointed to the potential inconsistencies, lack of comparability, and absence of informative data that would result from the proposed carbon footprint and WACI disclosure requirements. For example, to the extent funds must make good faith estimates of a portfolio company's Scope 1 and Scope 2 GHG emissions, the estimates would likely be based on assumptions and methodologies that differ among the estimating funds, which would result in differences between one fund's WACI and another fund's WACI. Because such differences could be based more on the varying assumptions and methodologies applied rather than the climate-related exposures, the disclosure may not provide investors with helpful information regarding the climate-related exposures of such funds' portfolios. In addition, some Commenters noted that because many operating companies are unable to report consistent, comparable, and reliable Scope 3 emissions data, requiring funds to disclose Scope 3 emissions information relating to their portfolio companies would not benefit investors. Several Commenters urged the SEC to not impose any GHG emissions disclosure requirements until public companies are required to make climate-related disclosures and to eliminate entirely the proposed Scope 3 emissions reporting requirement.

While the SEC will almost certainly retain some GHG emissions disclosure requirement, at least for ESG-Focused Funds, it could modify the proposed reforms in response to Commenters' concerns by limiting the scope of the disclosure requirements so that it applies only to funds with a principal investment strategy relating to reducing GHG emissions or, although less likely, limiting the applicability to funds that have explicit emissions reduction targets. The SEC could address Commenters' concerns regarding private litigation by providing funds with the requested safe harbor from liability where funds are reporting GHG emissions information that is dependent on third-party data sources. It may also agree with Commenters that GHG emissions reporting should not be required until public companies are required by the SEC to make such disclosures and that Scope 3 emissions data should not be required at all.

Proposed Compliance Period Is Insufficient and Should Be Extended

Many Commenters asserted that the proposed compliance period was greatly insufficient in light of the significant changes that would need to be implemented if the proposed reforms were adopted. Some Commenters urged that the compliance period be extended to 36 months, while others suggested compliance periods of 24 or 18 months with respect to the prospectus disclosure. Commenters explained that funds would be required to develop and test new policies and procedures, such as those required of ESG-Focused Funds needing to calculate the proposed metrics; collect and, if applicable, estimate GHG emissions data; and incorporate the required disclosures into fund prospectuses.

Although the SEC has expressed a strong desire to impose ESG-related disclosure requirements on funds for some time, it may address Commenters' concerns by extending the proposed compliance periods for prospectus disclosure and Form N-CSR requirements to at least 18 months and 24 months, respectively. This seems particularly likely if the SEC agrees with Commenters that GHG emissions data should not be required to be reported until public companies are required to make disclosures regarding their Scope 1 and Scope 2 emissions.

Proposed Requirements Impose Additional Challenges for Funds Employing Certain Strategies

Commenters also raised concerns relating to particular investment approaches. For example, Commenters noted that:

- *Derivatives*—Derivatives should be excluded from the scope of the reforms, or at least certain calculations, for a variety of reasons, including that the proposed approach to GHG emissions of derivatives inappropriately treats exposure through a derivatives investment as being the same as holding securities of the referenced portfolio company, and including derivatives in the GHG emissions analysis could artificially overstate a portfolio's carbon footprint and WACI, which could result in investor confusion.
- *Multi-Manager Funds*—The proposed reforms cannot be applied to a fund that has sub-advisers employing different investment considerations and that approach ESG in varying ways. The proposed disclosure requirements will result in overly complex and potentially confusing ESG-related disclosure for investors of multi-manager funds, including because such funds may need to include the required tabular disclosure for each sub-adviser employing an ESG-focused investment strategy.
- *Exclusions*—A fund that excludes a certain industry from its portfolio based on an adviser-level exclusion policy would, without any intention of being regarded as an "ESG fund," be deemed an ESG-Focused Fund. Furthermore, the mere application of a limited exclusionary screen would, by itself, cause a fund to be considered an ESG-Focused Fund without any requirement that such screen be more significant than other factors or a main component of the fund's investment strategy.

Comments on the Names Rule Proposal

Initially adopted in 2001, the Names Rule makes it unlawful for a fund "to adopt as a part of the name or title of such company, or of any securities of which it is the issuer, any word or words that the SEC finds are materially deceptive or misleading."[7] The Names Rule also establishes that a fund with a certain type of name operating under the Names Rule must adopt a corresponding 80% Policy to, under normal circumstances, invest at least 80 percent of the fund's assets in the manner suggested by the fund's name. For example, a fund with a name that suggests investment in certain types of investments, industries, countries, or geographical regions, or that suggests the fund's distributions are tax-exempt, must adopt a corresponding 80% Policy. Historically, funds with names that suggest an investment strategy rather than an investment type have not had to adopt an 80% Policy.

In a significant departure from past practice, the Names Rule Proposal would expand the scope of the Names Rule to also include fund names that include terms suggesting that a fund focuses in "investments that have, or whose issuers have, particular characteristics." This means that, if the Names Rule Proposal were adopted without modification, in addition to easily quantifiable terms such as "real estate" or "large capitalization," terms that historically connoted a specific strategy, such as "growth," "value," "income," "global," "international," and "intermediate term (or similar) bond" would now be subject to the requirements of the Names Rule. Notably, the term "ESG" or similar terminology in a fund's name would also be subject to the Names Rule.

The Names Rule Proposal also includes enhanced disclosure requirements for how a fund defines the terms in its name and selects investments for its 80% Policy. In addition, it prescribes when funds may deviate (and for how long) from an 80% Policy, mandates how the Names Rule will be applied to derivatives exposure calculations, requires that unlisted closed-end funds and BDCs with certain names adopt a corresponding fundamental 80% Policy (which would require shareholder approval to change), and requires new or expanded notice, recordkeeping, and reporting requirements.

The SEC has proposed a one-year period for implementation of the Names Rule Proposal, if adopted, to provide time for funds to bring their fund names and disclosures into conformity with the amendments.

While the Names Rule Proposal received considerable industry comments, Commenters seemed to focus their attention on the common concerns that follow below.

Proposed Expansion of the Scope of the Names Rule to Apply to Funds Whose Names Include Terms Suggesting a Focus in Investments That Have, or Whose Issuers Have, "Particular Characteristics"

Commenters noted that the Names Rule's focus on investment types and not on investment strategies has proven to be an effective framework for ensuring that funds' portfolios reflect the types of investments indicated by their names. Cited as evidence of this effectiveness is that fund names were not noted as an examination priority for the past four years, as well as the lack of enforcement proceedings and investor lawsuits against funds or their advisers alleging the use of misleading names.

Particular Characteristics

Commenters expressed concern that the expansion of the rule to encompass new terms indicating certain issuer "characteristics" (for example, growth, value, income, global, and international, which have traditionally been excluded from Rule 35d-1) would subject funds and advisers to substantial compliance risks and lead to confusing and inconsistent application of the 80% Policy requirement. This is exacerbated by the considerable uncertainty as to precisely what terms (outside of those specifically cited in the Names Rule Proposal) would be deemed to suggest a focus in investments that have, or whose issuers have, particular characteristics. Further, even where the Commission has explicitly identified a term as being within the scope of the Names Rule Proposal, Commenters noted that the proposed "particular characteristics" standard introduces considerable subjectivity and uncertainty and invites inconsistent application.

Commenters noted that certain terms do not have universally accepted definitions and could have multiple context-dependent meanings. This would present significant interpretive challenges with respect to funds that pursue thematic investment strategies, which often are difficult to reduce to a coherent 80% Policy based on particular characteristics because their investments may vary widely in terms of industries, capitalization ranges, revenue sources, asset classes, and other key characteristics. Commenters noted that these increased difficulties will necessarily result in increased costs to develop and apply compliance testing aimed at capturing the corresponding subjective characteristics. They also lamented that this aspect of the Names Rule Proposal could encourage sponsors to either lengthen and overcomplicate fund names or make them more generic and less descriptive, thereby potentially undermining the Commission's goals. Further, certain Commenters expressed concern that this could have an anti-competitive impact on the fund industry by encouraging homogenization and discouraging creative and innovative strategies in actively managed funds, while also limiting the range of acceptable indices that a passively managed fund may track.

Emphasis on a Name

Several Commenters cited the Commission's misplaced emphasis on a fund's name, which serves to undermine the SEC's repeated admonitions that investors should not rely too heavily on a fund's name to understand the fund's investment decisions and strategies. Such Commenters also remarked that this comes at a time in which investors who wish to obtain information about a fund and its holdings have ready access to more information than they have ever had before through prospectus, shareholder reports and other disclosure filings, funds' websites, and third-party channels, such as retirement and brokerage platforms. This is not to mention the potential for enhanced disclosure in the form of tailored shareholder reports as considered in the Staff's tailored shareholder report proposal[8] for which a final rule is expected in the later part of 2022 according to the SEC's most recent regulatory flex agenda.[9]

Focus on ESG

With respect to funds using ESG terms in their names, Commenters generally were consistent in their opposition to the expansion of the Names Rule to encompass ESG-related terms. Several Commenters noted that the ESG Proposal is better suited than the Names Rule Proposal to improve investor understanding of ESG funds and for addressing concerns such as greenwashing. Some Commenters noted that they supported the inclusion of a provision in the Names Rule stating that a fund using an ESG term in its name must comply with the ESG disclosure requirements. Others commented on the sequencing of the tailored shareholder report proposal and the ESG Proposal, noting that the Commission should evaluate investor understanding of any new disclosure approach before proceeding with fundamental changes to the Names Rule. To the extent ESG-related names remain in the final rule, there should be latitude to describe what is meant by the name and compliance tests should be aligned with the description.

Unlisted Closed-End Funds and BDCs

Under the Names Rule Proposal, the 80% Policy of an unlisted BDC or closed-end fund must always be a fundamental investment policy and, thus, changeable only if approved by shareholders. Commenters generally opposed the proposed shareholder approval requirement and noted that, in the alternative, the Commission could offer an exemption for funds that provide a redemption opportunity to all shareholders, in accordance with applicable Commission rules and subject to certain conditions.

While the SEC almost certainly will expand the scope of the Names Rule beyond merely investment types, particularly with respect to funds that have ESG-related terms in their names, the SEC could seek to address Commenters' concerns by requiring an 80% Policy only for funds with objectively measurable and well-defined investment attributes and otherwise focus on improving disclosure regarding how a fund's name relates to its intended investment strategy. Additionally, the SEC could provide guidance as to the "particular characteristics" that they are intending to capture. Further, the SEC could tailor the requirements with respect to unlisted closed-end funds and BDCs as noted above.

Proposed Changes Related to Temporary Departures from the 80% Policy

While the Names Rule has historically required funds to comply with its 80% Policy "under normal circumstances," the Names Rule Proposal would permit a fund to deviate from its 80% Policy only in certain enumerated circumstances and would require the fund to return to compliance as soon as reasonably practicable and, in any event, within 30 days, with certain specified exceptions. Further, while the current Names Rule allows funds to measure compliance using a time-of-acquisition test, the Names Rule Proposal would require a continuous testing regime, requiring funds to test compliance daily, regardless of the fund's trading activity, to identify any passive breaches of the fund's 80% Policy.

Commenters argued that in contrast to the existing framework, which inherently recognizes that periods of extreme market conditions require thoughtful oversight and accommodates the concept that market dislocations are unpredictable in their timing and severity, the proposed 30-day deadline for returning to compliance has the potential to harm shareholders by (1) forcing funds to sell securities at undesirable prices and inappropriate times, (2) encouraging funds to invest in securities or markets that may not be in the best interests of shareholders, and (3) increasing market instability and potentially driving down prices.

Commenters noted the SEC's concern with portfolio drift, but they noted that the existing time of investment framework, along with other requirements, already provide an effective check on a fund's ability to deviate from its 80% Policy. Accordingly, a fund that trades portfolio investments on a daily basis is already subject to a continuous testing regime, insofar as it cannot make an investment if doing so would cause it to be further out of compliance with its 80% Policy. Under this framework, funds are required to evaluate their holdings prior to each trade. In the case of certain of the highly subjective terms that the Names Rule Proposal would include, which are not readily quantifiable, ongoing testing would impose substantial burdens on funds, their sponsors, and their administrators. In some cases, relevant information on whether a particular investment satisfies a fund's 80% Policy on a daily or ongoing basis would not be available at such a frequency, thus further frustrating efforts to effectively characterize investments.

Commenters widely expressed their support for the retention of the existing "under normal circumstances" and "time of acquisition" standards. In the event that the SEC determines to amend these standards, certain Commenters have suggested that a less harmful and burdensome alternative be implemented, such as a requirement that a fund notify its board if it deviates from its 80% Policy for more than 60 days.

Commenters suggested that any final rule should contemplate greater flexibility for managers to adjust a fund's portfolio holdings in response to times of crisis or market stress. Under a principles-based approach, a manager could exercise its reasonable judgment in determining whether circumstances warrant deviation from a fund's 80% Policy, and a fund's disclosure could clearly communicate that possibility to shareholders. For example, Commenters noted that funds seeking to retain flexibility perhaps could include the term "managed" in the fund name among other disclosures to communicate to investors that the fund is permitted to depart from its 80% Policy in a manner consistent with the current Names Rule's "under normal circumstances" standard.

In addition, if the Commission adopts the proposed ongoing compliance approach, the Commission should expand the scope of the prong that would permit a fund to take a position in cash and cash equivalents or government securities to avoid losses in response to adverse market, economic, political, or other conditions by permitting a fund to invest in other types of instruments beyond those enumerated in the proposal (but otherwise consistent with the fund's investment policies and strategies). Further, Commenters noted that if the final rule should include a more expansive prescriptive list of permissible circumstances under which a fund may deviate from its 80% Policy (instead of a principles-based approach), then such circumstances should also include (1) periods necessary for the repositioning of fund assets in connection with sub-adviser or portfolio manager changes, (2) periods prior to a material strategy change, (3) periods during which there is an addition or removal of a sub-adviser, and (4) instances involving the purchase and sale of assets that require more time to acquire or sell/redeem.

Among other potential measures, the SEC could seek to address Commenters' concerns by maintaining the time-of-acquisition standard subject to not making an investment if doing so would cause it to be further out of compliance with its 80% Policy and providing additional guidance as to instances where funds could reasonably rely on temporary investment policies outside of normal circumstances. The SEC could also require that funds periodically report which holdings are counted towards the 80% Policy and that funds regularly report to boards and shareholders regarding deviations from the 80% Policy.

Proposed Treatment Regarding Antithetical Investments and the Expansion of Index Provider Oversight

Antithetical Investments

The Names Rule Proposal would codify Commission guidance that a fund's name may be materially deceptive and misleading even if the fund adopts, and is in compliance with, its 80% Policy if the other 20 percent is invested in certain "antithetical" investments. Commenters expressed concern that the evaluation of whether an investment is "antithetical" to a fund's name is highly subjective and could expose funds to second-guessing. Consequently, in certain cases, a fund's adviser could be compelled to conservatively apply the fund's 80% Policy to 100 percent of the fund's investments out of concern that the investments included in the fund's 80% Policy would be viewed by the Commission Staff as antithetical to the fund's name.

Commenters suggested that if the Commission does adopt a form of the antithetical investments guidance in any final amendments, it must clearly define the contours of what it would view as misleading under this framework and make clear that an investment that is merely not consistent with a fund's 80% Policy would not rise to the level of being antithetical.

Expansion of Index Provider Oversight

In the Names Rule Proposal, the Commission stated that even though an index fund may be appropriately invested in its disclosed index, the "underlying index may have components that are contradictory to the index's name" and that, under such circumstances, the fund's name may be materially deceptive or misleading.

Accordingly, the Names Rule Proposal could also impose significant increased burdens on investment advisers, including considerable costs, and would drastically transform the existing dynamic between investment advisers to index funds and the providers of the funds' indices. Commenters noted that this treatment could also result in increased tracking errors to the extent a fund would be required to modify its investments because an index no longer has 80 percent of its constituents with characteristics that are consistent with its index methodology. Commenters also expressed concern that this requirement may place a fund in the untenable position of needing to choose between following its replication/sampling strategy or violating the Names Rule and its 80% Policy. Commenters suggested that an index fund should not have to perform a daily compliance test with respect to whether an underlying index has components that could be perceived to be, or to have become, contradictory to the index's name. Commenters suggested that the Commission should also make clear that as long as an index rebalances at least once per year, an index fund tracking that index would not be expected to deviate from the index should characteristics of a particular issuer included in the index change during the period between rebalances (for example, in the case of a small-cap issuer that becomes a mid-cap issuer between rebalances).

Commenters further suggested that any final rule or adopting release should clarify that passively managed funds will meet their obligations under the Names Rule so long as they invest at least 80 percent of their assets in the constituents of their underlying index and, thus, not be required to develop unnecessary, burdensome, and costly fundamental analysis capabilities.

The SEC could seek to address Commenters' concerns by providing clear guidance as to what constitutes an "antithetical investment" and by addressing the concerns regarding index funds by requiring enhanced disclosure of the risks that the underlying index may have regarding components that are contradictory to the index's name and inconsistent with the fund's 80% Policy and disclosure regarding how the manager anticipates it will handle any deviations.

Proposed Calculation and Treatment of Derivatives

Historically, "assets" under the Names Rule were defined as a fund's net assets, plus the amount of any borrowings for investment purposes. This has led to some questions for funds as to whether derivatives are included in the fund's 80% Policy and, if so, whether they should be calculated using market value and not notional value. The Names Rule Proposal would require funds to value each derivatives instrument using its notional amount and reduce the value of the fund's assets by excluding any cash and cash equivalents up to the notional amount of the derivatives instrument when calculating for compliance with the 80% Policy. Further, funds would be required when calculating notional amounts to convert interest rate derivatives to 10-year bond equivalents and delta adjust for options contracts.

Commenters acknowledged that while they generally support the proposed use of notional value for purposes of the Names Rule, subject to certain adjustments, the notional value of certain derivatives instruments may not accurately represent the exposure a fund obtains through such instruments and may lead to skewed compliance results. For example, a fund may view a notional exposure measure as more appropriate when it invests in a derivatives instrument to gain investment exposure to an underlying asset, whereas the same fund may view market value or another value as more appropriate when it is using a derivatives instrument as a hedge. Rather than mandating notional value for all derivatives instruments, certain Commenters suggested that the Commission should permit funds to test each type of derivative for Names Rule purposes using a reasonable exposure metric and method that fully reflects the economic exposure the fund obtains through the use of such derivatives instrument, as long as the fund consistently applies the metric and method and discloses whether notional value, market value, or another metric is used for these purposes. Further, such Commenters noted that the proposed approach for calculating a fund's exposure to derivatives and the required adjustments to the notional value of certain derivatives instruments should be permitted, but not required, consistent with the adjustments permitted under Rule 18f-4 (the Derivatives Rule) under the 1940 Act for calculating a fund's "derivatives exposure."

Commenters further urged that the Commission acknowledge that funds should be permitted to consider all derivatives that provide exposure to risk factors associated with investments suggested by a fund name (not just those enumerated in the release) when testing Names Rule compliance, as this would otherwise raise interpretive challenges in determining whether a particular derivatives instrument can be included in the 80% Policy.

Commenters argued that the Commission should permit funds to exclude all closed-out positions regardless of counterparty from Names Rule compliance, not just derivatives that were closed out with the same counterparty, citing differences in the risks of Names Rule compliance and Section 18 and Rule 18f-4. Further, Commenters urged that it should be permissible rather than required for funds to include physical short sales and short derivatives positions in their 80% Policy, noting that long and short positions both can be used to obtain exposures suggested by a fund's name. Finally, Commenters sought the Commission to clarify that derivatives valuation methods under the Names Rule may be different than for other 1940 Act requirements, including for diversification purposes and portfolio concentration policies.

While the SEC is likely to require the use of notional value for purposes of valuing derivatives instruments under the Names Rule, it could seek to address Commenters' concerns by incorporating some of the additional flexibility and clarification sought by Commenters as noted above subject to corresponding disclosures.

Proposed Form N-PORT Reporting and Recordkeeping Requirements Are Overly Burdensome and Costly

Form N-PORT

Under the Names Rule Proposal, funds would be subject to several new reporting requirements on Form N-PORT. These include reporting as to whether an individual portfolio investment is included in a fund's 80% Policy, the total value of securities included in a fund's 80% Policy (as a percentage of the fund's total assets), and the number of days during the reporting period that the fund was not in compliance with its 80% Policy.

Certain Commenters expressed concern that the proposed changes could require certain funds to obtain supplemental and perhaps specially tailored data on their portfolio investments from third-party data vendors (similar to those utilized for monitoring under Rule 22e-4 (Liquidity Rule) and the Derivatives Rule) and may require substantial and costly upgrades to advisers' post-trade compliance systems to enable them to perform the required daily testing and mapping of the data to the N-PORT—all at a significant cost.

The Commenters noted that the proposed requirement that funds publicly report the number of days in which a fund was not in compliance with its 80% Policy—if presented to investors publicly on Form N-PORT—would not communicate meaningful context and information to investors and risk unnecessary confusion and concern.

Recordkeeping

Commenters also noted that requiring funds to maintain records documenting each investment included in the 80% Policy and the basis for such inclusion is unlikely to greatly benefit funds and their shareholders and would impose significant burdens on funds' compliance and portfolio management personnel.

The Names Rule Proposal would require funds that do not adopt an 80% Policy to maintain a written record documenting the basis for concluding that the fund's name does not require adoption of such a policy. Such a requirement would extend the scope of the Names Rule to every single fund, thereby creating a presumption that a fund is subject to the Names Rule.

The SEC could seek to address Commenters' concerns by aligning its approach with respect to Form N-PORT with that of analogous reporting requirements under the Commission's Liquidity Rule and Derivatives Rule, which are not made publicly available. Further, the SEC could mandate that extended departures (that is, beyond 30–60 days) from the 80% Policy require board and shareholder reporting.

Concerns Relating to the Economic Analysis and Proposed Compliance Period

Economic Analysis

Commenters expressed concern that the SEC did not demonstrate the need to make wholesale changes to the Names Rule, which would impact more than 10,000 funds. As a result, shareholders will likely bear much of the aggregate costs of complying with the proposed amendments, which, by the SEC's own estimates, could total as much as US$5 billion.

Commenters argued that the economic analysis significantly underestimated the implementation and ongoing costs of the proposed reforms, and ignored (1) opportunity costs, and (2) the complexity, effort, and resources necessary to either enhance existing systems and processes or build new systems and processes to comply with the proposed amendments.

Compliance Period

Further, Commenters argued that the proposed one-year compliance period is unrealistic and wholly inadequate given the significant legal, compliance, and operational challenges presented by the proposed amendments. This is particularly true because (1) additional reforms affecting the same funds and advisers will likely also be adopted with respect to different matters (for example, reforms relating to ESG and disclosure framework reforms) during the same time, and (2) many fund sponsors will need to rely on third-party service providers to assist in conducting ongoing assessment of fund portfolios to comply with the proposed Names Rule amendments, and such service providers will need considerable time to develop and test the necessary systems and capabilities. Accordingly, certain Commenters have suggested that fund sponsors should have at least three years to evaluate the impact of the proposed amendments, determine necessary changes, modify policies and procedures (if necessary), and seek board and shareholder approval of any required changes in names or strategies.

The compliance date for the implementation of the initial Names Rule was 15 months after the effective date. The SEC could seek to address the Commenters' concerns by extending the proposed compliance period to at least 18 months given the expanded scope of the Names Rule Proposal, the required internal compliance systems changes, and the potential need to rationalize the name and policies of every fund in the fund complex.

Summary Conclusion

The SEC released both proposals on the same day and sought comments on the same day. While separate rules, there is commonality in that both proposals deal with fund disclosure and the disclosure of ESG-related investment strategies. We anticipate that the final disclosure framework reforms and public company client change disclosure rule will have an impact on whatever ESG and Names Rule amendments are ultimately adopted.

The comments provided by the industry groups highlighted above raise valid concerns regarding the proposals. In expressing their views, Commenters sought for the SEC to address the concerns raised in the final rule or in accompanying guidance. The spirit of the comment period would be well served if the Commission responds to these concerns.

Ms. Riemer and **Mr. Dupuy** are attorneys at K&L Gates LLP.

NOTES

1 *Investment Company Names*, SEC Release No. IC-34593 (May 25, 2022).

2 U.S. Sec. & Exch. Comm'n, Rulemaking, How it Works, Investor.gov, *https://www.investor.gov/introduction-investing/investing-basics/glossary/rulemaking-how-it-works*.

3 Scope 1 emissions are direct GHG emissions that occur from sources owned or controlled by a company, such as emissions from company-owned or controlled machinery or vehicles. Scope 2 emissions are those indirect emissions primarily resulting from the generation of electricity purchased and consumed by the company.

4 Scope 3 emissions are all other indirect emissions not accounted for in Scope 2 emissions.

5 *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, SEC Release No. IC-34594 (May 25, 2022) [hereinafter Proposing ESG Release].

6 The SEC proposed that the term "ESG engagement meeting" means a "substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given time period, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal." *See* Proposing ESG Release at 81.

7 *Final Rule: Investment Company Names*, SEC Release No. IC-24828 (Mar. 31, 2001).

8 *Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements*, SEC Release Nos. 33-10814, 34-89478, IC-33963 (Nov. 5, 2020).

9 Off. of Info. & Regul. Affs., Agency Rule List—Spring 2022, Reginfo.gov, *https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235*.