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SEC PROPOSES ESG DISCLOSURE RULES, AND UPDATES TO THE NAMES RULE

On May 25, 2022, the US Securities and Exchange Commission (the "SEC" or the "Commission") proposed to amend rules and forms under both the Investment Advisers Act of 1940 (the "Advisers Act") and the Investment Company Act of 1940 (the "Investment Company Act") to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies ("BDCs"), to provide additional information regarding their environmental, social, and governance ("ESG") investment practices ("ESG Proposal").[1]

On the same day, the Commission proposed to amend Rule 35d-1 under the Investment Company Act (the "Rule 35d-1 Proposal"[2] together with the ESG Proposal, the "Proposals") which according to the SEC is designed to increase investor protection by improving and clarifying the requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund's name suggests. The Rule 35d-1 Proposal is also proposing enhanced prospectus disclosure requirements for terminology used in fund names, and additional requirements for funds to report information on Form N-PORT regarding compliance with the proposed names-related regulatory requirements.

[1] U.S. Sec. & Exch. Comm'n, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (May 25, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11068.pdf.

[2] U.S. Sec. & Exch. Comm'n, Investment Company Names (May 25, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11067.pdf.

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This Client Alert provides details regarding each Proposal, which we believe, if adopted in the proposed forms, would have far reaching implications for the asset management industry, including with respect to current and future product offerings, compliance oversight of investment programs both in the United States and globally and, disclosure obligations.

ESG PROPOSAL

Asset managers continuously strive to meet client demand for innovative investment products. Over the last few years, "E" (environmental) "S" (social) "G" (governance) investment strategies have attracted the attention of many investors and, as a result, asset managers around the world have created investment products to accommodate investor appetite for these strategies. In his statement on the ESG Proposal, Chair Gensler noted that "while the estimated size of this sector varies, one estimate says that the 'U.S. sustainable investment universe' has grown to $17.1 trillion. Suffice it to say there are hundreds of funds and potentially trillions of dollars under management in this space."[3]

Due to the increased activity in this space, regulators in the United States and the rest of the world have also started to focus on this growing area of the market. The increased regulatory scrutiny has led to certain new regulatory requirements in parts of the world. For example, as part of the European Commission's Sustainable Finance Action Plan, the new Sustainable Finance Disclosure Regulation ("SFDR") imposes an obligation on asset managers, advisers, and certain other firms in the European Union (and likely to non-EU asset managers that market their funds in the European Union) to disclose information on various ESG considerations to potential investors, and on their websites.[4] With the ESG Proposal, the SEC appears to be following in the footsteps of its regulatory counterparts. Below, we outline certain key aspects of the ESG Proposal.

Proposed Fund Disclosures to Investors – Prospectus

The ESG Proposal seeks to require a registered fund to provide additional information about the fund's implementation of ESG factors[5] in the fund's principal investment strategies. The level of detail required by this enhanced disclosure would depend on the extent to which a fund considers ESG factors in its investment process. As a result, funds that meet the proposed definition of

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[3] *See* Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Statement on ESG Disclosures Proposal (May 25, 2022), https://www.sec.gov/news/statement/gensler-statement-esg-disclosures-proposal-052522.

[4] In 2019, the European Commission adopted the Sustainable Finance Disclosure Regulation ("SFDR"), a sustainability disclosure framework for providers of certain financial products and financial market participants including asset managers. See Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 Nov. 2019 on sustainability-related disclosures in the financial services sector and Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 PE/20/2020/INIT.

[5] The ESG Proposal does not seek to define "ESG" or similar terms and, instead, the ESG Proposal would require funds to disclose to investors (1) how they incorporate ESG factors into their investment selection processes and (2) how they incorporate ESG factors in their investment strategies.

"Integration Fund"[6] would provide limited disclosures. "ESG-Focused" Funds,[7] which would include, for example, funds that apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement with the issuers in which they invest, and funds that seek to achieve a particular ESG impact, would be required to provide more detailed information in a tabular format. The proposed amendments would apply to registered investment companies and BDCs, and in particular to open-end funds (including ETFs) and closed-end funds (including BDCs) that incorporate one or more ESG factors into their investment selection process.

All ESG-Focused Funds would provide disclosure in a tabular format, an ESG Strategy Overview Table, which would be included in a fund's prospectus. An open-end fund would be required to provide the disclosure at the beginning of its "risk/return summary," while a closed-end fund would provide the table at the beginning of the discussion of the fund's organization and operation.

The tabular format disclosure provides the following categories of required disclosure:

- First Row - *An Overview of a Fund's ESG Strategy*. In this category, a fund would be required to specify how it implements its [ESG] strategy. The ESG Proposal lists the following categories:
  - track an index
  - applies an inclusionary screen[8]
  - applies and exclusionary screen[9]
  - seeks to achieve specific impact
  - proxy voting
  - engagement with issuers
  - other
- Second Row - *How a Fund incorporates [ESG] factors in its investment decisions*

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6 According to the ESG Proposal, an Integration Fund, is a fund that considers one or more ESG factors along with other, non-ESG factors in its investment decisions, "but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio."

7 The ESG Proposal defines an ESG-Focused Fund as "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. ESG-Focused Funds would also include ESG Impact Funds. Thus, an ESG Impact Fund would be an ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts.

8 The ESG Proposal notes that if a fund applies an inclusionary or exclusionary screen to select or exclude investments, the fund's summary must briefly explain the factors the screen applies, such as particular industries or business activities it seeks to include or exclude, and if applicable, what exceptions apply to inclusionary or exclusionary screen. Moreover, a fund would be required to state the percentage of the portfolio, in terms of net asset value, to which the screen applies, if less than 100%, excluding cash and cash equivalents held for cash management and to explain briefly why the screen applies to less than 100% of the portfolio.

9 An impact fund would be required to state in the second row how it incorporates [ESG] factors in its investment decisions, an overview of the impact(s) the fund is seeking to achieve, and how the fund is seeking to achieve the impact(s). The ESG Proposal notes that the overview must include (i) how the fund measures progress toward the specific impact, including the key performance indicators the fund analyzes, (ii) the time horizon the fund uses to analyze progress, and (iii) the relationship between the impact the fund is seeking to achieve and financial return(s).

- Third Row - *How a Fund votes proxies and/or engages with companies about [ESG] issues*[10]

Proposed Fund Disclosures to Investors – Annual Report

In addition to the proposed prospectus disclosure, the ESG Proposal also sets out several amendments to fund annual reports. Specifically, for registered investment companies, the proposed disclosure would be included in the management's discussion of fund performance ("MDFP") section of the fund's annual shareholder report and for BDCs, the disclosure would be included in the management discussion and analysis, or "MD&A," in the fund's annual report on Form 10-K.

The specific disclosure would mandate that Impact Funds discuss their progress toward achieving impact in both qualitative and quantitative terms during the reporting period.[11] An Impact Fund would also be required to discuss the key factors that "materially" affected the fund's ability to achieve its impact.[12] Furthermore, the ESG Proposal notes that for funds for which proxy voting is a significant means of implementing their ESG strategy, such fund would be required to disclose certain information regarding how the fund voted proxies relating to portfolio securities on ESG issues during the reporting period.[13] Similarly, funds for which engagement with issuers on ESG issues through means other than proxy voting is a significant means of implementing their ESG strategy, would be required to disclose certain information about their engagement practices.[14]

Commissioner Peirce in her dissenting remarks noted that it "will be interest[ing] to see what commenters say on the matter. Among other things, would such a rule set a precedent for SEC micromanagement of asset management?"[15]

GHG Emissions Disclosure

The ESG Proposal would require an ESG-Focused Fund that considers environmental factors to disclose the aggregated GHG emissions of its portfolio.[16]

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[10] The ESG Proposal notes that if a fund checks either the proxy voting or engagement box in the first row of the ESG Strategy Overview Table indicating that proxy voting or engagement with issuers is a significant means of implementing its ESG strategy then such fund would be required to provide a brief narrative overview in the last row of the ESG Strategy Overview Table of how the fund engages with portfolio companies on ESG issues. The ESG Proposal goes on to note that a fund would only check the boxes regarding proxy voting or engagement with issuers if such strategy is a "significant" means of implementing the fund's ESG strategy. While the SEC acknowledges that a fund's determination of whether either strategy is "significant" would depend on facts and circumstances, the Commission believes that "a fund that regularly and proactively votes proxies or engages with issuers on ESG issues to advance one or more particular ESG goals the fund has identified in advance would be using voting and engagement as a significant means to implement its strategy."

[11] ESG Risk Alert at 71.

[12] For example, a community development fund that seeks to enhance services in underserved communities by investing in the construction of community facilities may disclose that, during the reporting period, the companies in which the fund invests constructed a specific number of recreational centers in target communities.

[13] ESG Risk at 71.

[14] The ESG Proposal defines "ESG engagement meeting" to mean 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. The ESG Proposal notes that in order to support compliance with the Federal securities laws, funds should generally consider including in their compliance policies and procedures a requirement that employees memorialize the discussion of ESG issues, for example by creating and preserving meeting agendas and contemporaneous notes of engagements relating to ESG issues to assure accurate reporting on the number of engagements.

[15] *See* Hester Peirce, Commissioner, U.S. Sec. & Exch. Comm'n, Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies (May 25, 2022), https://www.sec.gov/news/statement/peirce-statement-esg-052522.

[16] The Commission proposes to require an ESG-Focused Fund that considers environmental factors as part of its investment strategy to disclose the carbon footprint and the weighted average carbon intensity ("WACI") of the fund's portfolio in the MDFP or MD&A section of the fund's annual report as applicable.

The SEC, however, acknowledged that not all ESG-Focused Funds that consider environmental factors as part of their investment strategies consider the GHG emissions of the issuers in which they invest as part of their investment strategies. Thus, a fund would not be required to disclose its GHG emissions metrics if it affirmatively states in the ESG Strategy Overview Table that it does not consider issuers' GHG emissions as part of its investment strategy.

Additionally, for both the carbon footprint and WACI measures, a fund would be required to determine GHG emissions associated with each "portfolio company" (or "portfolio holding").[17] The ESG Proposal defines portfolio company as: (a) an issuer that is engaged in or operates a business or activity that generates GHG emissions; or (b) an investment company, or an entity that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act (a "private fund"), that invests in issuers described in clause (a), except for an investment in reliance on Rule 12d1-1 under the Investment Company Act (*i.e.*, investments in money market funds).

In addition to the above metrics, an ESG-Focused Fund that is environmentally focused fund would also be required to disclose the Scope 3 emissions of its portfolio companies, to the extent that Scope 3 emissions data is reported by the fund's portfolio companies.

In her dissent, Commissioner Peirce noted the following with respect to GHG reporting:

> Forcing ESG-Focused funds to make good faith estimates of a portfolio company's greenhouse gas emissions, when they cannot get such data from "non-reporting portfolio companies," will in turn play a coercive role. This time the coercion will be on companies to disclose greenhouse gas emissions so that funds will invest in them without the burden of greenhouse gas guessing (and subsequent enforcement second-guessing). If demand for greenhouse gas disclosures is becoming the norm, let the standards and expectations develop organically; let investors shape industry practice through their investing decisions, not through regulatory mandates about what investors *ought* to be considering.[18]

Adviser Brochure Amendments (Form ADV Part 2A)

The ESG Proposal proposes to add new sub-Item 8.D, which would require an adviser to provide a description of the ESG factor or factors it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors. Similar to registered funds, the ESG Proposal would require advisers to provide a description of the ESG factor or factors they consider, and disclose to clients how they incorporate these factors when providing investment advice, including when recommending or selecting other investment advisers.

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[17] Fund investments that are not "portfolio companies" such as cash, foreign currencies (or derivatives thereof), and interest rate swaps, are excluded under the ESG Proposal from the GHG metrics calculations because these investments do not generate GHG emissions.

[18] *See infra*, note 15.

In addition, the ESG Proposal would amend Item 10.C. to require an adviser to describe any relationship or arrangement, "that is material" to the adviser's advisory business or to its clients, that the adviser or any of its management persons have with any related person that is an ESG consultant or other ESG service provider (for purposes of this release, a "related person ESG provider"). Related person ESG providers may include, for example, ESG index providers and ESG scoring providers.

In addition, the ESG proposal would amend Item 17.A to require advisers that have specific voting policies or procedures that include one or more ESG considerations when voting client securities to include in their brochures a description of which ESG factors they consider and how they consider them.[19]

Wrap Fee Brochure (Form ADV Part 2A, Appendix 1)

The ESG Proposal proposes to amend Item 4 to specify that advisers that consider ESG factors in their wrap fee programs must provide a description of what ESG factors they consider, and how they incorporate the factors under each program. In addition, the ESG Proposal proposes to amend Item 6 to require advisers that consider ESG factors when selecting, reviewing, or recommending portfolio managers within the wrap fee programs they sponsor, to describe the ESG factors they consider and how they consider them.[20] In connection with the Wrap Fee Brochure amendments, the Commission is also proposing three disclosure requirements as part of advisers' description of how they consider the relevant ESG factors described above. The first of the three disclosures would require advisers to describe any criteria or methodology they use to assess portfolio managers' applications of the relevant ESG factors into their portfolio management. The ESG Proposal notes that this would include any industry or other standards for presenting the achievement of ESG impacts and/or third-party ESG frameworks, and any internal criteria or methodology.[21] The second of the three disclosures would require advisers to provide an explanation of whether they review, or whether a third party reviews, portfolio managers' applications of the relevant ESG factors described above and if so, advisers would be required to describe the nature of the review and the name of any third party conducting the review.[22] Finally, the third disclosure would require that an adviser explain, if applicable, that neither the adviser nor a third party assesses portfolio managers' applications of the relevant ESG factors into their portfolio management, and/or that the portfolio managers' applications of the relevant ESG factors may not be calculated, compiled, assessed, or presented on a uniform and consistent basis.[23]

In connection with Wrap Fee Brochure amendments, the ESG Proposal proposes to amend Item 6.C. to require any adviser that acts as a portfolio manager for a wrap fee program described in its wrap fee program brochure, to respond to an additional specified brochure Item, specifically proposed Item 8.D.[24]

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[19] If an adviser has different voting policies and procedures for strategies that address ESG-related matters, or for different clients or different ESG-related strategies, the adviser generally should describe those differences.
[20] ESG Proposal at 142.
[21] ESG Proposal at 143.
[22] ESG Proposal at 144.
[23] ESG Proposal at 144.
[24] ESG Proposal at 145.

Regulatory Reporting on Form N-CEN and Form ADV Part 1A

The ESG Proposal would amend Form N-CEN in order to collect census-type information regarding certain funds and the ESG-related service providers they use in a structured data language.[25] The ESG Proposal would also amend Form ADV Part 1A in order to collect information about an adviser's uses of ESG factors in its advisory business. These proposed amendments would expand the information collected about the advisory services provided to separately managed account clients and reported private funds.[26]

In addition, the ESG Proposal proposes to require advisers to report whether they follow any third-party ESG framework(s) in connection with their advisory services, and if so, the adviser would be required to report the name of the framework.[27] According to the SEC, this information would inform the Commission and current and prospective advisory clients that the adviser follows certain framework. The ESG proposal notes that "[r]equiring this information would provide Commission staff with additional data to assess and evaluate trends in this industry.[28]

The ESG Proposal would also require advisers to disclose whether they conduct other business activities as ESG providers or have related persons that are ESG providers by amending Items 6 and 7 of Part 1A (and Sections 6.A. and 7.A. of Schedule D). For each related person ESG provider, the adviser would be required to complete the relevant items in Section 7.A of Schedule D, which requires, for example, the related person's SEC file number (if any) and additional information about the adviser's control relationship (if any) with the related person. The Commission noted that it believes that this type of disclosure would assist the public in better understanding advisers' conflicts of interests when related persons offer ESG provider services, or when the adviser offers its own ESG provider services to others.[29]

Compliance Policies and Procedures and Marketing

The ESG Proposal notes with all disclosures, advisers' and funds' compliance policies and procedures should address the accuracy of ESG disclosures made to clients, investors and regulators. In addition, the ESG Proposal notes that the policies should address portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund.[30] By way an example, the ESG Proposal offers the following:

> If an adviser discloses to investors that it considers certain ESG factors as part of an integration strategy, the adviser's compliance policies and

[25] The ESG proposal notes that collecting this type of information would inform SEC's regulatory enforcement, examination, disclosure review, and policymaking roles, and help it track trends in this evolving area of asset management. It is important to note that, in the past, the Commission has brought enforcement actions resulting from disclosures that the Commission deemed to be materially misleading. See, *e.g.*, Press Release 2008-157, SEC Charges Mutual Fund Manager for Violating Socially Responsible Investing Restrictions (July 30, 2008), available at https://www.sec.gov/news/press/2008/2008-157.html; See also, Press Release 2022-86, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations, (May 23, 2022), available at https://www.sec.gov/news/press-release/2022-86.
[26] ESG Proposal at 155.
[27] ESG Proposal at 158.
[28] ESG Proposal at 158.
[29] ESG Proposal at 163.
[30] ESG Proposal at 166.

procedures should be reasonably designed to ensure the adviser manages the portfolios consistently with how the strategy was described to investors (*e.g.,* actually considering the ESG factors in the way it says it considers them). If a registered fund discloses to investors that it adheres to a particular global ESG framework, its policies and procedures should include controls that help to ensure client portfolios are managed in accordance with that framework. Similarly, if an adviser uses ESG-related positive and/or negative screens on client portfolios, the adviser should maintain adequate controls to maintain, monitor, implement, and update those screens. Relatedly, if an adviser has agreed to implement a client's ESG-related investing guidelines, mandates, or restrictions, the adviser's compliance policies and procedures should be designed to ensure these investment guidelines, mandates, or restrictions are followed.

Compliance Dates

Compliance date for the following items would be one year following the effective date, which would be sixty days after the date of publication in the Federal Register: (i) the proposed disclosure requirements in prospectuses on Forms N-1A and N-2, (ii) the proposed disclosure requirements for UITs on Form N-8B2; (iii) the proposed regulatory reporting on Form N-CEN, and (iv) the proposed disclosure requirements and regulatory reporting on Form ADV Parts 1 and 2.

The compliance date of any adoption of the proposed disclosures in the report to shareholders and filed on Form N-CSR would be 18 months following the effective date, which would be sixty days after the date of publication in the Federal Register. The ESG Proposal notes that this extended compliance date would also provide extra time for affected funds to develop any needed procedures for gathering data necessary to comply with the GHG metrics, proxy voting, and engagement reporting requirements if adopted. Commissioner Peirce noted in her remarks that "[g]iven the ambiguity and breadth of the proposed requirements, the planned one-year compliance date for funds and advisers to get their Es, Ss, and Gs in order is laughably short."[31]

RULE 35d-1 PROPOSAL

According to the Commission, Rule 35d-1 Proposal is designed to increase investor protection by improving and clarifying the requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund's name suggests, updating the rule's notice requirements, and establishing recordkeeping requirements.[32] In her dissenting comments, Commissioner Peirce, however, noted that the proposed amendments "…may create more fog than they dissipate and may place unnecessary constraints on fund managers."[33]

Section 35(d) of the Investment Company Act prohibits a registered investment company from adopting as part of its name or title any word or words that the

[31] *See* Hester Peirce, Commissioner, U.S. Sec. & Exch. Comm'n, Statement on Investment Company Names (May 25, 2022), available at https://www.sec.gov/news/statement/peirce-fund-names-statement-052522. ("Peirce's Comments on the Rule 35d-1 Proposal.

[32] The Commission is also proposing enhanced prospectus disclosure requirements for terminology used in fund names, and additional requirements for funds to report information on Form N-PORT regarding compliance with the proposed names-related regulatory requirements.

[33] Peirce's Comments on the Rule 35d-1 Proposal.

Commission finds are materially deceptive or misleading. In 2001, the SEC adopted rule 35d-1 under the Investment Company Act (the "Names Rule") as an investor protection measure, designed to help ensure that investors are not misled or deceived by a fund's name. Specifically, the Names Rule prohibits any fund from adopting as part of its name any word or words that the Commission finds are materially deceptive or misleading. The Names Rule does not apply to investment strategies, instead, the Names Rule requires that a fund purporting in its name to cover a certain type of investment (*e.g.*, stocks or bonds), industry (*e.g.,* oil and gas, health care, etc.) or geographic focus (*e.g.*, the ABC Japan Fund or XYZ Latin America Fund), the fund must adopt a policy to invest at least 80% of the value of its assets in the type of investment, or in investments in the industry, country, or geographic region, suggested by its name. The Names Rule acknowledges the importance of a fund's name to investors, which is often the first piece of fund information investors see, and it can substantively influence investment decisions.

In what appears to be an acknowledgment of potential concerns around "greenwashing," in March 2020, the Commission issued a request for comment ("Request for Comment")[34] regarding whether the Names Rule should apply to registered investment companies that include terms such as ESG in their name. In the Request for Comment, the Commission acknowledged that the Names Rule has not been amended since 2001 and since that time, the investment market has obviously changed greatly. Those changes include a substantial development of index-based funds, hybrid financial instruments, and derivatives, and the Request for Comment specifically sought industry input on the applicability of the Names Rule to funds that pursue such investment strategies. With respect to ESG Funds, the Request for Comment acknowledged that "funds with investment mandates that include criteria that require some degree of qualitative assessment or judgment of certain characteristics (such as funds that include one or more environmental, social, and governance-oriented assessments or judgments in their investment mandates (for example, ESG investment mandates))" may present novel challenges under the Names Rule.

According to the SEC, Rule 35d-1 Proposal would address fund names with ESG and similar terminology by providing that funds whose names include these terms are subject to the rule's 80% investment policy requirement, and by defining certain uses of ESG terminology in fund names as materially deceptive and misleading. According to the Commission, the proposed amendments would help to prevent potential "greenwashing" in fund names by requiring a fund's investment activity to support the investment focus its name communicates so that investors will not be deceived or misled by the fund's name.[35]

Overview of the Proposal

Rule 35d-1 Proposal covers the following areas, which this Client Alert discusses in greater detail herein:

- Expansion of Scope

[34] U.S. Sec. & Exch. Comm'n, Request for Comments on Fund Names, 85 Fed. Reg. 13,221 (Mar. 6, 2020).
[35] Rule 35d-1 Proposal at 14.

- Changes Over Time and Temporary Departures from a Fund's 80% Investment Policy
- Derivatives
- Unlisted Closed-End Funds and BDCs
- Effect of Compliance on an 80% Investment Policy
- Enhanced Prospectus Disclosure
- Plain English Requirements for Terms Used in Fund Names
- Materially Deceptive and Misleading Use of ESG Terminology
- Modernization of Notice Requirement
- Form N-PORT Reporting Requirements
- Recordkeeping
- Funds That Do Not Adopt an 80% Investment Policy

Expansion of Scope

Rule 35d-1 Proposal seeks to expand the rule's 80% investment policy requirement beyond its current scope, to apply to any fund name with terms suggesting that the fund focuses on investments that have, or investments whose issuers have, particular characteristics. By way of example, the Proposal notes that this would include fund names with terms indicating that the fund's investment decisions incorporate one or more ESG factors. In her dissent, Commissioner Peirce noted that:

> the application of the 80% investment policy requirement to names suggesting that a fund focuses on investments with "particular characteristics," most prominently, those associated with ESG, will rely on subjective judgments. Given the breadth of terms such as ESG, growth, and value, how will industry implement the rule and how will we enforce it without engaging in Monday morning asset managing? The inability to draw discernible boundaries around a centrally important term renders creative enforcement actions based on second-guessing in hindsight almost inevitable. Applying the Names Rule to investment strategies, which is essentially what the proposal would do, may have the detrimental effect of forcing homogeneity in the way funds are managed.

Rule 35d-1 Proposal notes that "...we believe that fund names included in the proposed expanded scope—such as names with terms like 'growth,' 'value,' or 'sustainable' where a fund may not have adopted an 80% investment policy under the current rule—communicate to investors that the fund will concentrate in investments that the fund believes have those particular characteristics."[36] In addition, the Proposal notes that the amendment also would apply to other fund names that historically may have not required an 80% investment policy (depending on the context), such as names that include terms like "global," "international," "income," or "intermediate term (or similar) bond."[37] If a fund name

[36] Rule 35d-1 Proposal at 23.
[37] Rule 35d-1 Proposal at 23-24.

suggests multiple elements (*e.g.*, ABC Preferred Securities and Income Fund) then the fund's 80% investment policy must address all of the elements in the name, however, the fund would be permitted to take a reasonable approach in specifying how the fund's investments will incorporate each such element in the name.[38] Commissioner Peirce noted that this approach would encourage "more generic names so that managers can preserve flexibility in their portfolio management, but more generic names are less informative for investors."[39]

Changes Over Time and Temporary Departures from a Fund's 80% Investment Policy

Rule 35d-1 Proposal seeks to add specific circumstances under which a fund may depart from its 80% investment policy, including specific time frames for getting back into compliance. This presents a departure from the current requirement where a fund's policy applies at the time of investment, and "under normal circumstances." Commissioner Peirce noted that "...the consequence of this intentionally inflexible approach may include inducing portfolio managers to make undesirable investments in order to remain in compliance with the rule or forcing funds to shut down in times of even relatively short-lived market stress."[40]

Rule 35d-1 Proposal notes that temporary departures would be permitted in the following circumstances:

- as a result of market fluctuations, or other circumstances where the temporary departure is not caused by the fund's purchase or sale of a security or the fund's entering into or exiting an investment;
- to address unusually large cash inflows or unusually large redemptions;
- to take a position in cash and cash equivalents or government securities to avoid a loss in response to adverse market, economic, political, or other conditions; or
- 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.

Under each of the foregoing circumstances, except fund launches (where accompanying temporary departures could not exceed a period of 180 consecutive days), reorganizations (for which Rule 35d-1 Proposal does not specify a required time frame for accompanying temporary departures), or where the 60-day notice has been provided to shareholders, a fund would have to bring its investments back into compliance with the 80% investment requirement within 30 consecutive days. In all cases, a fund would have to come back into compliance as soon as reasonably practicable.[41]

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[38] Rule 35d-1 Proposal at 26.

[39] Peirce's Comments on the Rule 35d-1 Proposal.

[40] Id.

[41] Rule 35d-1 Proposal at 34. Rule 35d-1 Proposal notes that "as soon as reasonably practicable" would not strictly mean "as soon as possible" in all cases and is intended to allow for consideration by an adviser of how to return to compliance in a manner that best serves the interest of the fund and its shareholders (but in no case longer than the proposed 30-day limit where applicable). By way of example Rule 35d-1 notes that a fund need not return to compliance within 2 days, even if doing so is technically possible, if such an approach would harm the fund or its shareholders by, for instance, causing the fund to purchase illiquid assets at a premium.

Derivatives

Rule 35d-1 Proposal proposes to require funds to use a derivatives instrument's notional amount, rather than its market value, for the purpose of determining the fund's compliance with its 80% investment policy. Also, the Proposal seeks to amend the Names Rule to address the derivatives instruments that a fund may include in its 80% basket. Thus, in addition to any derivatives instrument that a fund includes in its 80% basket because such derivative provides investment exposure to the investments suggested by the fund's name, Rule 35d-1 Proposal approach would permit a fund to include in its 80% basket a derivatives instrument that provides investment exposure to one or more of the market risk factors associated with the investments suggested by the fund's name. As a result, the derivatives instruments included in a fund's 80% basket would either be functioning as a substitute for direct investments in the securities suggested by the fund's name or used to facilitate the fund's investment in those securities by increasing or decreasing the fund's exposure to risk factors associated with those securities.[42]

Unlisted Closed-End Funds and BDCs

Rule 35d-1 Proposal would require that a registered closed-end fund or BDC, whose shares are not listed on a national securities exchange and that is required to adopt an 80% investment policy, must make its 80% investment policy a fundamental policy in all cases. Thus, unlisted closed-end funds and BDCs would not be permitted to change their 80% investment policies without a shareholder vote. According to the Commission, this proposed amendment is meant to address investor protection concerns regarding funds that can change their 80% investment policies without shareholders having the ability to vote on the change or "readily exit the fund".

Effect of Compliance on an 80% Investment Policy

Rule 35d-1 Proposal does not change how a fund should invest the remaining 20% of its portfolio. Nonetheless, the Rule 35d-1 Proposal notes that a fund's name could be materially deceptive or misleading for purposes of Section 35(d) if, for example, a fund complies with its 80% investment policy but makes a substantial investment that is antithetical to the fund's investment focus (*e.g.*, a "fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves). Similarly, a fund's name could be materially deceptive or misleading for purposes of Section 35(d) if a fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name, regardless of the fund's compliance with the requirements of the Names Rule (*e.g.*, a short-term bond fund using the 20% basket to invest in highly volatile equity securities that introduce significant volatility into a fund that investors would expect to have lower levels of volatility associated with short-term bonds).[43] Moreover, the Rule 35d-1 Proposal notes that a fund that is perpetually out of compliance with the 80% investment requirement on account of temporary departures may have a name

[42] Rule 35d-1 Proposal at 56.
[43] Rule 35d-1 Proposal at 69.

that is materially deceptive or misleading under Section 35(d) even if each temporary departure is permissible under the Names Rule.

Enhanced Prospectus Disclosure

Rule 35d-1 Proposal proposes amendments to funds' prospectus disclosure requirements that would, among other things, require a fund to define the terms used in its name, including the criteria the fund uses to select the investments that the term describes. Thus, Rule 35d-1 Proposal proposes to replace the specific disclosure requirement for fund names focusing on particular countries or geographic regions with the general requirement to define terms used in a fund's name whenever the fund's name suggests an investment focus requiring an 80% investment policy. According to the Proposal, in order to satisfy an investor's reasonable expectations of a fund's investment focus, funds would be required to use terminology in the fund's name in a manner that is consistent with the plain English or established industry use. By way of example, Rule 35d-1Proposal notes that a fund that calls itself a "solar energy fund" would not be able to use disclosure to qualify the name in the prospectus by stating that the fund's 80% basket includes investments in the securities of any type of alternative energy company.[44]

Plain English Requirements for Terms Used in Fund Names

Consistent with the discussion above, Rule 35d-1 Proposal notes that any terms used in a fund's name that suggest either an investment focus, or that the fund is a tax-exempt fund, must be consistent with those terms' plain English meaning or established industry use.

Materially Deceptive and Misleading Use of ESG Terminology in Certain Fund Names

Rule 35d-1 Proposal notes that it would be materially deceptive or misleading for an "Integration Fund" to use a name that indicates that the fund's investment decisions incorporate one or more ESG factors. Thus, Rule 35d-1 Proposal would deem "Integration Funds" incorporating ESG terminology in their names as *per se* materially deceptive or misleading. Commissioner Peirce in her dissenting comments noted that "…putting [Rule 35d-1 Proposal] together with the accompanying [ESG Proposal]—spoiler alert—generates a puzzling result: integration funds would have heightened disclosure obligations, but would be unable to use their name to signal to investors that they are integrating ESG." Commissioner Peirce further noted that "[s]ome advisers may choose to convert their integration funds into ESG-focused funds, which will decrease options for investors. Or an adviser might try to run from ESG to avoid the heightened disclosure requirements."[45]

Modernization of Notice Requirement

Rule 35d-1 Proposal proposes to update the Names Rule's notice requirement to, among other things, expressly address funds that use electronic delivery methods to provide information to their shareholders. Thus, if the notice is provided electronically, the proposed amendments would require the statement to appear

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[44] Rule 35d-1 Proposal at 79.
[45] Peirce's Comments on the Rule 35d-1 Proposal.

on the subject line of the email communication that includes the notice. With respect to notices that are provided in paper format, proposed amendments would require a statement to appear on the envelope in which the notice is delivered. This is an expansion of the current requirement which only requires the statement to appear on the envelope when the envelope includes other materials. According to the SEC, this amendment is designed to help draw shareholders' attention to an important document that provides them information about the change in the fund's investment policy.

Form N-PORT Reporting Requirements

Rule 35d-1 Proposal proposes to amend Form N-PORT to require greater transparency on how fund investment selection methods match the investment focus that the fund's name suggests. As a result, if adopted, the proposed amendments would include a new reporting item regarding a fund's names rule compliance. In addition, they also would include a new reporting item requiring a fund subject to the 80% investment policy requirement to indicate, with respect to each portfolio investment, whether the investment is included in the fund's 80% basket.

Recordkeeping

Rule 35d-1 Proposal proposes to require funds that must adopt an 80% investment policy to adhere to recordkeeping requirements that are designed to provide the Commission and staff, as well as the fund's compliance personnel, the ability to evaluate the fund's compliance with the rule's requirements. Funds that do not adopt an 80% investment policy would be required to maintain a written record of their analysis that such a policy is not required under the names rule.

Specifically, those funds that are required to adopt an 80% investment policy, would be required to maintain written records documenting the fund's compliance. As a result, such funds would be required to maintain:

- a fund's record of which investments are included in the fund's 80% basket (generally defined as investments that are invested in accordance with the investment focus the fund's name suggests or, as applicable, consistent with the tax treatment suggested by a tax-exempt fund's name) and the basis for including each such investment in the 80% basket;
- the value of the fund's 80% basket, as a percentage of the value of the fund's assets;
- the reasons for any departures from the 80% investment policy;
- the dates of any departures from the 80% investment policy; and
- any notice sent to the fund's shareholders pursuant to the rule.

These records would need to be maintained for at least six years following the creation of each required record (or, in the case of notices, following the date the notice was sent), the first two years in an easily accessible place.

Rule 35d-1 Proposal notes that the maintenance of these records would allow SEC staff to better identify and assess violations, and, according to the Proposal,

this recordkeeping requirement would increase the effectiveness of the Commission's oversight of the fund industry, which will, in turn, benefit investors.[46]

Funds That Do Not Adopt an 80% Investment Policy

As noted above, a fund that does not adopt an 80% investment policy would be required to maintain a written record of the fund's analysis that such a policy is not required under the Names Rule.

Rule 35d-1 Proposal notes that this provision would also assist compliance practices, as fund boards generally should consider names rule compliance, including the requirement for certain funds to adopt an 80% investment policy, in approving their funds' policies and procedures under rule 38a-1(a)(2).[47]

Compliance Dates

Compliance with the proposed Names Rule amendments, if adopted, would be required one-year from the date of the publication of the final rule amendments in the Federal Register. The Commission noted that the one-year transition period is being provided in order to give funds time to prepare to come into compliance with the proposed rule amendments, if adopted. Commissioner Peirce in her dissenting remarks noted that the proposed one-year implementation period is too short given the number of funds that may have to make adjustments in their portfolios or change their names.

Comments on both Proposals are due 60 days after the date each Proposal is published in the Federal Register.

[46] Rule 35d-1 Proposal at 104.
[47] Rule 35d-1 Proposal at 107.

CONTACTS

Vadim Avdeychik
Partner

T +1 212 878 3055
E vadim.avdeychik@cliffordchance.com

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman@cliffordchance.com

Susan Burkhardt
Partner

T +1 212 878 3279
E susan.burkhardt@cliffordchance.com

Cliff Cone
Partner

T +1 212 878 3180
E clifford.cone@cliffordchance.com

Daniel Drabkin
Partner

T +1 212 878 8255
E daniel.drabkin@cliffordchance.com

Steven Gatti
Partner

T +1 202 912 5095
E steven.gatti@cliffordchance.com

Robert Houck
Partner

T +1 212 878 3224
E robert.houck@cliffordchance.com

Kelly Labritz
Partner

T +1 212 878 3456
E kelly.labritz@cliffordchance.com

Jefferey LeMaster
Partner

T +1 212 878 3206
E jefferey.lemaster@cliffordchance.com

Michael Sabin
Partner

T +1 212 878 3289
E michael.sabin@cliffordchance.com

Bill Sturman
Partner

T +1 212 878 3453
E william.sturman@cliffordchance.com

David Adams
Counsel

T +1 202 912 5067
E davidg.adams@cliffordchance.com

Philip Angeloff
Counsel

T +1 202 912 5111
E philip.angeloff@cliffordchance.com

Young Kim
Counsel

T +1 212 878 4902
E young.kim@cliffordchance.com

Eric Bernstein
Associate

T +1 212 878 3411
E eric.bernstein@cliffordchance.com

Andrew Nelson
Associate

T +1 212 878 8284
E andrew.nelson@cliffordchance.com

Michelle Mount
Law Clerk

T +1 212 878 8091
E michelle.mount@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

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