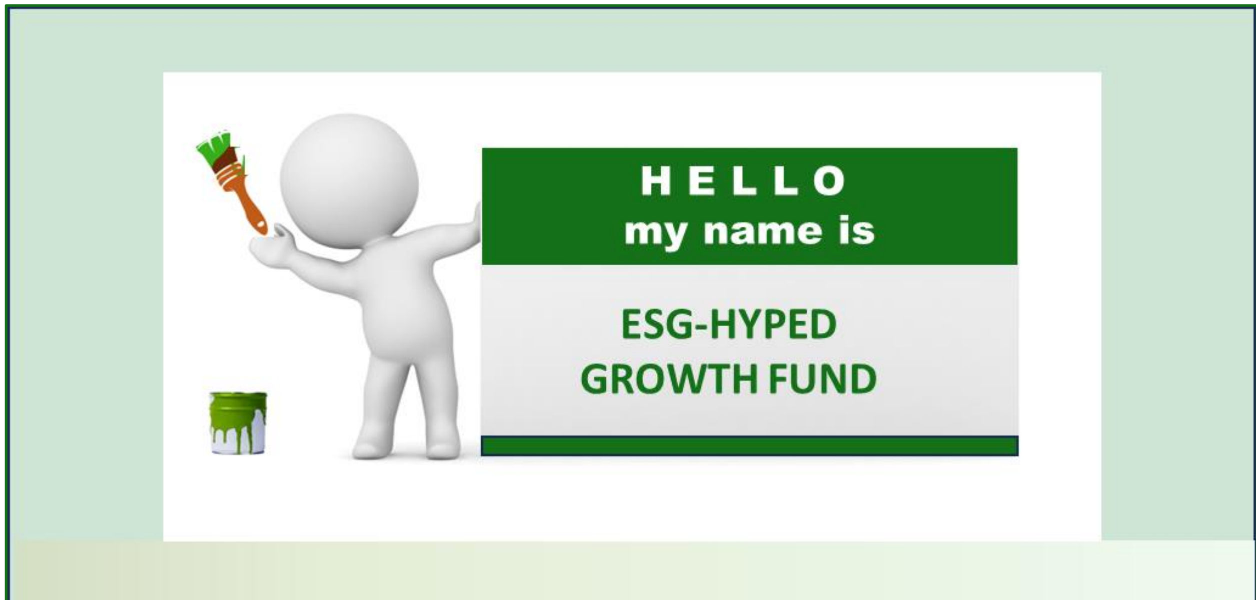
INSIGHT | October 4, 2023

Cracking Down on Greenwashing in ESG-Labeled Funds: Updates to the SEC's "Names Rule"



Executive Summary

On September 20, 2023, the U.S. Securities and Exchange Commission (SEC) adopted significant amendments to Rule 35d-1 under the Investment Company Act of 1940, the rule that regulates the names of mutual funds, ETFs, and other registered investment companies (the "Names Rule"). Under the amended Names Rule, an estimated 2,200 additional funds — including self-described growth, value, thematic and ESG funds — are now required to adopt an 80% investment policy, which obligates them to invest at least 80% of their assets in alignment with their name's suggested investment focus. (A copy of the SEC adopting release is available here.)

A key driver for the amendments is the need to combat "greenwashing," where fund names mislead investors as to how sustainable or ESG-friendly their investments actually are, and which otherwise fail to accurately reflect the fund's underlying investment mix. The amendments make clear that a fund with a name that suggests it incorporates one or more ESG factors must invest at least 80% of its assets consistent with its name.

These amendments mark a significant expansion of the rule's scope, impacting how funds name themselves, frame their investment policies, and report their compliance to investors and the SEC. Fundamentally, the amended Names Rule seeks to curb, on a broader basis, the use of fund names that

© 2023 R | McHale Law. All rights reserved.

misrepresent the fund’s investments and risks, and serves as an important check against exaggerated—or outright false—claims about ESG investments implied by a fund’s name.

Expansion of Names Rule Scope

The amendments to Rule 35d-1 significantly broaden the scope of what constitutes a misleading or deceptive fund name. Historically, the rule applied to fund names that suggested a focus on specific investment types, industries, countries, or geographic regions, or indicated a tax-exempt status.

The recent amendments broaden the scope of the rule’s 80% investment policy requirement, now also applying to any fund name with terms suggesting the fund focuses in investments that have, or investments whose issuers have, “particular characteristics.” This expansion applies regardless of whether such terms connote an investment strategy, which before were not subject to the 80% investment policy requirement.

> “We are adopting amendments that do not distinguish between a type of investment and an investment strategy because a fund name might connote a particular investment focus and result in reasonable investor expectations regardless of whether the fund’s name describes a strategy as opposed to a type of investment.” — SEC Adopting Release (footnotes omitted)

The SEC did not explicitly define “particular characteristics”[1] but provided examples in its adopting release. These examples include terms like “growth” and “value,” terms with ESG- or sustainability-related characteristics, or terms that reference a “thematic” investment focus, such as artificial intelligence, big data, or robotics.

By not defining “particular characteristics,” the SEC seeks to ensure the rule remains “evergreen.” Nevertheless, the amendments provide flexibility for fund managers to “ascribe reasonable definitions for the terms used in their names” and to determine the criteria used to select the investments the terms describe.

Certain terms will continue to be excluded from the Names Rule, as they communicate the overall characteristics of a fund’s portfolio, rather than a particular investment focus. Excluded terms include those that:

- **Suggest a portfolio-wide result to be achieved**, such as “real return,” “balanced” or “managed risk”
- **Describe a bond fund’s maturity,** such as “intermediate-term”
- **Represent a fund’s approach to constructing a portfolio,** but do not communicate the composition of the fund’s portfolio with any particularity, such as “global” or “international” (versus, for example, “Japan” or “Europe”)

---

[1] While not defining “particular characteristics,” the SEC did share its belief that “this term will be adequately understood to mean any feature, quality, or attribute.” SEC Adopting Release.

- **Reference a particular investment technique** such as “long/short” or “hedged”
- **Identify negative or exclusionary screening processes** for investments, such as “fossil fuel-free”
- **Specify certain target audiences, well-known organizations, or affinity groups**, such as “generation Z”
- **Reference asset allocation determinations that evolve over time**, including target date funds and sector rotation funds

Regardless of whether a fund falls within or outside the purview of the Names Rule, all funds remain subject to the anti-fraud provisions of the federal securities laws in connection with their disclosures to investors.

Impact on ESG-Labeled Funds

The SEC acknowledges that the growing prevalence of terms such as “sustainable,” “green,” and “socially responsible” in fund names has created challenges, leading to the risk of greenwashing, wherein funds overstate their ESG focus to lure unwitting investors.

> “Funds that consider ESG factors in their investment strategies comprise a thematic area that entails unique considerations, and that involves the use of terminology that may be especially powerful in fund names to attract investors. The use of ESG or similar terminology … in fund names may present particular investor protection concerns for several reasons. Investor interest in—and funds that offer—ESG strategies have rapidly increased in recent years. Asset managers have created and marketed funds that consider ESG factors in their selection process, and these funds can attract significant interest and stand out to investors by using ESG and related terms in their names. Approaches to ESG investing vary, however, and funds that consider ESG factors have strategies that vary in the extent to which ESG factors are considered versus other factors. The breadth of ESG-related terms, as well as evolving investor expectations around terms like “sustainable” or “socially responsible,” compound the possibility of investor confusion and potential “greenwashing” in fund names.” — SEC Adopting Release (footnotes omitted)

To alleviate these concerns, under the amended Names Rule, if a fund’s name suggests an ESG focus, the fund must now adopt an 80% investment policy indicating that it invests at least 80% of its assets in ESG-oriented securities or adopt a new name that accurately reflects its investment strategy. This change will likely require many funds to adjust their investment policies and possibly rebrand themselves to comply with the amended Names Rule.

Define Fund Name Terms in Prospectus

In addition to adopting an 80% investment policy, funds subject to the Names Rule are now required to define the terms used in their names in their prospectuses, and include the specific criteria the fund uses to select the investments described by those terms. These definitions must be consistent with the terms' plain English meaning or established industry use. The flexibility provided to funds in defining these terms allows them to tailor their definitions to align with their specific investment strategies while ensuring clarity for investors.

The SEC's acknowledgment that different portfolio managers or third-party data providers may use different definitions for the same term introduces an element of discretion in interpretation. Consider, for example, two funds that include the term "growth" in their names. Each of these funds may be guided by portfolio managers who employ distinct strategies for selecting investments with growth characteristics. It would, therefore, be natural for these two funds to adopt differing policies that mirror their unique approaches towards growth investing. Both funds would be required to communicate to their investors how they define the term "growth," and allocate 80% of their investments in accordance with the defined criteria. Provided their definitions align with the term's plain English meaning and industry norms, fund names with the same word but different definitions are permitted, assuming the fund name does not otherwise mislead investors.

Compliance with the 80% Investment Rule Is Not a Safe Harbor

A fund's name may still be materially deceptive or misleading under section 35(d) of the Investment Company Act even if the fund adopts and implements an 80% investment policy and otherwise complies with Rule 35d-1. As the SEC noted in its adopting release, "[t]o the extent a fund uses its 20% basket to invest in assets that are materially inconsistent with the investment focus or risk profile reflected by the fund's name, the fund's name would be materially deceptive or misleading under section 35(d)."

In other words, the Names Rule's 80% investment policy requirement does not create a safe harbor from liability under section 35(d) for materially deceptive or misleading fund names. If a fund's 20% basket is "antithetical" to its "sustainable" label, for example, the fund may still find itself the target of an SEC enforcement action, even if the fund's 80% basket is otherwise in perfect alignment with its name.

> "[W]e continue to believe that a fund's name could be materially deceptive or misleading for purposes of section 35(d) even if that fund has complied with the names rule's 80% investment policy requirement. For example, a fund's name could be materially deceptive or misleading for purposes of section 35(d) if the fund invests in a way such that the source of a substantial portion of the fund's risks or returns is materially 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 "green energy and fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves, or a "conservative income 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 lower-yielding bonds). To the extent a fund uses its 20% basket to invest in assets that are materially inconsistent with the investment focus or risk profile reflected by the fund's name, the fund's name would be materially deceptive or misleading under section 35(d)." — SEC Adopting Release (footnotes omitted)

No Absolute Prohibition on the Use of ESG Terms in the Names for "Integration Funds"

A notable departure from the proposed rule is the decision not to designate as materially deceptive and misleading the use of ESG-related terms in the names of "integration funds" — that is, funds that consider ESG factors alongside other non-ESG factors in investment decisions, but where the ESG factors are not dispositive in deciding to include or exclude any particular investment in the portfolio.

The SEC's determination not to adopt the proposed change to integration funds allows these funds to continue operating without an absolute prohibition on the use of ESG terms in their names, at least for now. The SEC stated that it would reconsider this issue at a later date in connection with a more narrowly ESG-focused rulemaking.

That said, integration funds must still adopt an 80% investment policy and comply with the other provisions of the amendments.

Temporary Departures from a Fund's 80% Investment Policy

The amendments introduce changes in how funds handle temporary departures from their 80% investment policy, with important implications for compliance testing and timeframes for variance from compliance. Funds will continue to determine compliance with the 80% investment policy at the time of investment, but they must conduct quarterly reviews to reassess their portfolio assets' inclusion in the fund's 80% basket.

Notably, should a fund depart from compliance with its 80% investment policy, either due to portfolio drift or permitted intentional departure, it must come back into compliance within 90 days of identifying or initiating the departure. This requirement represents a significant change from prior practices, as it cannot be waived by a fund's board.

Additionally, funds can temporarily depart from their 80% investment policies in specific circumstances, such as reorganizations (no required timeframe to come back into compliance), fund launches (180 days to come back into compliance), or after providing notice of a change in fund policy to shareholders (no required timeframe to come back into compliance).

New Reporting and Recordkeeping Requirements

The amendments impose additional reporting and recordkeeping requirements on funds with 80% investment policies, excluding money market funds and business development companies (BDCs). These funds are now required to report specific information on Form N-PORT (filed quarterly), including whether an investment falls within the fund's 80% basket and the value of the 80% basket as a percentage of the value of fund assets.

To demonstrate compliance with the Amendments, funds must also maintain written records of various types, including a record of investments included in the 80% basket and basis for inclusion, quarterly reviews, reasons for departures, and notices sent to shareholders. These records must be kept for at least six years following their creation, with the first two years in an easily accessible location. Notably, the amendments do not require a fund without an 80% investment policy to document the reasons why the fund determined an 80% investment policy is not required.

Changes to Notice Requirements

The amendments retain the requirement that funds must provide shareholders with at least 60 days' prior notice of any change in the 80% investment policy, except for changes to a fundamental policy—that is, a policy that cannot be changed without a vote of the majority of the fund's outstanding voting securities. However, funds are now required to inform shareholders not only of changes to the 80% investment policy but also changes in the fund's name itself. The notice must include: a description of the fund's 80% investment policy, the nature of the change to the 80% investment policy, the fund's old and new names, and the effective date of any name or investment policy change.

Compliance Dates

The amendments to Rule 35d-1 will be effective 60 days after their publication in the Federal Register. Fund groups with net assets of $1 billion or more have 24 months to comply, while smaller fund groups with net assets of less than $1 billion have 30 months.

Greener Days Ahead

The recent amendments to the SEC's Names Rule represent a significant step toward enhancing transparency and accountability in the mutual fund and ETF industry. These changes signal the SEC's commitment to safeguarding investors and maintaining integrity in the investment industry, and they will require fund managers to carefully review and adjust their practices to meet the new regulatory requirements.

Most importantly, by expanding the rule's scope to include funds with names suggesting "particular characteristics," such as ESG or thematic focus, the SEC is taking a firm stance against greenwashing and helping to ensure that ESG-related fund names are more than just an attractive coat of green paint.

If you have any questions about this article, please contact:

Robert McHale, Esq.
R | McHale Law
9 West Broadway, Suite 422
Boston, MA 02127
Tel. 617.306.2183
Email: robert.mchale@rmchale.com

DISCLAIMER: *This article is provided for informational purposes only—it does not constitute legal advice and does not create an attorney-client relationship between the firm and the reader. Readers should consult legal counsel before taking action relating to the subject matter of this article.*