

Regulatory Alert

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Investor Protections: SEC proposed Names Rule and ESG Investment Practices Disclosure

The SEC's proposed changes to the Investment Company Act's Names Rule, and enhanced disclosures related to ESG, are intended to bring investors enhanced transparency with regard to ESG strategies. The SEC is seeking to mitigate potential "greenwashing" by placing increased accountability on investment advisors to disclose, in sufficient detail, the investment process consistent with the name of a fund and investors' expectations. The proposals are in line with prior SEC's Risk Alert, public statements and supervisory/enforcement focus relative to the importance of transparency and accuracy in ESG-related disclosures.

The Securities and Exchange Commission (SEC) approved two proposed rules intended to provide investors with more consistent, comparable, and "decision-useful" information regarding investment options, particularly with regard to ESG. The proposals would apply to registered investment companies and business development companies (BDCs) (together "funds") and registered investment advisers and certain advisers that are exempt from registration (together "advisers"). Comment on each of the proposals will be accepted for a period of 60 days following publication in the Federal Register.

Investment Company Names

The SEC proposes to amend Section 35d-1 of the Investment Company Act of 1940, commonly referred to as the [Names Rule](#), to "help ensure that a fund's name accurately reflects the fund's investments and risks." As proposed, the key amendments impacting registered investment companies and business development companies (BDCs), together "funds," include:

- **Expansion of the 80 percent investment policy requirements:** The Names rule currently

requires funds whose names suggest a focus on particular investments, industries, or geographical regions to adopt an 80 percent investment policy in assets that reflect the investment fund's name. Additionally, investment funds with names suggesting that their distributions are tax-exempt must adopt an 80 percent investment policy as a fundamental policy. Under the proposed amendments, the SEC is expanding the requirements of the 80 percent investment policy to any fund name that includes terminology "suggesting that the fund focuses on investments that have, or whose issuers have, particular characteristics", including terms that suggest ESG factors.

- **Temporary departures from a fund's 80 percent investment policy:** The SEC proposes amendments that specify certain circumstances under which a fund may depart from its 80 percent investment policy, as well as the timeframe for 'getting back into compliance'.
- **Derivatives:** Proposed amendments would require funds to use a derivatives instrument's notional amount, instead of its market value, in

order to determine the fund's compliance with its 80 percent investment policy. Additionally, amendments will address the derivatives instruments that a fund may include in its "80 percent basket."

- **Unlisted closed-end funds and BDCs:** The SEC's proposed amendments would prohibit registered closed-end funds and BDCs whose shares are not listed on a national securities exchange and that are required to adopt an 80 percent investment policy (under the Names Rule) from changing their 80 percent investment policy without a shareholder vote. Additionally, close-end funds and BDCs would be required to make their 80 percent investment policy a fundamental policy (as defined) in all cases.
- **Enhanced prospectus disclosure, reporting, and recordkeeping:** Funds' prospectus disclosure would be required to define the terms used in their name, including the criteria that was used to select the investments that the term describes. Also, amendments to Form N-PORT would require more transparency on the fund's selection method to match investment focus of the fund's name, and include new reporting items relating to a fund's compliance with the Names Rule. Additionally, funds would be required to keep certain records regarding how they comply with the rule (or why they think they are not subject to it).
- **"Plain English" requirements for terms used in fund names:** Proposed amendments would require any term used in the fund's name that suggests an investment focus, or a tax-exempt fund, to be consistent with the term's "plain English" definition or established industry use.
- **Materially deceptive and misleading use of ESG terminology:** Funds that consider ESG factors alongside non-ESG factors in the fund's investment decisions ("integration funds"), would be prohibited to use "ESG" or similar terminology in their name. The SEC defines non-compliance with this requirement as "materially deceptive or misleading".
- **Notice requirements:** Proposed updates to the Names Rule's notice requirement would require funds that use electronic delivery methods to provide information to their shareholders, as well as describe changes in the fund's 80 percent investment policy and changes to the fund's name that accompany the investment policy change.

Enhanced Disclosure of ESG Investment Practices

The SEC has [proposed amendments](#) to rules and disclosure forms to promote consistent, comparable, and reliable information for investors around how funds (together registered investment companies and business development companies) and advisers (together registered investment advisers and certain advisers that are exempt from registration) incorporate ESG (environmental, social, and governance) factors into their investment practices, products, and advisory services. The rule and form amendment are outlined below.

ESG Strategy Disclosures. The proposal would require funds and advisers that consider ESG factors in their investment processes to disclose specific information about their strategies. The required disclosures would depend on how central ESG factors are to the strategy, as outlined below:

- **Integration funds.** Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required to provide limited disclosures in both their summary prospectuses and the management discussion and analysis (MD&A) portion of their annual reports (Form 10-K) describing how ESG factors are incorporated into their investment process.
- **ESG-focused funds.** Funds for which ESG factors are a significant or main consideration would be required to provide more detailed disclosures in their summary prospectuses and Form 10-K, including investment processes and methodologies, metrics, and thresholds within a proposed, standardized ESG Strategy Overview Table.
- **Impact funds.** A subset of ESG-focused funds that seek to achieve a particular ESG impact, impact funds would, in addition to the disclosures required of ESG-focused funds, be required to disclose how they measure progress on their specific impact objectives. Likewise, the proposal would require funds that use proxy voting or engagement with issuers as a significant means of implementing their ESG strategy to provide additional information about their proxy voting or ESG engagements.
- **Advisers.** Advisers that consider ESG factors would be required to make similar disclosures in both their brochures (Form ADV Part 2A) and

annual reports. Specifically, Items 8 (Methods of Analysis, Investment Strategies, and Risk of Loss), 10 (Other Financial Industry Activities and Affiliations), and 17 (Voting Client Securities) would be updated to include ESG considerations, if applicable.

Integration funds that consider GHG emissions would be required to disclose additional information about how the fund considers GHG emissions, including the methodology and data sources the fund may use as part of its consideration of GHG emissions.

Structured data requirements. The SEC also proposed requiring funds and advisers to report and disclose the above information in Inline XBRL format to make disclosures and reports more available and accessible to investors, market participants, and others.

For additional information, please contact [Amy Matsuo](#), [Mike Sullivan](#), or [Larry Godin](#).

GHG emissions reporting. Complementing the emissions disclosures in the SEC's recent climate-related disclosures proposal, the current proposed rule would require certain environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their portfolio investments. These funds would be required to disclose both the carbon footprint and the weighted average carbon intensity (WACI) of their portfolio.

Contact the author:



Amy Matsuo
Principal and Leader
Regulatory and ESG Insights
amatsuo@kpmg.com

kpmg.com/socialmedia



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