The ESG Name Game Continues: Sorting Through the New SEC Proposals

This alert updates a memorandum we published in October 2021 on Environmental, Social, Governance ("ESG") funds.[1] In that memorandum, we discussed the prevalence of investment companies that claim in their disclosures and marketing materials to further ESG goals, the inherent ambiguity of broadly purporting to further ESG goals, given the sheer breadth of the divergent issues encompassed by the acronym, and the Security and Exchange Commission's ("SEC") newly-prioritized focus on ensuring that ESG disclosures are not misleading.[2] Specifically, we noted that there were two ways that the SEC might achieve its goal: (1) by regulating how companies may use the term "ESG" in fund names and marketing materials, and/or (2) by providing additional disclosure guidance through rulemaking.[3] As we predicted, this week on Wednesday the SEC announced that it was going to do both, proposing new ESG naming[4] and disclosure requirements.[5]

In a proposal addressing investment company and fund names, the SEC would expand the "Names Rule" (Rule 35d-1 under the Investment Company Act of 1940). The Names Rule currently requires funds with a name suggesting a focus on a particular type of investment (e.g. "domestic stock fund" or "international bond fund") to invest at least 80% of its assets accordingly. The proposal would expand the Names Rule to apply to fund names with terms indicating that the fund's investment decisions incorporate one or more ESG factors (e.g. "socially responsible investing," "ethical," or "green").[6] In addition, the proposal would bar funds that consider ESG factors along with other factors (sometimes referred to as "integration funds") from using ESG-related terms in their names.[7]

In a statement supporting the proposal, SEC Chair Gary Gensler noted that there are "gaps in the current Names Rule" that have resulted in funds claiming that the 80 percent investment requirement "does not apply to them – even though their name suggests that investments are selected based on specific criteria or characteristics."[8] Elaborating on these gaps, Commissioner Allison Herren Lee noted that the Names Rule currently distinguishes "terms describing an investment 'focus'" like "stocks," "bonds," or "utilities," that are covered by the rule from "terms describing an investment 'strategy,'" like "growth" or "value" that are not covered by the rule.[9] She said, "[t]he proposal would eliminate this distinction to ensure that investors receive the benefits of the rule whenever a fund's name suggests that the fund concentrates in investments with particular characteristics."[10] In a statement against the proposal, Commissioner Hester M. Peirce noted that "the application of the 80% investment policy requirement to names suggesting that a fund focuses" on ESG considerations "will rely on subjective judgments," and that enforcement of the rule would necessarily require the SEC to "engag[e] in Monday morning asset managing."[11]

Regarding ESG disclosure requirements, the SEC proposed amendments to rules and reporting forms to require certain registered investment advisers, advisers exempt from registration, registered investment companies, and business development companies to provide more specific ESG disclosures.[12] For example, funds focused on the consideration of environmental factors would be required to disclose the greenhouse gas emissions associated with their portfolio investments and funds claiming to pursue specific ESG impacts (e.g., increasing educational equity or increasing board diversity) would be required to describe those goals as well as the progress toward achieving them. In addition, the amendments would require ESG disclosures on certain forms, including Forms N-CEN and ADV Part 1A.

In a statement supporting this proposal, SEC Commissioner Allison Herren Lee remarked that the proposed rule would "help protect investors from 'greenwashing,' or exaggerated or false claims about ESG practices."[13] In contrast, Commissioner Peirce, who voted against the proposal, referenced a recent ESG enforcement action – *In the Matter of BNY Mellon Investment Adviser, Inc.*, SEC Release No. IA-6032 (May 23, 2022) (charging BNY Mellon for misstatements related to its review of ESG factors in selecting investments) – and remarked that "[a] new rule to address greenwashing . . . should not be a high priority" because "we can enforce the laws and rules that already apply."[14]

The comments from the Commissioners likely preview the themes that will emerge during the comment process. We will closely monitor these proposals as they wind their way through the rulemaking process.

In the meantime, as we noted in our October memoranda, investment advisers should carefully and critically review their disclosures for the use of term "ESG" as well as ESG-related terms. Having robust policies and well-documented procedures to guard against inaccurate ESG-related disclosures and marketing materials will remain of paramount importance. This point is highlighted by the SEC's recent enforcement action against BNY Mellon resulting in censure and a $1.5 million settlement for, in part, "lack[ing] written policies and procedures reasonably designed to prevent inaccurate or materially incomplete statements in prospectuses, in RFP Responses," and other statements about the "use of ESG quality reviews when selecting investments."[15]

***

If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to us:

Michael Liftik
Co-Chair, SEC Enforcement Practice
Email: michaelliftik@quinnemanuel.com
Phone: +1 202-538-8141

Stacylyn Doore
Partner
Email: stacylyndoore@quinnemanuel.com
Phone: +1 617-712-7121

---

1 https://www.quinnemanuel.com/the-firm/publications/the-name-game-sorting-through-the-esg-frenzy/
2 https://www.quinnemanuel.com/the-firm/publications/the-name-game-sorting-through-the-esg-frenzy/
3 https://www.quinnemanuel.com/the-firm/publications/the-name-game-sorting-through-the-esg-frenzy/
4 https://www.sec.gov/news/press-release/2022-91?utm_medium=email&utm_source=govdelivery
5 https://www.sec.gov/news/press-release/2022-92?utm_medium=email&utm_source=govdelivery
6 https://www.sec.gov/rules/proposed/2022/33-11067.pdf?utm_medium=email&utm_source=govdelivery
7 Id.
8 https://www.sec.gov/news/statement/gensler-statement-proposed-updates-names-rule-052522?utm_medium=email&utm_source=govdelivery
9 https://www.sec.gov/news/statement/lee-names-rule-statement-052522
10 Id.
11 https://www.sec.gov/news/statement/peirce-fund-names-statement-052522?utm_medium=email&utm_source=govdelivery
12 https://www.sec.gov/rules/proposed/2022/ia-6034.pdf?utm_medium=email&utm_source=govdelivery
13 https://www.sec.gov/news/statement/lee-statement-esg-052522?utm_medium=email&utm_source=govdelivery
14 https://www.sec.gov/news/statement/peirce-statement-esg-052522?utm_medium=email&utm_source=govdelivery
15 https://www.sec.gov/litigation/admin/2022/ia-6032.pdf