Naming a Private Fund: How to Navigate the SEC and European Union ESG-Related Rules

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RPCK understands that the terms environmental, social and corporate governance are becoming increasingly important to investors, investment advisors, legislators and regulators. This article is the second of a series of articles (i) related to the evolving ESG landscape and (ii) devoted to providing practical guidance for investment professionals operating in this space.

Introduction and Background.

The name of a fund is typically the first piece of information shared with investors, as such it can significantly influence investors´ investment decisions. This is especially true for funds claiming to invest in environmental, social, or governance ("ESG") and/or sustainable economic activities. Over the years, ESG claims and labels within the asset management industry, particularly as applied to fund names, have faced little regulation. Meanwhile, and some argue consequently, the industry has faced increasing claims of greenwashing and misleading fund names. Regulators have responded both in the United States and the European Union by imposing (or proposing) heightened rules on the use of ESG elements in fund names, with the stated objective of improving confidence, transparency and reliance on fund names and the associated ESG strategies marketed to investors.

In this article, we discuss the current regulatory regimes both in the United States and the European Union related to fund names and proposed amendments to such regimes and ESG and/or sustainable investment activities. We also discuss the potential implications of these rules for funds with cross-border operations or marketing in the United States and the European Union.

ESG Naming Rules in the United States.

(a) The General Naming Principles, the Names Rule and Proposed Names Rule Amendments.

In the United States, the Securities and Exchange Commission (the "SEC") regulates fund names and, as a general rule, prohibits funds from using a name that is materially deceptive or misleading.[1] By extension, funds should only use terms such as "ESG", "green", "sustainable", "social", "ethical", "impact" or any other ESG-related term in their name, when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the fund's investment objectives, policy and strategy. Enforcing these general naming principles has become a priority for the SEC[2], which is also taking a proactive attitude to enforce ESG-related compliance through the Commission's Climate and ESG Task Force, formed in 2021.[3] These naming principles apply to (i) funds

[1] Section 35(d) of the Investment Company Act of 1940, applicable to Registered Funds, and Rule 206(4) of the Investment Advisers Act of 1940, applicable to investment advisers to Private Funds and Registered Funds.

[2] "Examples of Enforcement Actions Related to ESG Issues or Statements", Securities and Exchange Commission website, December 14, 2022.

[3] Securities and Exchange Commission, Press Release "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues", March 4, 2021.

required by the Investment Company Act of 1940 (the "ICA") to register with the SEC ("Registered Funds") and (ii) funds excluded from the definition of investment companies under certain registration exemptions identified in the ICA ("Private Funds").[4]

Furthermore, Registered Funds are subject to what is called the "Names Rule",[5] which requires that Registered Funds using names with certain descriptive terms that suggest a focus on a specific type of investment, industry (or group of industries), or geography, adopt a policy to invest 80 percent of their assets in the investments suggested by those descriptive terms (the "80% Rule"). The SEC had previously taken the position that the Names Rule does not apply to the use of terms that connote an investment objective or strategy.[6] As a result, the SEC staff observed that some funds would have been excluded from the Names Rule because the name contains a term suggesting an investment strategy, even if the name also suggested an investment focus. The SEC has proposed amendments to the Names Rule (the "Proposed Names Rule Amendments"), which, if adopted, would expand the 80% Rule to any Registered Fund's name that suggests a focus on investments or issuers with particular characteristics.[7] This expansion would encompass, for example, Registered Fund names with terms such as "growth", "value", "income", or "global" and those names indicating that the fund's investment decisions incorporate one or more ESG factors.

It is important to note that the Names Rule and the Proposed Names Rules Amendments are only applicable to Registered Funds, and, as such, the Private Funds are not required to comply with the Names Rule or the Proposed Names Rule Amendments, if adopted. However, as discussed in the following section, Private Funds that include one or more ESG factors in their names are subject to another set of SEC-proposed rules.

(b) The Proposed ESG Rules.

On May 25, 2022, the SEC proposed the "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices" (the "Proposed ESG Rules"). The main objectives of the Proposed ESG Rules are (i) to achieve more standardized and comparable disclosures and reporting of ESG information from funds and advisers that consider ESG factors and (ii) to establish a new ESG disclosure framework for prospectuses, annual reports, and adviser brochures, incorporating qualitative and quantitative information regarding ESG-related investment strategies. Unlike the Names Rule and the Proposed Names Rule Amendments, which only apply to Registered Funds, the enhanced disclosures on funds under the Proposed ESG Rules would apply to both Registered Funds and Private Funds.

The contemplated disclosure requirements vary depending on how central ESG related factors are to the fund's strategy. For instance, a Private Fund that considers ESG or other impact factors alongside, but not more centrally than, non-ESG/impact factors in its investment decisions (what the SEC has provisionally defined as an "ESG-Integration Fund") would not be permitted to use the term "ESG", "impact" or similar

[4] Through application of Section 35(d) of the Investment Company Act of 1940, applicable to Registered Funds, and Rule 206(4) of the Investment Advisers Act of 1940, applicable to investment advisers to Private Funds and Registered Funds.

[5] Rule 35d-1 under the Investment Company Act of 1940.

[6] "Investment Company Names", Securities and Exchange Commission, May 25, 2022.

[7] "Investment Company Names", Securities and Exchange Commission, May 25, 2022.

language in its name; doing so would be deemed materially deceptive or misleading.[8] An ESG-Integration Fund would be required to disclose how the fund incorporates ESG factors into its investment selection process using a layered disclosure approach. ESG-Integration Funds that consider the greenhouse gas ("GHG") emissions of portfolio investments (as one or several factors considered) would be required by the Proposed ESG Rules to disclose to investors the methodology used to consider portfolio company GHG emissions in particular.

Funds for which ESG factors are a significant or main consideration in the investment selection process or the fund's engagement strategy with portfolio companies (e.g., the fund adheres to a policy of voting proxies to advance certain ESG-related goals or considerations) would qualify as an "ESG-Focused Fund" under the Proposed ESG Rules. Importantly, the inclusion of one or more ESG factors in a fund's name, by itself, would warrant treatment as an ESG-focused Fund. ESG-Focused Funds would be required by the proposed rules to provide detailed disclosures, including a standardized ESG strategy overview table in which the fund discloses the methodology the fund uses to implement its ESG strategy, how the fund incorporates ESG factors into its investment decisions and how the fund votes proxies or otherwise engages with companies about ESG issues. If the fund tracks an index, the fund's prospectus or private placement memorandum must identify the index and briefly describe the index and how it utilizes ESG factors in constructing the referenced portfolio.

A subset of ESG-Focused Funds seeking to achieve a specific ESG impact (an "Impact Fund", under the Proposed ESG Rules) would, in addition to the disclosure requirements applicable to an ESG-Focused Fund, be required to disclose how the fund measures progress with respect to the stated impact objectives, including the key performance indicators to be applied in such measurements. Impact Funds would then be required to annually report to investors progress towards stated ESG objectives. Funds that advertise a strategy of environmental sustainability would also be subject to an annual reporting requirement that involves disclosure of the carbon footprint and the weighted average carbon intensity of the fund's portfolio. This reporting would not be required of funds that disclose to investors that they do not consider GHG emissions in the fund's investment selection process.

If the Proposed ESG Rules are adopted, Private Funds would be required to comply with the Rules within an anticipated one-year to eighteen-month compliance period running from the date of publication in the Federal Register. As of the date of this article, no clear timeline for publication of such final rules has been provided by the SEC.

The Names Rule, in its current and proposed amended form, and the Proposed ESG Rules are applicable to Private Funds that are domiciled in the U.S. or marketed to U.S. investors. Private Funds formed in the United States with operations or considering marketing within the European Union will also need to take into consideration the regulatory environment in the bloc. While similarities exist between the approaches and, in some instances, particular rules of the U.S. and European frameworks for regulating investment funds with an advertised ESG strategy, there are important distinctions and potential inconsistencies between them, as discussed below.

[8] See rule 35d-1 under the Investment Company Act; Investment Company Names; Investment Company Act Release No. 34593 (May 25, 2022).

ESG Naming Rules in the European Union (EU).

(a) The General Naming Principles in the EU.

Two material EU-level rules pertaining to the regulation of investment funds – the UCITS[9] Directive and the AIFM[10] Directive – required member states of the EU ("Member States") to draw up rules of conduct which implement at least the principle that a (investment) management company "acts honestly and fairly in conducting its business activities"[11] and ensures that all information included in marketing communications is fair, clear and not misleading.[12]

As EU directives (in contrast to EU regulations that are directly applicable in each of the Member States) require individual national legislative implementation, each of the 27 Member States had to adopt the contents both of UCITS Directive and AIFM Directive into its own national laws.[13] EU regulations (in contrast to EU directives) at times include authorizations to the Member States to adopt individual national rules relating to specific issues covered by such EU regulation.[14] Both EU directives and regulations can lead to significant variance (such as "gold plating", i.e. stricter rules) in the individual national laws among the 27 Member States. Thus, a Fund[15] domiciled or marketed[16] (or pre-marketed)[17] in at least one of the Member States must comply, not only in relation to naming rules, with the applicable rules both at the EU-level and the national level of the Member States concerned.

[9] Undertakings for Collective Investment in Transferable Securities.

[10] Alternative Investment Fund Manager.

[11] As set out in Art. 14 (1) lit. a) UCITS Directive for UCITS and as set out in Art. 12 (1) lit. a) AIFM Directive for AIFMs.

[12] As set out in Art. 4 (1) of the Regulation (EU) 2019/1156 on facilitating cross-border distribution of collective investment undertakings (Regulation on cross-border distribution).

[13] For example, Germany adopted the Kapitalanlagegesetzbuch ("KAGB"; *Act on the Creation of Uniform Standards for the Management of Investment Funds*). Based on this act the German regulatory authority, BaFin, issued binding fund category guidelines introducing certain categories of funds used in the naming or marketing of funds if they can be classified accordingly. Furthermore, these guidelines imposed specific name suffixes on specific categories of funds.

[14] For example, Art. 22 of the Taxonomy authorizes the Member States to establish rules on measures and penalties applicable to infringements of certain provisions of the Taxonomy provided that such measures and penalties are "effective, proportionate, and dissuasive" (i.e., deterring).

[15] The herein used terms "Fund" or "Funds" relate to all financial products to which EU ESG naming rules apply.

[16] As set out in Art. 4 (1) lit. x) AIFM Directive marketing means a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM or units or shares of an alternative investment fund ("AIF") it manages to or with investors domiciled or with a registered office in the EU.

[17] As set out in Art. 4 (1) lit. a) AIFM Directive pre-marketing refers to the provision of information or communication, direct or indirect, on investment strategies or investment ideas by an EU AIFM, or on its behalf, to potential professional investors domiciled, or with a registered office in, the EU in order to test their interest in an AIF or a compartment which is not yet established, or which is established but not yet notified, for marketing in accordance with Art. 31 or 32, in that Member State where the potential investors are domiciled or have their registered office, and which in each case does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF or compartment.

Under SFDR[18] a Fund disclosing under Art. 8 ("Art. 8 Fund") is a fund promoting, among other characteristics, environmental and/or social characteristics provided that the investee companies follow good governance practices, whereas a Fund disclosing under Art. 9 ("Art. 9 Fund") is a fund with a sustainable investment as its objective (all Funds that do not qualify as either an Art. 8 Fund or Art. 9 Fund are Art. 6 funds). SFDR and Taxonomy[19] do not contain specific rules on the naming of Funds with an ESG- and/or sustainability-focused investment strategy. For this and other reasons, ESMA[20] issued a supervisory briefing relating to sustainability risks and disclosures[21], including risks pertaining to fund names, aiming to provide national regulators in Member States with further guidance on a non-binding basis. In addition, ESMA published a consultation paper with guidelines for Fund names containing ESG or sustainability-related terms.[22] Notably, SFDR, the Taxonomy and the ESMA's guidelines target not only the objectives, shared with U.S. regulators, of greater transparency, consistency and disclosure regarding ESG- and impact strategies, but go further to actively promote the adoption of ESG and sustainable investment strategies among fund managers.

(b) ESMA Supervisory Briefing´s Guidance on Fund Names.

According to the ESMA SB, Fund names should not be misleading. Terms such as "ESG", "green", "sustainable", "social", "ethical", "impact" or any other ESG-related terms[23] should be used only when supported in a material way by evidence of sustainability characteristics, themes or objectives that are reflected fairly and consistently in the Fund's investment objectives and policy and its strategy as described in the relevant Fund documentation. The following principles should be considered:[24]

- The term "sustainable" or "sustainability" should be used only by (i) Art. 9 Funds, (ii) Art. 8 Funds which in part invest in economic activities that contribute to environmental or social objectives and (iii) either Art. 8 Funds or Art. 9 Funds to which the Art. 5 Taxonomy also applies;
- The use of "impact" or "impact investing" or any other impact-related term should be used only by Funds whose investments are made with the intention to generate positive, measurable social and environmental impact alongside a financial return; and
- Funds designating an index as a reference benchmark could use any ESG-related terms if the index the Fund designates itself as being ESG-focused as long as the Fund does not apply an exclusion policy which only excludes a small number of securities. Principles applicable under the ESMA SB to ESG-focused fund names include the following:[25]

[18] Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector ("SFDR").

[19] Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investments and amending SFDR ("Taxonomy").

[20] European Securities and Markets Authority.

[21] Supervisory Briefing ("ESMA SB") on May 31, 2022, relating to sustainability risks and disclosures in the area of investment management.

[22] Consultation Paper ("ESMA CP") on November 18, 2022, on Guidelines on fund names using ESG or sustainability-related terms.

[23] According to ESMA´s open hearing on ESG terms in fund names on Jan 23, 2023, SRI (Socially responsible investment) is an ESG-related word.

[24] ESMA SB, section 30, pages 9/10.

[25] ESMA SB, section 31, page 10.

- A "climate impact" Fund investing in companies engaged in activities focused on enabling the adaptation to, or mitigation of, climate change can refer to the Fund's climate impact strategy in its name.
- A "sustainable water" Fund investing in sustainable companies targeting the water supply value chain or which offer products or technologies which are more water efficient than others in their category can refer to their sustainable water strategy in their name.
- A "sustainable energy" Fund having a non-specific investment policy not supported by a strategy aiming to invest in sustainable energy companies engaged in alternative energy and/or energy technologies should not be allowed to use "sustainable energy" terms in its name.
- An index-tracking Fund that applies an exclusion policy which only excludes a small number of securities, or where the holdings are not materially different from a similar non-ESG index should not use ESG-related terms in its name.

(c) ESMA Consultation Paper on Guidelines on fund names using ESG or sustainability-related terms.

i) Purpose, Scope and Timing

ESMA CP´s purpose is – building on the already existing rules[26] – to specify uniform criteria throughout the EU, including potentially in terms of quantitative thresholds. This purpose extends to assessing whether the name of a Fund containing terms that are suggestive of a focus on investments that have, or investments whose issuers have, ESG or sustainability features, is fair, clear and not misleading.[27]

If adopted, the draft guidelines contained in the ESMA CP[28] would have a significant impact, applying to all Fund documentation and marketing communications delivered to (potential) investors for UCITS[29] and AIFs,[30] irrespective of whether directed at retail or institutional investors. The proposed guidelines address the national regulators in EU member countries, calling for them to adopt the guidelines and begin enforcing them.

Publication of the final draft guidelines can be expected in Q3 2023. The national regulators will then have two months to comply or to explain their non-compliance. The guidelines enter into effect three months after the date of publication on ESMA´s website. Funds launched prior to the guidelines' effective date will have a six-month grace period to comply. Within the applicable compliance period, Funds using ESG- and/or sustainability-related terms in their name must bring their investments in line with the guidelines or change their name to not include such terms.[31]

ii) Minimum Safeguards and Quantitative Thresholds

[26] See under Section 2.a hereinabove.
[27] ESMA CP, section 5.3, Annex III (8 and 9), page 20.
[28] ESMA CP, section 5.3 Annex III, pages 19 to 22.
[29] Undertakings for Collective Investments in Transferable Securities.
[30] Alternative Investment Fund.

[31] ESMA CP, section 4.4 (22 and 23), page 12.

ESMA CP proposes minimum safeguards, including exclusion criteria,[32] that would apply to 100% of investments by a Fund using an ESG- or sustainability-related term in its name.[33] These criteria would prohibit investments in the following companies:

- Companies involved in any activities related to controversial weapons.[34]
- Companies involved in the cultivation and production of tobacco.
- Companies that are found in violation of the United Nations Global Compact (UNGC) principles or the Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises.
- Companies that derive 1% or more of their revenues from the exploration, mining, extraction, distribution or refining of hard coal and lignite.
- Companies that derive 10% or more of their revenues from the exploration, extraction, distribution of refining of oil fuels.
- Companies that derive 50% or more of their revenues from the exploration, extraction, manufacturing, or distribution of gaseous fuels.
- Companies that derive 50% or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO_2 e|kWh.

Also proposed to be prohibited are investments in companies found or estimated[35] to significantly undermine one or more of the six environmental objectives referred to in the Taxonomy.[36]

Furthermore, ESMA CP proposes two (minimum) thresholds:[37]

1. If a Fund has any ESG-, or impact-related words in its name, a minimum of 80% of all of portfolio investments should meet the environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy, which are disclosed in Annexes II and III of RTS.[38]
2. If a Fund has the word "sustainable" or any other term derived from the word "sustainable" in its name, it should allocate at least 50% (of all of its investments) to sustainable investments as defined by Article 2 (17) SFDR.[39]

According to ESMA CP, the use of the word "impact" or "impact investing" or any other impact-related term should be used only by Funds meeting the two proposed quantitative thresholds described above and additionally whose investments are made with the intention of generating positive, measurable social or environmental impact alongside a financial return.[40]

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[32] As defined in Art. 12 (1) and (2) Commission Delegated Regulation (EU) 2020/1818 (Benchmark CDR).

[33] ESMA CP, section 5.3, Annex III, subsection 4 (18), page 22.

[34] As referred to in international treaties and conventions, United Nations principles and, where applicable, national legislation (Art. 12 (1) final paragraph Benchmark CDR).

[35] In accordance with the rules on estimations in Art. 13 (2) Benchmark CDR.

[36] As set out in Art. 9 Taxonomy.

[37] ESMA CP, section 5.3, Annex III, subsection 4 (16 and 17), pages 21/22.

[38] Regulatory Technical Standards ("RTS").

[39] See also Annexes II and III of RTS.

[40] ESMA CP, section 5.3, Annex III, subsection 4 (20), page 22.

iii) Supervisory Expectations

ESMA recommends that the national regulators of Member States adopt rules implementing the guidelines so that national regulators can start enforcing such rules. Market participants and national regulators could then verify compliance through periodic disclosures under SFDR and RTS. A temporary deviation from the rules, if not due to a deliberate choice of the asset manager, should – according to ESMA – only be treated as a passive breach and corrected in the best interest of the Fund's investors. Intentional failures to adhere to the quantitative thresholds may be considered by the national regulators in the light of the circumstances and, depending on those circumstances, may prompt further investigation and regulatory action.

Application of EU rules to US Funds.

As a general rule, a U.S.-domiciled Fund is subject to the EU regulatory framework,[41] including the guidelines discussed above, if adopted, upon marketing[42] or pre-marketing[43] of the Fund in any of the EU Member States.

Again, as noted above, in addition to applying EU-level rules, individual Member States may choose to treat U.S. (Non-EU) Funds and/or U.S. (Non-EU) fund managers more strictly than local (i.e., EU) Funds or managers. Further, Member States may vary with respect to the threshold at which a Fund is deemed to be engaged in marketing versus pre-marketing (and thus subject to additional disclosure and other compliance requirements) and whether the use of certain terms in a Fund's name subjects the fund to additional disclosure and reporting requirements. Consequently, a Fund sponsor considering marketing a U.S.-based Fund within the EU should conduct, ideally prior to naming the Fund, or otherwise certainly prior to any pre-marketing activities, an evaluation of applicable EU- and national-level rules that are applicable to fund names and more broadly to the Fund's activities in the Member States in which (pre-)marketing is planned.

Conclusion

U.S.-based investment funds are increasingly adopting names that indicate to investors that the fund will pursue an ESG strategy, which choice has the potential to subject the Fund to stricter scrutiny and disclosure and other compliance requirements, particularly should the SEC adopt the Proposed ESG Rules in the United States.

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[41] It depends on the specific financial product. It usually includes, but is not limited to, UCITS Directive, AIFM Directive, Regulation on cross-border distribution, SFDR, Taxonomy, Directive 2014/65/EU of May 15, 2014 on markets in financial instruments (MiFID II), Regulation (EU) No 1286/2014 of Nov 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPS Regulation), Regulation 2017/2402/EU of Dec 12, 2017 laying down a general framework for securitization and creating a specific framework for simple, transparent and standardized securitization (EU Securitisation Regulation), Regulation 2015/2365/EU of Nov 25, 2015 on transparency of securities financing transactions and of re-use (SFTR), Regulation (EU) No 600/2014 of May 15, on markets in financial instruments (MiFIR).

[42] See footnote 15.

[43] See footnote 16.

Similarly in the EU, the number of ESG Funds is increasing rapidly and ESG and sustainability terms are often used to market such Funds. Considering these developments, EU and national regulators have launched numerous initiatives and proposals to reduce greenwashing. At this stage, ESMA has issued proposals (ESMA SB and ESMA CP) which aim to enhance supervisory convergence and to introduce uniform rules on transparency and investor protection relating to Fund names which include ESG- or sustainability-related terms. Regardless of whether and the extent to which ESMA´s naming rules are adopted, the future focus of EU regulators is widely expected to turn increasingly to supervising and enforcing the existing EU ESG legislative framework, which is targeted at mitigating greenwashing risks and, unlike the US regulatory regime, actively promoting the adoption of ESG and sustainable investment strategies among fund managers.