



August 16, 2022

Via E-Mail ([rule-comments@sec.gov](mailto:rule-comments@sec.gov))

Vanessa A. Countryman, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: Investment Company Names (File No. S7-16-22)<sup>1</sup>**

Dear Secretary:

Environmental Defense Fund (“EDF”)<sup>2</sup> respectfully submits the following comments to the Securities and Exchange Commission (“SEC” or “Commission”) regarding its proposed revisions to the Fund Names Rule (“Proposal”). As detailed below, EDF supports the Proposal and its swift finalization, and additionally offers a set of recommendations.

## **I. Background**

Investors have long relied upon the name of a fund to accurately indicate the fund’s investment strategy, holdings, and risks. Given this investor dependency, Congress expressly authorized the Commission to adopt a rule to define what names may be “materially deceptive or misleading,” and prohibit funds from using such names.<sup>3</sup>

In 2001, the Commission adopted the Fund Names Rule, which generally declares that a fund name is “materially deceptive and misleading” if it suggests that the fund:

- is guaranteed or approved by the US government;<sup>4</sup>
- focuses its investments in a particular type of investment or particular industry, unless:
  - the fund has a “policy to invest, under normal circumstances, at least 80% of the

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<sup>1</sup> Sec. & Exch. Comm’n, Investment Company Names, 87 Fed. Reg. 36,594 (June 17, 2022), [hereinafter “Proposal”]. The Proposal would revise 17 C.F.R. 270.35d-1 (adopted as Sec. & Exch. Comm’n, Investment Company Names, 66 Fed. Reg. 8,509 (Feb. 1, 2001) [hereinafter “Names Rule Adopting Release”]).

<sup>2</sup> One of the world’s leading international nonprofit organizations, EDF creates transformational solutions to the most serious environmental problems. To do so, EDF links science, economics, law, and innovative private-sector partnerships.

<sup>3</sup> 15 U.S.C. 80a-34(d).

<sup>4</sup> Names Rule Adopting Release, *supra* note 1.

- value of its Assets in the particular type of investments, or in investments in the particular industry or industries,” suggested by the name; and
- the policy either requires a fund shareholder vote to change or investors are given at least 60 days notice of changes;<sup>5</sup>
  - focuses its investments in a particular country or geographic region, unless:
    - the fund has a “policy to invest, under normal circumstances, at least 80% of the value of its Assets in investments that are tied economically to the particular country or geographic region suggested by its name,”
    - the fund discloses in its prospectus the “specific criteria used by the fund to select these investments”; and
    - the policy either requires a fund shareholder vote to change or investors are given at least 60 days notice of changes;<sup>6</sup> or
  - has distributions that are “exempt from federal income tax or from both federal and state income tax, unless the fund has adopted a fundamental policy” to invest, under normal circumstances:
    - “at least 80% of the value of its Assets in investments the income from which is exempt, as applicable, from federal income tax or from both federal and state income tax;” or
    - “its Assets so that at least 80% of the income that it distributes will be exempt, as applicable, from federal income tax or from both federal and state income tax.”<sup>7</sup>

Further, if a fund’s investments diverge from the 80 percent requirement, then the fund’s future investments “must be made in a manner that will bring it back into compliance.”<sup>8</sup> Compliance with the Fund Names Rule does not prevent a finding that a name is nonetheless misleading.

Put simply, the Fund Names Rule plays a crucial role in ensuring that a fund is accurately communicating to its investors what assets it invests in, how, and why.

## II. Need for Revisions to the Fund Names Rule

In 2020, the Commission released a broad “request for information” on how to modernize the Fund Names Rule.<sup>9</sup> The Commission did not issue any rule proposals or guidance thereafter, until the instant Proposal. In recent years, changes in the fund industry have highlighted weaknesses in the Fund Names Rule, including: (1) increasing disconnects between names and actual investment strategies and (2) funds’ increased use of derivatives.

First, investment advisers are increasingly adopting names for new funds or re-naming existing

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<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 8,519.

<sup>9</sup> Sec. & Exch. Comm’n, Request for Comments on Fund Names, 85 Fed. Reg. 13,221 (Mar. 6, 2020).

funds in efforts to make those funds appear to be focused on areas of higher investor interest,<sup>10</sup> which may enable those advisers to impose higher fees or collect greater revenues. Funds often use names to describe geographic, sectoral, or other investment or engagement strategies. Some of those fund names convey traditional, generalized strategies. For example, over one thousand fund names include the terms “value” or “growth.”<sup>11</sup> Others are more targeted. For example, there are reportedly now over 300 mutual funds with “ESG” in their names.<sup>12</sup> This plethora of ESG-named funds is a result of high investor demand,<sup>13</sup> which has enabled investment companies to sometimes charge higher fees for these funds.<sup>14</sup>

Of course, in return, investors may

reasonably expect funds with these names to invest in companies with policies, practices, or characteristics that are consistent with these standards, particularly when the fund’s name contains the term “ESG” or similar terminology (such as “sustainable,” “green,” or “socially responsible”).<sup>15</sup>

Nevertheless, there are significant questions as to whether funds that include ESG-related terms in their names actually engage in investment practices that are consistent with those terms. For example, there have been numerous press reports of funds adopting names suggesting an “ESG” focus, but which appear to not generally have ESG-focused strategies.<sup>16</sup> Similarly, are “growth” funds really invested in securities that would reasonably meet investors’ expectations for a fund with “growth” in the name? These words have significance for investors, and the Commission should ensure that the use of terms in funds’ names better matches investor expectations.

Second, funds have increasingly relied upon financial derivatives to effectuate their investment strategies. In 2020, the Commission significantly revised rules regarding the use of derivatives by investment companies and business development companies (“BDCs”).<sup>17</sup> These rules were intended to address the dramatic expansion in use of derivatives by investment companies and BDCs over the past several years. As the Investment Company Institute has explained to the

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<sup>10</sup> See, e.g., Dave Michaels, *SEC Is Investigating Goldman Sachs Over ESG Funds*, WALL ST. J. (June 10, 2022), <https://www.wsj.com/articles/sec-is-investigating-goldman-sachs-over-esg-funds-sources-say-11654895917>.

<sup>11</sup> Sam Potter, *SEC Planned Crackdown on ‘Misleading’ Funds Goes Far Beyond ESG*, BLOOMBERG (May 26, 2022), <https://www.bloomberg.com/news/articles/2022-05-26/sec-planned-crackdown-on-misleading-funds-goes-far-beyond-esg>.

<sup>12</sup> *Id.*

<sup>13</sup> Tania Lynn Taylor & Sean Collins, *Ingraining Sustainability in the Next Era of ESG Investing*, DELOITTE (Apr. 5, 2022), <https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-and-sustainability.html>.

<sup>14</sup> MORNINGSTAR, 2020 U.S. FUND FEE STUDY (2021), <https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/annual-us-fund-fee-study-updated.pdf>.

<sup>15</sup> Proposal, *supra* note 1, at 36,597.

<sup>16</sup> See, e.g., Patrick Temple West & Joshua Franklin, *SEC Investigating Goldman Sachs for ESG Claims*, FIN. TIMES (June 10, 2022), <https://www.ft.com/content/5812ab1f-c2d4-4681-a6be-45f0befd92df>.

<sup>17</sup> Sec. & Exch. Comm’n, *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 85 Fed. Reg. 83,162 (Dec. 21, 2020).

Commission, today, funds commonly use derivatives to:

- hedge risk;
- manage interest rate risk and duration;
- enhance liquidity compared to other, more traditional securities;
- gain or reduce exposure, including when access by other instruments is difficult, costly, or practically impossible;
- manage or equitize cash; and
- reduce costs or manage portfolios efficiently.<sup>18</sup>

However, the growing use of derivatives has made determining what counts towards or against the 80 percent threshold increasingly complex and inconsistent. As one of the largest asset managers in the world explained to the Commission in 2020, “funds have been inconsistent in how derivative investments apply towards the 80% investment requirement: while some funds assert that a derivative’s notional value is more appropriate than its market value for purposes of complying with the 80% investment policy, many funds employ a derivative’s market value for the asset-based test.”<sup>19</sup>

To ensure that investors have an accurate, consistent, and comparable understanding of funds’ exposures, clarity is needed on how derivatives positions are counted for the 80 percent threshold.

### **III. Analysis of Proposal**

The Proposal would directly address both of the above concerns, which have grown since the original Fund Names Rule was adopted. It would also improve the Fund Names Rule by updating investor notice requirements and establishing recordkeeping requirements to better ensure compliance.

#### **A. Defining Terms**

The Proposal would 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.”<sup>20</sup> EDF agrees with this approach.

The Commission’s approach in the Proposal sensibly allows funds to define their own terms, so long as those definitions align with “plain English meaning or established industry use,” rather than attempting to standardize definitions for terms.<sup>21</sup> While this approach may somewhat reduce comparability across funds and advisers, it permits funds the flexibility to accurately reflect their

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<sup>18</sup> Letter from Paul Schott Stevens, Inv. Co. Inst., to Vanessa A. Countryman, Sec. & Exch. Comm’n (Apr. 20, 2020), at 2, <https://www.sec.gov/comments/s7-24-15/s72415-7098125-215777.pdf>.

<sup>19</sup> Letter from Walter R. Burkley & Erik A. Vayntrub, Capital Research & Mgmt. Co., to Vanessa A. Countryman, Sec. & Exch. Comm’n (May 5, 2020), at 6, <https://www.sec.gov/comments/s7-04-20/s70420-7153839-216425.pdf>.

<sup>20</sup> Proposal, *supra* note 1, at 36,598.

<sup>21</sup> *Id.*

investment strategies, and avoids unnecessary and wasteful efforts to categorize funds. This may be especially important over time, as investors' preferences and demands change.

Rigid, universal definitions of “growth” or “climate” or “sustainable,” for example, would be difficult to craft effectively. And while the Commission could perhaps make delineations that would be consistent with the bulk of industry practices today, there would likely be significant disagreements and outliers. Further, it would be difficult for the Commission to accurately predict how those terms may be defined and understood by investors over time. What may have been viewed as “sustainable” in 2005 is very different today, and will likely be very different in the future. Therefore, the Commission's approach of requiring funds to provide their own definitions for terms, which must align with plain English meaning or established industry use, strikes a reasonable balance.

The Proposal contains specific requirements for funds that claim to be ESG via their names to have policies to effectuate ESG investments and strategies. Likewise, the Proposal would prohibit the use of ESG or similar terminology in a fund's name if the identified ESG factors do not play a central role in the fund's strategy.<sup>22</sup> Specifically, a fund could not use an ESG term in its name even if the fund “considers one or more ESG factors alongside other, non-ESG factors in its investment decisions,” if “such 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.”<sup>23</sup>

The additional specificity and restrictions on use of ESG terms are important because, compared to other terms often used in fund names, such as “stock” or “technology” or “China,” there is significantly greater variability amongst investors and other market participants about what many ESG-related words mean. To address the risk of greater potential ambiguities, inconsistencies, or misleading marketing of ESG funds (commonly referred to as greenwashing), the Proposal would direct a fund to define these terms and establish how its strategies are consistent with them.

The Proposal would provide important guardrails and transparency to protect investors from misleading marketing of funds, including in the rapidly growing ESG space. Put simply, if ESG is not central to how a fund operates, then ESG should not be part of the fund's name.

#### B. Meeting the 80 Percent Threshold

The 80 percent threshold is essential to ensuring that fund names are not materially misleading. EDF agrees with the Proposal's approach: maintaining the level of that threshold, while also modifying (1) when it should be applied and (2) how assets are calculated with respect to it.

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<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

The Proposal would expand the application of the 80 percent requirement to any terms “suggesting that the fund focuses on investments that have, or investments whose issuers have, particular characteristics.”<sup>24</sup> This is entirely appropriate, as any such terms are clearly intended to have impacts upon the decision-making of investors. Fund practices should match the expectations that fund names create.

The Proposal would seek to resolve the inconsistent treatment of derivatives under the Fund Names Rule by adopting a clear, one-size-fits-all approach: using the notional values. This “all-notional, all-the-time” approach would preclude funds from applying a “market value” approach to derivatives. EDF recommends that the Commission consider how the Proposal’s requirements would apply to potential situations where a fund may distort application of the 80 percent requirement through notional valuation of derivatives, and whether additional anti-evasion measures may be warranted.

The Commission could consider providing specific examples of fund names that would be materially misleading based upon derivatives use. As the Proposal notes,

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 the 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.<sup>25</sup>

Finally, the Proposal would require funds to take steps to ensure that they remain in compliance with the 80 percent threshold over time, and there would be only specific circumstances for when “temporary departures” are permitted.<sup>26</sup> These requirements could help ensure that the benefits of the Fund Names Rule are not lost over time, and could help prevent significant strategy drift.

The 80 percent threshold provides an important investor protection, and should be modernized and strengthened as set forth in the Proposal. Far from inhibiting advisers’ fulfillment of their fiduciary

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 36,610-11.

<sup>26</sup> *Id.* at 36,597.

obligations, a concern some have expressed,<sup>27</sup> the threshold helps ensure that their fund names do not materially mislead investors regarding the fund’s investment strategy, holdings, or risks.

C. Implementation and Compliance

The Proposal anticipates that the revisions to the Fund Names Rule would be implemented within one year. This period seems to appropriately balance regulated entities’ need for time to come into compliance with investors’ need for the protections the Proposal would provide.

**IV. Conclusion**

For decades, the Fund Names Rule has helped to ensure that investors are not materially misled by a fund’s name regarding the fund’s investment strategy, holdings, or risks. However, the details of the Fund Names Rule have not kept pace with the modern markets. The Proposal would address key investor protection needs and should be swiftly finalized pursuant to the SEC’s clear and express authority granted by Congress in the Investment Company Act, Securities Act, and Exchange Act.

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Respectfully Submitted,

/s/ Stephanie Jones

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Michael Panfil

Environmental Defense Fund

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/s/ Jake Hiller

Jake Hiller

EDF + Business

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<sup>27</sup> See Comm’r Hester Peirce, *Statement on Investment Company Names*, SEC. & EXCH. COMM’N (May 25, 2022), <https://www.sec.gov/news/statement/peirce-fund-names-statement-052522>.