

# SEC Proposes New ESG Disclosures for Funds and Investment Advisers

Courtney L. Kleshinski

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On May 25, 2022, the SEC adopted in a 3-1 vote [proposed rules](#) and forms amendments to require specific disclosure of funds' and investment advisers' use of environmental, social and governance (ESG) factors as part of their investment decisions and strategies (the Proposed Rules). The Proposed Rules come in the wake of substantial scrutiny of disclosure practices involving ESG investment practices by the SEC and its Staff.

The Proposed Rules are intended to promote "consistent, comparable, and reliable" information to investors in order to facilitate informed decision-making related to ESG investment product and strategy offerings. In particular, the Proposed Rules would seek to change existing disclosure practices by (among other provisions):

- requiring ESG-related disclosures in fund prospectuses and annual reports and investment adviser regulatory filings (where funds use and strategies use ESG investment techniques);
- implementing a standardized approach for certain types of ESG funds to disclose their ESG investing processes; and
- requiring, for the first time, disclosure of the use of greenhouse gas (GHG) emissions data in certain circumstances.

The SEC is also proposing to generally enhance the quantitative data for environmentally focused fund strategies, where methodologies for reporting emissions metrics are becoming more standardized.

These Proposed Rules come amid the growing popularity of ESG-focused funds. ESG investing now accounts for one-third of total U.S. assets under management (See, Letter from Morningstar to Chair Gensler (June 9, 2021) attaching Sustainable Funds U.S. Landscape Report –More funds, more flows, and impressive returns in 2020, Morningstar Manager Research (Feb. 19, 2021), available at <https://www.sec.gov/comments/climate-disclosure/cll12-8899329-241650.pdf>).

The comment period for the Proposed Rules is 60 days after publication in the Federal Register. If adopted, registered funds and advisers would be required to comply with the Proposed Amendments within one year of the publication of the final rules.

## To Whom Would the Proposed Rules Apply

The Proposed Rules would apply at least in part to registered investment companies, business

development companies (BDCs), and both registered and exempt reporting investment advisers. In a separate proposal adopted the same day, the SEC proposed changes to the [Names Rule](#) applicable to registered investment companies and BDCs.

If adopted, the Proposed Rules would require specific disclosure regarding ESG strategies in fund registration statements, the management discussion of fund performance in fund annual reports, and adviser brochures.

Specifically, the Proposed Rules would amend the Investment Advisors Act and the Investment Company Act to impose new disclosure requirements on registered investment companies, investment funds, investment advisers, and certain unregistered advisers based on three types of funds/strategies:

- **Integration Fund** – A fund that considers ESG factors among many others in its investment selection process. For such funds, ESG factors would generally not be given greater weight or consideration than other non-ESG factors in the investment selection process.
- **ESG-Focused Fund** – A fund that markets itself as ESG focused and relies on ESG factors as a significant or main consideration in its investment selection. ESG-Focused Funds include funds that apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement with issuers, and funds that track an ESG-focused index. This category includes any fund that markets itself as having an ESG focus and would likewise include a fund that has a policy of voting its proxies and engaging with the management of its portfolio companies to encourage ESG practices or outcomes.
- **Impact Fund** – An ESG-Impact Fund is a subset of ESG-Focused Funds that seek to achieve one or more specific ESG impacts (*e.g.*, financing the construction of affordable housing units or advancing the availability of clean water). An Impact Fund would have additional disclosure requirements, including how the fund measures progress towards the stated impact; the time horizon used to measure that progress; and the relationship between the impact the fund is seeking to achieve and the fund’s financial returns.

A fund’s disclosure obligations will depend upon whether it is an Integration Fund, an ESG-Focused Fund, or an Impact Fund under the Proposed Rules.

## ESG-Related Prospectus Disclosures

Under the Proposed Rules, a fund engaged in ESG investing would be required to disclose certain additional information about the fund’s implementation of ESG factors in its principal investment strategies through a layered disclosure framework.

As proposed, the disclosure requirements would apply to open-end funds (including ETFs) and closed-end funds (including BDCs) that incorporate one or more ESG factors in their investment selection process. The Proposed Rules do not define “ESG” or similar terms but, instead, would “require funds to disclose to investors:(1) how they incorporate ESG factors into their investment selection processes and (2) how they incorporate ESG factors in their investment strategies.”

ESG-Focused” Funds and Impact Funds (*e.g.*, funds that focus on ESG-related engagement with the issuers in which they invest and funds that seek to achieve a particular ESG impact) would be required to provide more detailed information in a tabular format. See below.

## As Proposed by the SEC: ESG Strategy Overview

The Fund engages in the following to implement its [ESG] Strategy:

### Overview of the Fund's [ESG] strategy

- Tracks an index
- Applies an inclusionary screen
- Applies an exclusionary screen
- Seeks to achieve a specific impact Proxy voting
- Engagement with issuers
- Other

### How the Fund incorporates [ESG] factors in its investment decisions

Information to be provided.

### How the Fund votes proxies and/or engages with companies about ESG issues

Information to be provided.

The Proposed Rules require investment advisers to disclose with specificity their ESG investing approach by strategy, as well as certain relationships with related persons, and any ESG-related impacts on proxy voting.

The hope is that these proposed rule changes would allow investors to identify funds more readily and advisers that do or do not consider ESG factors, differentiate how they consider ESG factors, and help inform their analysis of whether they should invest.

We summarize below the specific disclosure requirements:

- **ESG Strategy Disclosure.** As proposed, the new rules would require advisers to describe the ESG factor(s) considered for each significant investment strategy or method of analysis, including whether and how the adviser incorporates a particular ESG factor and/or a combination of factors into its management of the strategy. In addition, similar to registered funds, the proposed disclosure must explain whether and how the adviser employs integration and/or ESG-focused strategies and if ESG-focused, whether and how the adviser also employs ESG impact strategies. If an adviser considers different ESG factors for different strategies, separate disclosures would be required for each strategy.
- **ESG Criteria.** As proposed, the new rules would also require advisers to describe any criteria or methodology used to evaluate, select, or exclude investments based on the consideration of ESG factors, including any: (1) internal methodology or third-party framework, (2) inclusionary or exclusionary screen, and/or (3) index, including the name and a description of how the index utilizes ESG factors.
- **Proxy Voting.** If an adviser has specific proxy voting policies and procedures to include one or more ESG considerations when voting client securities, the adviser would be required to describe in the brochure which ESG factors are considered and how they are considered. To the extent this information is previously disclosed, a cross reference would also satisfy this

requirement.

- ***Relationships with Related Persons.*** As proposed, the new rules amend advisers' Form ADV Part 2A (the "brochure") to include information about advisers' ESG practices. Advisers would be required to describe in their brochure any material relationship or arrangement with any related person that is an ESG consultant or other service provider. The proposed form amendments would not define or otherwise provide guidance regarding the scope or application of the term "ESG consultants or other service providers."
- ***Disclosure of Greenhouse Gas (GHG) Emissions.*** The Proposed Rules would require ESG-focused funds that consider environmental factors to disclose the carbon footprint and average carbon intensity of their portfolio. This would not be required of funds that state that they do not consider emissions as part of their GHS strategy.
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  - The carbon footprint and weighted average carbon intensity calculations would be based on portfolio companies' Scope 1 and 2 emissions, and funds would not be allowed to reduce the GHG emissions associated with a portfolio company based on the company's use of purchased or generated carbon offsets. In addition, these funds would be required to separately disclose by industry sector, in their annual reports, the Scope 3 emissions of their portfolio companies to the extent such data is reported by their portfolio companies.
- ***Amendments to the Fund Names Rule.*** Under the SEC's proposed changes to the Names Rule, registered investment companies whose names suggest a focus on a particular type of investment are required to invest at least 80% of the value of their assets in those investments. As it stands, the Names Rule applies to registered funds and business development companies (BDC).
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  - The proposed set of amendments to the Names Rule would expand its scope to apply to any fund whose name suggests the fund focuses its investments on particular characteristics—such as "growth," "value," or names indicating the incorporation of ESG factors. Note: The proposal does acknowledge circumstances whereby the fund may depart from the 80% requirement—such as sudden changes in the market value of the underlying investments.
- ***Annual Report Disclosure Requirements.*** The Proposed Rules require various ESG disclosures in registered funds' and BDCs' annual reports. Impact funds will be required to disclose their progress toward achieving the impact objective of the fund in both qualitative and quantitative terms during the reporting period and key factors that materially affected the fund's ability to achieve its impact. For an ESG-focused fund where proxy voting is a significant means of implementing its strategy, the fund will be required to disclose certain information regarding how the fund voted proxies relating to portfolio securities with respect to ESG issues. For an ESG fund where engagement other than proxy voting is a significant means of evaluating and advancing elements of an ESG strategy for an investment, the fund will be required to disclose certain information about its engagement practices.

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- The proposed disclosure for registered funds will be included in management’s discussion of fund performance section of the annual shareholder report, and for BDCs in the management discussion and analysis, in the fund’s annual report on Form 10-K.
- The Proposed Rule sets forth separate Form ADV disclosures for registered investment advisers that consider ESG factors as part of their advisory services. The disclosure for integration, ESG-focused, and ESG-impact strategies follows the stratification outlined for disclosures by investment companies.

## Likely Compliance Challenges

We encourage clients to pay particular attention to the compliance suggestions throughout the release that reflect the SEC’s expectations of registrants as they will likely be a focus in examinations and enforcement matters, including by the SEC’s Climate and ESG Task Force, which has begun bringing [actions](#) relating to ESG. (See, [SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations](#), May 23, 2022.)

We anticipate that registered investment companies will likely encounter difficulties compiling and reporting data on GHG emissions. For example, not all companies in which registered investment companies invest report GHG emission numbers. We believe this type of requirement should be reserved until GHG emission numbers are more widely reported globally by public and private issuers.

## Conclusion: The Proposed Rules Are a Significant Departure from the SEC’s Existing Disclosure Framework

The Proposed Rules, by being very prescriptive and detailed in their requirements, could make efforts by investment companies and advisers and their investors to adjust in response quite difficult.

### **As a first step, we encourage clients to:**

**Develop ESG Disclosure Procedures (and Strategies).** Apart from fund names, all funds that consider ESG factors should consider how they would be classified under the proposals and how they would implement the required ESG disclosures into their registration statements and annual reports.

**Outline Best Practices for Investment Practices That Are Consistent with Stated Disclosures.** In light of continued SEC scrutiny around ESG investing, funds may wish to consider carefully reviewing their ESG investment practices to ensure they are consistent with disclosures to investors.

It is worth noting that Commissioner Hester Peirce’s critical dissent from the new rules observes that “markets are dynamic and equipped in ways we can never duplicate when it comes to the efficient dissemination of information. This proposal would displace the market’s efficient signaling mechanisms with value-laden regulatory nudges.” We believe that Commissioner Peirce’s point is, in part, that the level of prescriptive disclosure here almost ensures a difficult, ill-fitting application.