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SEC rule proposal designed to enhance ESG disclosure

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Overview

On May 25, 2022, the Securities and Exchange Commission (SEC) published a rule proposal which would improve disclosures by funds and investment advisers that take Environmental, Social, and Governance (ESG) factors into consideration when making investing decisions. The proposal, which would apply to registered investment advisers, advisers exempt from registration, registered investment companies, and business development companies (BDCs), is intended to mitigate the risk of exaggerating ESG practices stemming from the lack of specific disclosure requirements tailored to ESG investing. The proposal requires additional specific disclosures regarding ESG strategies in fund registration statements, the management discussion of fund performance in fund annual reports (MD&P), and adviser disclosure brochures.

This rule proposal aims to prevent potential "greenwashing," which is an exaggeration of ESG strategies to attract business. Interestingly, however, the SEC has chosen not to define the term "ESG." The proposal was approved by the SEC in a 3-1 vote along party lines, with Commissioner Peirce dissenting, and will remain open for public comment for sixty (60) days after its publication in the Federal Register. As of the date of this update, the proposal has not been published in the Federal Register.

Fund Disclosure

For registered funds and BDCs, the proposal distinguishes among funds based on the extent to which they consider ESG factors in their investment processes. In this regard, the proposal places funds into one of three categories, as follows:

- ***ESG-Integration Funds***, which are funds that consider one or more ESG factors alongside other, non-ESG factors, as part of their investment selection process, such that ESG factors may not be dispositive with respect to any particular investment. An ESG-integration fund would be required to provide fewer new disclosures than the other two categories of funds. Such funds would be required to describe, in a few sentences in the summary prospectus, how ESG factors are incorporated into the investment process, including the ESG factors considered, with a more detailed description provided later in the statutory prospectus. In addition, ESG-integration funds that consider greenhouse gas (GHG) emissions as part of the investment process would be required to describe, later in the statutory prospectus, how the fund considers the GHG emissions of its portfolio holdings, including the methodology that the fund uses as part of its consideration of portfolio company GHG emissions.
- ***ESG-Focused Funds***, which are funds for which ESG factors are a significant or main consideration in selecting investments or in engaging with portfolio companies (e.g., a fund that applies a screen to include or exclude investments in particular industries based on ESG factors or has a policy of voting its proxies to encourage ESG practices or outcomes). Additionally, to help ensure that any fund that markets itself as ESG provides sufficient information to investors to support the claim,

the proposed definition of an ESG-Focused Fund explicitly includes (i) any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors, and (ii) any fund whose advertisements indicate that the fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. An ESG-focused fund would be required to include a standardized ESG "strategy overview table" in the summary prospectus which provides an overview of the fund's ESG strategy, a summary of how the fund incorporates ESG factors into its investment decisions, and a description of how the fund votes proxies and/or engages with companies about ESG issues, with additional disclosure required if the fund's engagement with portfolio companies on ESG issues (either by voting proxies or otherwise) is significant. Such funds would be required to provide a more detailed description of each of these items later in the statutory prospectus.

- ***ESG-Impact Funds***, which are a subset of ESG-focused funds that seek to achieve a specific ESG impact or impacts (e.g., a fund that invests with the goal of seeking current income while also furthering the fund's disclosed goal of financing the construction of affordable housing units). In addition to the disclosure requirements applicable to ESG-focused funds, an ESG-impact fund would be required to disclose, as part of the ESG "strategy overview table," how the fund measures progress towards its stated impact (including the key performance indicators the fund analyzes), the time horizon employed for measuring that progress, and the relationship between the impact the fund seeks to achieve and the fund's financial returns, with more detailed information provided later in the statutory prospectus. An ESG-impact fund would also be required to disclose in its *investment objective* the ESG impact that the fund seeks to result from its investments.

In addition to the new prospectus disclosures that would be required under the rule proposal, new disclosures would also be required to be made in the MD&P section of a fund's annual report. Namely:

- ESG-impact funds would be required to briefly summarize the fund's progress on achieving its specific impacts in both qualitative and quantitative terms during the reporting period, and the key factors that materially affected the fund's ability to achieve the specific impacts, on an annual basis in the annual report;

- Funds for which proxy voting is a significant means of implementing their ESG strategy would be required to disclose certain information regarding how the fund voted proxies on ESG issues during the reporting period, and funds for which engagement with issuers on ESG issues through means other than proxy voting is a significant means of implementing their ESG strategy would be required to disclose certain information about their engagement practices (including the number or percentage of issuers with whom the fund held ESG engagement meetings): and

- ESG-focused funds that consider environmental factors as part of their investment strategies would be required to disclose the carbon footprint and the weighted average carbon intensity of the fund's portfolio (i.e., the aggregated GHG emissions of the portfolio).

The rule proposal also includes amendments to Form N-CEN that are designed to collect additional census-type information about a fund's use of ESG factors, including its use of ESG service providers. The proposed amendments would collect information on the ESG strategy a fund employs (i.e., integration, focused or impact), the ESG factors it considers, the method it uses to implement its ESG strategy, and whether the fund considers ESG-related information or scores provided by a service provider. To further increase investors' ability to locate relevant information, the proposal states that all ESG-related disclosures would be required to be in a machine-readable XBRL format.

Adviser Disclosure

For registered investment advisers, the proposal would amend Form ADV Part 2A (the disclosure brochure) to include information about the adviser's ESG practices. These amendments are similar, in many respects, to the requirements in the proposal for funds, and include the following:

- Advisers would be required to provide a description of the ESG factors considered for each significant investment strategy or method of analysis for which the adviser considers any ESG factor, and disclose how they incorporate those factors when providing investment advice, including when recommending or selecting other investment advisers.

- Using definitions for ESG-integration, ESG-focused and EST-impact strategies which are similar to the proposed definitions of these terms for registered funds, the proposal would require advisers to provide an explanation of whether and how the adviser incorporates a particular ESG factor (i.e., E, S, or G) and/or combination of factors, and whether and how the adviser employs ESG-integration and/or ESG-focused strategies and, if ESG-focused, whether and how the adviser also employs ESG-impact strategies.
- If an adviser employs, for any significant strategy, criteria or a methodology to select or exclude investments based on the consideration of ESG factors, the proposal would require the adviser to describe the criteria and/or methodologies and how it uses them including, but not limited to, (i) any internal methodology, third-party methodology or combination of both; (ii) any inclusionary or exclusionary screen, including an explanation of the factors the screen applies; and (iii) any index, including the name and description of the index and an explanation as to how the index utilizes ESG factors in determining its constituents.
- An adviser would also be required to disclose any relationship or arrangement that is material to its advisory business or its clients that the adviser or any of its management persons have with any related person that is an ESG consultant or service provider.
- For advisers with proxy voting authority, the proposal would require such advisers that have specific voting policies or procedures that include ESG considerations when voting client securities to include a description of which ESG factors they consider and how they consider them.
- Advisers that sponsor wrap fee programs would be subject to additional disclosure requirements.

To complement the proposed client-facing disclosures, the proposal includes amendments to Form ADV Part 1A designed to collect information about an adviser's use of ESG factors in its advisory business. These proposed amendments would expand the information collected about the advisory services provided to separately managed account clients and private fund clients. For separately managed account reporting, the new disclosures only would apply to investment advisers registered or required to be registered with the SEC, and for private fund reporting, the new disclosures would apply to those advisers as well as exempt reporting advisers.

Compliance Policies and Procedures and Marketing

The SEC noted in the rule proposal that it has observed a range of compliance practices that do not appear to fully address a fund's or adviser's incorporation of ESG factors into its investment processes. As a result of this, as well as the comprehensive nature of the proposed ESG-related amendments to required disclosures, the rule proposal reaffirms existing obligations under the applicable Investment Company Act and Advisers Act compliance rules when funds and advisers incorporate ESG factors into their investment processes. In particular, the proposal states that funds' and advisers' compliance policies and procedures should address (i) the accuracy of ESG disclosures made to clients, investors, and regulators, and (ii) the portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the funds and/or adviser. Moreover, the rule proposal notes that current regulations seek to prevent false or misleading advertisements by advisers, including greenwashing, by prohibiting material misstatements and fraud. Therefore, the release states that it generally would be materially misleading for an adviser materially to overstate in an advertisement the extent to which it utilizes or considers ESG factors in managing client portfolios.

Transition Period and Compliance Dates

The SEC is proposing a one-year transition period, from the effective date of any final rulemaking, with respect to compliance with the prospectus disclosure requirements, the regulatory reporting on Form N-CEN, and the disclosure and regulatory reporting on Form ADV Parts 1A and 2A, and a longer, 18-month transition period, for annual report disclosure obligations.

Source: Environmental, Social and Governance Disclosures for Investment Advisers and Investment Companies, Release Nos. 33-11068, 34-94985, IC-34594, IA-6034 (May 25, 2022), available here; SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies about ESG Investment Practices, SEC Press Release 2022-92 (May 25, 2022), available here; SEC Fact Sheet, ESG Disclosures for Investment Advisers and Investment Companies (May 25, 2022), available here.