

SEC Proposes New Disclosures About ESG Investments

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INTRODUCTION

On May 25, 2022, the U.S. Securities and Exchange Commission (the “**Commission**”) proposed new rules and amendments under both the Investment Advisers Act of 1940, as amended (“**Advisers Act**”), and the Investment Company Act of 1940, as amended (“**Investment Company Act**”), to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies (“**BDCs**”) to provide additional information regarding their environmental, social, and governance (“**ESG**”) investment practices.

The proposed rules and amendments would facilitate enhanced disclosure of ESG issues to investors. The Commission stated that the purpose of the proposed rules and amendments is to create a consistent and comparable regulatory framework for ESG advisory services and investment companies to protect investors while facilitating innovation.

This Client Alert summarizes the new ESG requirements that would apply to investment companies and advisers under the proposed rules and amendments.

PROPOSED REGISTERED-FUND DISCLOSURES TO INVESTORS

The proposed rules and amendments would require registered investment companies and advisers to comply with requirements that would greatly expand the ESG information available to investors.

- **Proposed Prospectus ESG Disclosure Enhancements.** The proposal would require registered funds that consider ESG factors in their investment process to disclose additional information regarding their strategy. Funds that integrate ESG factors alongside non-ESG factors (“**Integration Funds**”) would be required to describe how ESG factors are incorporated within their investment process. Funds in which ESG factors are a significant factor (“**ESG-Focused Funds**”) would be required to provide detailed disclosure, as well as a standardized ESG strategy overview table. A subset of ESG-Focused Funds that seek to achieve a particular ESG impact (“**Impact Funds**”) would be required to disclose how they measure progress on their objective. The proposed amendments would

apply to open-end registered funds (including ETFs) and closed-end funds (including BDCs) that incorporate one or more ESG factors into their investment selection process.

- **Unit Investment Trusts.** A Unit Investment Trust (“UIT”) is an unmanaged company that invests the money that it raises from investors in a generally fixed portfolio of stocks, bonds, or other securities. Some UITs provide exposures to portfolios selected according to ESG factors. This proposal would require such UITs to provide investors with clear information about how portfolios are selected according to ESG factors. Any UIT with portfolio securities selected according to one or more ESG factors would be required to explain how those factors were used to select the portfolio securities.
- **Fund Annual Report ESG Disclosure. Registered Funds** would be required to disclose additional ESG information within their annual reports. For registered management investment companies, the proposed disclosure would be included in the management’s discussion of fund performance (“**MDFP**”) section of the fund’s annual shareholder report. For BDCs, the proposed disclosure would be included in the management discussion and analysis (“**MD&A**”) section in the fund’s annual report on **Form 10-K**. These disclosures would require **Impact Funds** to discuss the fund’s progress on achieving its ESG impact in both qualitative and quantitative terms. The Impact Fund would also be required to discuss the key factors that materially affected the fund’s ability to achieve its impact. **ESG-Focused Funds that use proxy voting** as a significant means of implementing ESG strategy would be required to disclose certain information regarding how the fund voted proxies related to portfolio securities on ESG issues. **ESG-Focused Funds for which engagement with issuers** through means other than proxy voting is a significant means of implementing their ESG strategy would also be required to disclose certain information about their engagement practice. **ESG-Focused Funds that consider environmental factors** would be required to disclose the aggregated greenhouse gas (“**GHG**”) emissions of the portfolio. ESG-Focused Funds and BDCs that consider environmental factors part of their investment strategy would be required to disclose the carbon footprint and the weighted average carbon intensity (“**WACI**”) of the fund’s portfolio in the MDFP or MD&A section of the fund’s annual report. A fund would not be required to disclose its GHG emissions metrics if it affirmatively states in the **ESG Strategy Overview** table within the prospectus that it does not consider issuers’ GHG emissions part of its investment strategy.
- **Inline XBRL Data Tagging.** The proposal would require funds to submit all proposed ESG-related registration statements and annual-report disclosures to the SEC in Inline XBRL, which allows investors and other market participants, such as data aggregators, to use automated analytical tools to extract the information sought wherever it may be located within a filing.

ADVISER BROCHURE (FORM ADV PART 2A)

Under the proposed rules, ESG-related disclosures would be mandatory for registered investment advisers that consider ESG factors part of their advisory businesses. This would provide clients with comparable information to help them better evaluate the growing number of advisers that offer ESG-related services and the variety of ways advisers currently approach ESG investing.

- **Item 8: Methods of Analysis, Investment Strategies and Risk of Loss.** A new **sub-Item 8.D** would be added. This amendment would require a registered adviser to provide a description of the ESG factor or factors it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors.
- **Item 10: Other Financial Industry Activities and Affiliations.** An amendment to **Item 10.C** would require registered advisers to describe any material relationship to their business that the adviser has with any related person that is an ESG consultant or other ESG service provider.
- **Item 17 Voting Client Securities.** This proposal would amend **Item 17.A** to require registered advisers that have specific voting policies or procedures that include one or more ESG considerations when voting client securities to include in their brochures a description of which ESG factors they consider and how they consider them. If an adviser has different voting policies and procedures for strategies that address ESG-related matters, or for different clients or different ESG-related strategies, the adviser generally should describe those differences.
- **Wrap Fee Brochure (Form ADV Part 2A, Appendix 1).** Advisers sponsoring wrap fee programs are required to describe in **Item 4** of their wrap fee brochures the services, including the types of portfolio management services,

provided under each program. The proposed amendment to Item 4 would require advisers that consider ESG factors in their wrap fee programs to provide a description of which ESG factors they consider, and how they incorporate such factors under each program. **Item 6** currently requires a description of any standards used to calculate portfolio manager performance. The proposed amendment to Item 6 would require advisers that consider ESG factors when selecting, reviewing, or recommending portfolio managers within the wrap fee programs they sponsor to describe the ESG factors they consider and how they consider them.

REGULATORY REPORTING ON FORM N-CEN AND ADV PART 1A

The proposal would amend **Form N-CEN** for registered funds and **Form ADV Part 1A** for both registered investment advisers and exempt reporting advisers to collect ESG information using the structured XML-based data languages in which those forms are currently submitted, thus providing the Commission and investors with consistent, usable, and comparable data.

- **Form N-CEN.** The proposal would add proposed **Item C.3(j)** of Form N-CEN that asks questions tailored to ESG funds' strategies and processes. A fund that indicates that it incorporates ESG factors would then be required to report, among other things, (i) the type of ESG strategy it employs (i.e., integration, focused, or impact); (ii) the ESG factor(s) it considers (i.e., E, S, and/or G); and (iii) the method it uses to implement its ESG strategy. In responding to proposed Item C.3(j) of Form N-CEN, an Impact Fund would be required to report that it is both an ESG-Focused Fund and an Impact Fund. The proposed amendments to Form N-CEN would also collect information regarding whether a fund considers ESG-related information or scores provided by ESG providers in implementing its investment strategy. If so, the fund would be required to provide the legal name and legal-entity identifier ("**LEI**"), or provide and describe other identifying numbers of each such ESG provider. A fund would also be required to report whether the ESG provider is an affiliated person of the fund. This amendment would also require a fund to report whether the fund follows any third-party ESG frameworks.
- **Form ADV Part 1A.** The proposed amendments to Form ADV Part 1A would collect information about advisers' uses of ESG factors for their **separately managed account ("SMA")** clients and **reported private funds**. The proposal would amend **Item 5.K (Separately Managed Account Clients)** and corresponding sections of **Schedule D**, which currently require advisers to provide information about their advisory businesses with respect to SMA clients. These amendments would collect aggregated information for an adviser's applicable SMA clients. The proposal would make similar amendments to private-fund reporting in **Section 7.B(1) of Schedule D** to collect information from private-fund advisers about their uses of ESG factors in managing each reported private fund. This information would be similar to the information proposing to be collected on Form N-CEN regarding ESG factors and would include, for example, type of strategy (i.e., integration, ESG-focused, and ESG impact). Advisers would be required to indicate for their SMA strategies whether they employ an integration or an ESG-focused approach and, if ESG-focused, whether they also employ an ESG-impact approach. These advisers would also report whether they incorporate one or more of E, S, or G factors into their SMA strategies. Similarly, if an adviser considers any ESG factors part of one or more significant investment strategies or methods of analysis in the advisory services it provides to a reported private fund, the adviser would report whether it employs in its management of that private fund an ESG-integration or ESG-focused approach and, if ESG-focused, whether it also employs an ESG-impact. Advisers would also be required to report whether they follow any **third-party ESG framework(s)** in connection with their advisory services. If so, the adviser would be required to report the name of the framework(s). The proposal would also amend **Items 6 and 7 of Part 1A** (and **Sections 6.A and 7.A of Schedule D**) to require advisers to disclose whether they conduct other business activities as ESG providers or have related persons that are ESG providers. For each related-person ESG provider, the adviser would be required to complete the relevant items in **Section 7.A of Schedule D**.

COMPLIANCE POLICIES AND PROCEDURES AND MARKETING

This proposal would reaffirm existing obligations under the compliance rules when advisers and funds incorporate ESG factors. Specifically, under the proposal, advisers' and funds' compliance policies and procedures would address the accuracy of ESG disclosures made to clients, investors, and regulators. Compliance policies and procedures also would address portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund. If an adviser discloses to investors that it considers certain ESG factors part of an integration strategy, the adviser's compliance policies

and procedures should be reasonably designed to ensure the adviser manages the portfolios consistently with how the strategy was described to investors. It would also report whether it incorporates one or more of E, S, or G factors (and which factor(s)). This information would categorize general approaches to incorporating ESG to help Commission staff understand industry trends, as well as prepare for, conduct, and implement our risk-based examination program.

COMPLIANCE DATES

This proposal would provide a transition period after the effective date of the amendments to give funds and advisers sufficient time to comply with the ESG disclosure requirements. The compliance date of any adoption of this proposal would be one year following the effective date. The compliance date of any adoption of the proposed disclosures in the report to shareholders and filed on Form N-CSR would be 18 months following the effective date. The public-comment period for the proposed rulemaking expired on August 16, 2022.

CONCLUSION

This Client Alert clarifies the new ESG requirements that would apply to investment companies and advisers under the proposed rules and amendments. The goal of this proposal is to create a consistent and comparable regulatory framework for ESG advisory services and investment companies. This proposal would require advisers, investment companies, and BDCs to provide more information regarding their ESG investment practices. These proposed rules and amendments would facilitate enhanced disclosure of ESG issues to investors and allow investment companies to protect clients while facilitating innovation.

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