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ESG and the SEC: Where Are We Now? (Part 3 of 4)



In this third post in our series, we tackle the U.S. Securities and Exchange Commission (SEC) May 2022 ESG-related disclosure proposals for registered funds and investment advisers.

Fund Names Rule Proposal

Currently, Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940 requires registered funds with certain names to invest at least 80% of their assets in the investments, industries, regions, or strategies suggested by their name. The Names Rule makes it deceptive and misleading for funds to do otherwise. [Emphasizing](#) that a "fund's name is an important marketing tool," the SEC's [proposed amendments](#) would:

- Expand the Names Rule to apply to fund names suggesting a focus in investments with particular characteristics, including, among others, "green," "sustainable," and other names indicating that investment decisions incorporate ESG factors;
- Define an "integration fund" as one that considers ESG factors alongside non-ESG factors, with ESG factors not more significant than others and not necessarily determinative; and
- Make it misleading and deceptive for an "integration fund" to use ESG-related terms in its name.

In other words, to use ESG terminology in its name, a fund would have to consider ESG factors not just alongside but more centrally than non-ESG factors in its investment decisions. The proposal would also strictly limit departures from a fund's 80% policy and require N-PORT tracking on the 80% bucket. The prospectus would need to disclose the ESG term(s) in the fund name and the ESG investment selection criteria using language consistent with common meaning or established industry use.

ESG Disclosure Proposal for Funds and Advisers

Designed to establish consistent ESG disclosure standards, the SEC's [proposal for Enhanced Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices](#) aims to facilitate investors' assessment of whether a fund's or adviser's ESG messaging is reflected in its investing. The SEC's April [2021 risk alert](#) on ESG investing is endorsed in the proposal and remains the most concrete ESG-related guidance for funds and advisers from the SEC as of this writing. *Registered Fund Disclosure Proposal* The proposal would apply to all registered funds, including business development companies, that consider ESG factors in their investment process. The extent of a fund's disclosure would depend on the extent of ESG in its investment process, in accordance with the following proposed categories. "Integration funds" would:

- Consider ESG factors alongside non-ESG factors (as in the Names Rule proposal, which would prohibit integration funds from having ESG-related names); and
- Be required to provide prospectus disclosure on how ESG factors are incorporated into their investments.

"ESG-focused funds" would:

- Have ESG factors as a significant or main consideration in selecting investments and explicitly include funds marketed by name or otherwise as having an ESG focus;
- Be required to provide detailed prospectus disclosure, including a standardized ESG Strategy Overview Table covering the fund's (1) strategy; (2) use of ESG screens, ratings/scores, indexes, and frameworks; and (3) proxy voting and management engagement;
- If they are environmentally focused and consider greenhouse gas emissions, be required to provide shareholder report disclosure on the aggregate carbon footprint and weighted average carbon intensity of their portfolio; and
- If they engage in "activism" as a significant strategy through proxy voting or management engagement, be required to provide shareholder report disclosure on their proxy voting on ESG issues and/or engagement with management beyond proxy voting.

"Impact funds" would:

- Be a subset of ESG-focused funds seeking to achieve a particular ESG impact;
- Be required to provide additional prospectus disclosure on how progress towards the impact goal is measured, the time horizon used to measure progress, and the relationship between the impact goal and financial returns; and
- Be required to provide qualitative and quantitative shareholder report disclosure on progress towards the impact goal and key factors materially affecting the fund's ability to achieve the goal.

Adviser Disclosure Proposal Under the proposal, advisers would have to disclose in their Forms ADV :

- ESG factor(s) considered for each significant investment strategy or method of analysis;
- Integration of particular E, S, or G factors, how ESG-focused strategies are employed, and any impact goals;
- Use of ESG-related methodologies, indexes, third-party rating/scoring providers and frameworks, and inclusionary or exclusionary screens;
- The ESG factors considered in ESG voting policies; and
- Material relationships with ESG consultants or other ESG service providers.

ESG-Related Considerations for Registered Fund Boards

In our fourth post in this series, we will wrap up by suggesting considerations for fund boards in the shifting regulatory landscape.

Authors

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