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Investment Advisers & Companies Face New ESG Disclosures

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On May 25, 2022, the SEC issued a 362-page proposal with new rules and disclosures to give investors consistent, comparable, and reliable information on funds' and advisers' use of environmental, social, and governance (ESG) factors. The changes would apply to registered investment companies (RIC) and business development companies (BDC), collectively "funds," and registered investment advisers and certain unregistered advisers, collectively "advisers." Highlights include:

- **New disclosures on ESG strategies in fund prospectuses, annual reports, and adviser brochures**
- **Implementing a layered, tabular disclosure approach for ESG funds to allow investors to easily compare ESG funds**
- **Greenhouse gas (GHG) emissions disclosure would be required for certain environmentally focused funds for portfolio investments**

Comments are due 60 days after Federal Register publication.

Background

The exponential growth in ESG funds continues unabated. U.S. funds with ESG strategies grew from $12 trillion in 2018 to $17.1 trillion in 2020. ESG funds now make up one in three dollars of total U.S. assets that are professionally managed. The number of ESG funds has increased from 55 in 1995 to 1,002 in 2016 and 1,741 in 2020. Funds and advisers define ESG differently, making it challenging for investors to compare funds. The proposal also is an attempt to limit greenwashing—the practice of overstating a fund or company's environmental friendliness.

Currently, funds must disclose material information on investment objectives, strategies, risks, and governance, and management must discuss a fund's performance in the shareholder report. Registered advisers must provide information about their advisory services in narrative format on Form ADV (generally referred to as a brochure) describing their firm's methods of analysis and investment strategies, fees, conflicts, and personnel. General disclosures about ESG-related investment strategies fall under these rules. Failure to comply violates federal securities laws, but there are no specific requirements about what a fund or adviser following an ESG strategy must include in these disclosures.

ESG Strategy

Funds that consider ESG factors in their investment process would be required to disclose additional information on strategy. The level of disclosure will depend on a layered framework, by fund type.

• **Integration Funds**. These funds integrate ESG factors alongside non-ESG factors in investment decisions, but the ESG factors are generally no more significant than other factors in the investment selection process. The ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio. These funds would need to disclose how ESG factors are incorporated into their investment process, as well as what ESG factors the fund considers. Open-end funds would provide this information in the summary section of the fund's prospectus. Closed-end funds would disclose the information as part of the prospectus's general fund description. Integration funds that consider GHG emissions must provide more detailed information in the fund’s statutory prospectus or later in a closed-end fund’s prospectus.

• **ESG-Focused Funds**. These funds focus on one or more ESG factors by using them as a significant or main consideration in selecting investments or in the funds’ engagement strategy with the companies they invest in. These funds would be required to provide detailed disclosure, including a standardized ESG strategy overview table.

[ESG] Strategy Overview

Overview of the Fund’s [ESG] strategy	
	The Fund engages in the following to implement its [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	
How the Fund votes proxies and/or engages with companies about [ESG] issues	

• **Impact Funds**. A subset of ESG-focused funds, these funds seek to achieve a specific ESG impact(s). For example, a fund could seek current income while also having a disclosed goal of financing affordable housing construction. Disclosure would include all the ESG-focused fund requirements above as well as how the fund measures progress toward 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 in its annual report.

Advisers that consider ESG factors would be required to make generally similar disclosures in their brochures with respect to their consideration of ESG factors in the significant investment strategies or methods of analysis they pursue and report certain ESG information in their SEC annual filings.

Proxy Voting

Funds and advisers take differing approaches on ESG issues with the issuers in which they invest, such as through proxy voting or manager engagement. In most cases, a fund’s adviser votes the proxies of the fund’s portfolio companies voting securities on the fund’s behalf, giving a fund significant power to influence actions of portfolio companies.

The proposal would require ESG-focused funds that use proxy voting or engagement with issuers as a **significant** means of implementing their ESG strategy to disclose the following in the MDFP or MD&A section:

- Additional information about strategies, including the impacts they seek to achieve and key metrics to assess their progress
- The percentage of ESG-related voting matters during the reporting period for which the fund voted in furtherance of its initiative
- The number or percentage of issuers with whom the fund held ESG engagement meetings during the reporting period related to one or more ESG issues and total number of ESG engagement meetings

The determination of whether a strategy is significant would depend on the facts and circumstances.

GHG Emissions Reporting

The proposal generally would require ESG-focused funds that consider environmental factors in their investment strategies to disclose the GHG emissions details for their portfolio investments, including the carbon footprint and the weighted average carbon intensity (WACI). Carbon footprint is an economic measure of the amount of absolute GHG emissions that a fund portfolio finances, through both equity ownership and debt investments, normalized by the size of the fund. WACI is a fund’s exposure to carbon-intensive companies, expressed in tons of CO2e per million dollars of the portfolio company’s total revenue, and measures a fund’s exposure to carbon-intensive companies. A fund cannot offset these metrics with the use of purchased or generated carbon offsets. The short sale of a security cannot reduce the GHG emissions used in the WACI or carbon footprint metrics.

An environmentally focused fund also would have to disclose the Scope 3 emissions of its portfolio companies if that data is reported by the fund's portfolio companies. Scope 3 emissions would be disclosed separately for each industry sector in which the fund invests.

Funds that disclose that they do not consider GHG emissions as part of their ESG strategy would not be required to report this information. Integration funds that consider GHG emissions would be required to disclose additional information about how the fund considers GHG emissions, including the methodology and data sources the fund may use as part of its consideration of GHG emissions.

Registered Advisers' ESG Practices

SEC-registered advisers must deliver a brochure and brochure supplements to their clients or prospective clients to cover their disclosure obligations as fiduciaries. The proposal would require an 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. Criteria and methodologies include, but are not limited to:

- An internal methodology, a third-party criterion or methodology such as a scoring provider or framework, or a combination of both, including an explanation of how the adviser evaluates the third-party data quality
- An inclusionary or exclusionary screen, including an explanation of the factors the screen applies, such as particular industries or business activities it seeks to include or exclude and if applicable, what exceptions apply to the inclusionary or exclusionary screen
- An index, including the name of the index and a description of the index and how the index uses ESG factors in determining its constituents

To avoid conflicts of interest, Item 10 of Form ADV would be updated to require a description of any **material** relationship or arrangement that the adviser or any of its management persons have with any related person who is an ESG consultant or other ESG service provider.

Currently, Form ADV Item 17 requires advisers that have—or will accept—the authority to vote client securities to briefly describe their voting policies and procedures. This would be updated to require disclosure if an adviser has specific voting policies or procedures that include one or more ESG considerations when voting client securities. Disclosure would include a description of which ESG factors are considered and how they are considered. 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 should describe those differences.

Advisers that sponsor wrap fee programs are required to prepare a specialized brochure. Advisers that consider ESG factors in their wrap fee programs must provide a description of what ESG factors they consider and how the factors are used in each program. If an adviser uses ESG factors when selecting, reviewing, or recommending portfolio managers within the wrap fee programs they sponsor, disclosure is required on the ESG factors considered and how they are considered.

The proposal also would expand the information collected on Form ADV about advisory services provided to separately managed account clients and reported private funds. This change would apply to SEC-registered investment advisers. This would include the type(s) of ESG-related strategy or strategies. If an adviser considers any ESG factors as 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 approach. An adviser would be required to report whether it follows any third-party ESG framework in its advisory services. Disclosure would be required for any ESG activities performed by related parties.

Advisers' and funds' compliance policies and procedures should be updated to address the accuracy of ESG disclosures made to clients, investors, and regulators, as well as portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund.

Compliance Date

Compliance would be required for most provisions one year after the effective date. Changes to Form N-CSR would be required 18 months after the effective date.

Conclusion

We will continue to follow this developing situation. If you have questions about these changes, contact one of our professionals today. For more information, visit forvismazars.us.

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