ESG RULE PROPOSALS FOR REGISTERED FUNDS AND ADVISERS

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* Image Source: https://www.lagazette-mag.io/environmental-social-and-governance-soyons-responsable/

Spring 2022 SEC ESG Rule Proposals

- Regulatory Background: 2019 – 2021
  - April 2021 ESG Risk Alert for Funds and Advisers

- 2022
  - Climate Risk Disclosure Proposal for Public Companies
  - ESG Enforcement Activity
  - Proposals for Funds and Advisers
    - Fund Names
    - Fund Disclosure
    - Adviser Disclosure
  - Dissenting Commissioners
  - Board Considerations

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REGULATORY BACKGROUND

Regulatory Background

- Crux of SEC focus is the problem of "greenwashing" to attract sustainability-focused investors
- Anti-fraud provisions of the federal securities laws
  - "truth in advertising" by funds and advisers
  - compliance programs reasonably designed to prevent fraud
- 2019:
  - SEC Exams staff began seeking information on topics that have remained at the center of the SEC's ESG focus:
    - the firm's definition of "ESG"
    - factors used in selecting ESG portfolio investments
    - use of ESG ratings/scores
    - ESG proxy voting record
    - achievement of stated ESG goals
    - adherence to UNPRI and/or other ESG benchmarks
    - top/bottom ESG investments and ESG performance record
    - ESG awards
    - results of any ESG audit

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Regulatory Background

- 2020:
  - exam priorities included the accuracy and adequacy of disclosures provided by advisers offering clients ESG strategies
  - SEC Request for Comments on Fund Names: should Rule 35d-1 under the Investment Company Act (the Names Rule) should be considered for registered funds with ESG strategies
- 2021
  - January 2021 Biden inauguration
  - by March SEC had announced
    - website: SEC Response to Climate and ESG Risks and Opportunities
    - Climate Counsel to SEC Chair Gary Gensler (Mika Morse)
    - Senior Policy Advisor on Climate Change and ESG (Satyam Khanna)
    - Enforcement Task Force Focused on Climate and ESG Issues and *identifying material gaps or misstatements* under current law in public company climate risk disclosures and analyzing disclosure and compliance issues relating to investment advisers' and funds' ESG strategies

Regulatory Background

- Annual Regulatory Agenda included:
  - public company disclosure relating to climate risk
  - ESG investment fund rules
- Exam Priorities included:
  - compliance programs of firms managing mutual funds, ETFs or private funds with ESG strategies, with an eye to:
  - ***alignment of all ESG messaging and firm operations, investment activities and proxy voting record*** including
    - an internally consistent definition of ESG (and/or SRI)
    - performance marketing, regulatory disclosures, representations to global ESG framework sponsors
    - the veracity of ESG advertising and the consistency and adequacy of disclosures regarding ESG strategies and practices
    - business continuity plans "in light of intensifying physical risks associated with climate change" (*i.e.*, Hurricane Sandy in NYC)

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Regulatory Background: April 2021 ESG Risk Alert

- *cannot oversell ESG story*
- controls should be in place to ensure accuracy of all ESG-related messaging
- CCO in best position to develop a holistic control framework to test and document the firm's adherence to ESG commitments
- ESG policies, codes and standards should be housed within the compliance program, be appropriately tailored for the firm's ESG business, and as appropriate, cover firm investment activities and general operations
- investment professionals with ESG expertise should be engaged on ESG strategies unless otherwise disclosed
- proxy voting must be consistent with client ESG investment strategies and firm ESG representations
- care should be taken to fully document internal ESG scoring and ESG performance measurement methodologies in a manner that can be tested
- any third party ESG score or ranking should be verified before using it in advertising or other communications
- an independent ESG audit could be appropriate given extent and complexity of ESG commitment
- enterprise risk management: as appropriate, firms should:
  - adopt procedures to address ESG-related reputational and other risks
  - adopt ESG whistleblower procedures
  - establish an ESG oversight committee

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MARCH 2022:
PUBLIC COMPANY CLIMATE RISK DISCLOSURE PROPOSAL

Public Company Climate Disclosure Proposal

- Division of Corporation Finance
  - first in the sequence of ESG rulemaking
  - key factors include
    - climate risks and how managed including by the board
    - greenhouse gas emissions
    - climate-related commitments (more heavily regulated, as with funds and advisers)
  - aims to provide a consistent data set on climate-related factors that should help funds and managers assess risk
  - ambiguity has complicated and even hobbled comparison of public company ESG data and ESG funds managed by different advisers
  - Note: ***BDCs are covered by the rule as proposed***

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ESG ENFORCEMENT

SEC ESG Enforcement

- 2022 Exam Priorities include ESG investing
- ESG Task Force work ongoing – enforcement cases flow from it and 2019-2021 SEC sweeps and Exam priorities
- focus is **ANTI-GREENWASHING (anti-misleading investors)**
- February: Robo Adviser Enforcement Settlement
  - SEC alleged that adviser *misled clients* when it failed to consistently apply Islamic norms/principles in investing for clients as it claimed to, including income purification procedures
- April: Public Company Enforcement Claims
  - Brazilian mining company (with ADRs trading in the U.S.)
  - charged by SEC with *misleading investors* about ESG (safety) practices prior to a catastrophic dam collapse
- *Note same focus in Europe*: August 2021 Duestche Bank whistleblower on overstatement of sustainable investing at DWS
  - May 2022 German regulators raid DWS offices on greenwashing claims, *misleading investors*

2022 SEC ESG Enforcement

- May: BNY Mellon Fund Complex/Adviser Settlement
  - SEC alleged Investment Company Act and Advisers Act violations, failure to adopt and implement policies and procedures to prevent
    - *misleading statements* suggesting that *ESG evaluations and quality reviews* were conducted for all mutual funds and SMAs when they were *conducted on most but not all investments*
      - Fund Prospectuses
      - Funds Board Minutes
      - RFP Responses Suggesting
      - Adviser Form ADV
      - Marketing Materials

- June: GSAM ESG Fund Probe Reported
  - SEC looking at whether marketing materials *misled investors*

- *Note: increasing criticism of lack of accountability around ESG investing from various sectors*

MAY 2022:

ESG PROPOSALS FOR FUNDS AND ADVISERS

- Fund Names
- Fund Disclosure
- Adviser Disclosure

Fund Names Rule Amendments

- Names Rule currently requires funds with *certain names* to adopt an 80% investment policy for the investments, industries, countries/geographic regions, or tax-exempt strategies suggested by their name (materially misleading to do otherwise)
- Chair Gensler:

  A fund's *name* is an important *marketing tool* and can have *a significant impact on investors' decisions* when selecting investments, and the Names Rule addresses *fund names that are likely to mislead* investors about a *fund's investments and risks*

- Proposed amendments would expand the Names Rule to apply to *any fund name suggesting that the fund focuses in investments with particular characteristics*

  - including "green" or "sustainable" fund names and
  - any others indicating that the fund's investment decisions incorporate one or more ESG factors
  - *and other names*: value, growth, long/short, target dates, balanced
  - Additional rules for derivatives names
    - fund would be required to use a derivative's notional amount, rather than its market value, for 80% policy purposes; specifications on the derivatives instruments that comply for the 80% basket

Fund Names Rule Amendments

- Proposed amendments would also specify where a fund can deviate from its 80% policy
  - currently, the Names Rule 80% policy requires compliance "at the time of investment" and "under ordinary circumstances," with departures allowed for temporary defensive positioning and other disclosed reasons
  - the proposal would allow departures only under specified circumstances
    - market fluctuations, or other circumstances unrelated to the fund's investment activity
    - unusually large inflows or redemptions
    - temporary defensive positioning (cash and cash equivalents or to avoid a loss in response to adverse market, economic, political, or other conditions)
    - repositioning or liquidation in connection with a merger, launch or 60-day notice of 80% policy change
- must restore 80% compliance ASAP, 30 days max

Fund Names Rule Amendments

- Proposed amendments would define an "integration fund"
    - Fund considers one or more ESG factors alongside other, non-ESG factors in investment decisions
    - *ESG factors are generally no more significant than other factors* in the investment selection process
    - ESG factors may not be determinative in the inclusion or exclusion of any particular investment in the portfolio
- Proposed amendments would make it materially misleading for an "integration fund" to use ESG-related terms in its name;
  - In other words, *to use ESG terminology in its name*:
    - Fund must consider ESG factors not just alongside but *more centrally than other non-ESG* factors in investment decisions,
    - ESG factors must be *more significant and determinative* in the investment selection process than other factors

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Fund Names Rule Amendments

- Proposed amendments would also require:
  - Fund prospectus disclosure:
    - to *define the term(s)* used in a fund's name
    - *including the criteria* the fund uses to select the investments that the term describes
  - *Plain English*:
    - terms must be *defined* in a reasonable manner
    - *consistent with* plain English meaning *or established industry use*
  - N-PORT disclosure:
    - tracking on securities within the 80% bucket
  - Recordkeeping:
    - for *all funds*
    - regarding *how they comply* with the Names Rule or *why they think they are not subject* to it

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Fund Disclosure Proposal

- Fund and Adviser Disclosure Proposal: SEC goal of transparency through disclosure
  - consistent standards for ESG disclosures to allow investors to determine
  - whether a fund's or adviser's ESG messaging is reflected in concrete and specific measures taken to address ESG goals and portfolio allocation

- Proposed fund disclosure rules would
  - apply to all registered funds and BDCs that consider ESG factors in their investment process
  - require additional information about the investment strategy, layered across the prospectus and shareholder reports and tagged in iXBRL

- The **April 2021 ESG risk alert is endorsed in the fund and adviser disclosure rule proposal**
  - the most concrete guidance for funds and advisers, together with enforcement cases

Fund Disclosure Proposal

- The extent of a fund's disclosure would depend on extent of ESG in the fund's investment process
  - "integration funds" consider ESG factors alongside non-ESG factors
  - "ESG-focused funds" have ESG factors as a significant or main consideration in selecting investments or engaging with portfolio companies
    - "impact funds" are a subset of ESG-focused funds that seek to achieve a particular ESG impact
      - for example: a fund that invests with **dual goals** of seeking current income and financing the construction of affordable housing units

Fund Disclosure Proposal

- Prospectus Disclosure
  - Integration Funds would be required to
    - describe how ESG factors are incorporated into their investments
    - with an overview in the summary prospectus
    - and other information in the longer statutory prospectus
    - so as to *not overemphasize ESG* story
    - *** Note cannot have ESG term in Fund name per Name Rule proposed amendments*

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Fund Disclosure Proposal

- ESG-Focused Funds would be required to
  - provide detailed disclosure
  - including a *standardized ESG Strategy Overview Table*

- "**ESG-Focused Funds**" would explicitly include
  - *funds that are marketed*
  - whether by name or marketing materials as having an ESG focus
  - for example:

    -- tracking an ESG-focused index
    -- applying an ESG screen
    -- policy of voting proxies and/or engaging with management to encourage ESG practices or outcomes
  - Activism: funds that use *proxy voting or management engagement* as a significant means of implementing their ESG strategy

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Fund Disclosure Proposal

- Impact Funds would be required to
  - provide the same detailed disclosure and ESG Strategy Overview Table as other ESG-Focused Funds
  - in addition, would be required to disclose

    -- how progress towards the stated impact goal is measured

    -- the *time horizon* used to measure that progress

    -- the *relationship* between the impact the fund is seeking to achieve and financial returns

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Fund Disclosure Proposal

- ESG Strategy Overview Table for ESG-Focused and Impact Funds
  - meant to facilitate comparison between ESG fund strategies
  - Row 1: **Overview of the Fund's ESG strategy**: concise description of the ESG factors that are the focus of the fund's strategy and whether the fund tracks an index, applies an inclusionary screen, seeks to achieve a specific impact, votes proxies or engages with management
  - Row 2: **How the Fund incorporates ESG factors in its investment decisions**: summary of process for evaluating, selecting, or excluding investments
    - *Screens:* inclusionary or exclusionary – description of screening factors and any exceptions; % of portfolio to which the screen applies
    - *Ratings/Scores:* how the fund uses internal methodologies, third party data providers, or both to rate/score investments
    - *Indexes:* identification and description of ESG index and constituent criteria
    - *Frameworks*: any third-party ESG frameworks utilized in fund investment process (UNPRI, UN SDGs)
  - Row 3: **How the Fund votes proxies and/or engages with companies about ESG issues**: for example, an overview of the fund's voting of proxies and meetings with management to encourage ESG matters

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Fund Disclosure Proposal

- Annual Report Disclosure
  - N-CSR for funds, 10-K for BDCs
  - Impact Funds
    - *progress on achieving impact* in qualitative and quantitative terms
    - *key factors* that materially affected the fund's ability to achieve its impact
    - Activism:
      - where *proxy voting* is a significant means of implementing the ESG strategy: disclosure on how the fund voted proxies on ESG issues
      - where *engagement with management* on ESG issues *other than through proxy voting* is a significant means of implementing the ESG strategy: additional information about practices
    - Environmental funds: an ESG-Focused fund that considers GHG emissions in its investment strategy would be required to disclose the **aggregated GHG emissions of the portfolio** (carbon footprint and the weighted average carbon intensity of portfolio)
- Form N-CEN Disclosure
  - tailored disclosure on ESG fund strategies and processes

Adviser Disclosure Proposal

- Form ADV Disclosure
  - any ESG factor(s) considered for each significant investment strategy or method of analysis
  - whether and how the adviser
    - incorporates particular E, S, or G factors
    - employs integration and/or ESG-focused strategies
    - employs ESG impact strategies
      - overview of the impact(s) the adviser is seeking to achieve and how
  - non-exclusive list of criteria and methodologies to address
    - use of internal methodology, third-party scoring provider or framework
    - inclusionary or exclusionary screens
    - use of indexes
  - material relationships with ESG consultants or other ESG service provider, for example, ESG index providers and ESG scoring providers
  - for advisers with specific ESG voting policies, a description of which ESG factors they consider and how they consider them

DISSENTING COMMISSIONERS

Dissenting Commissioners

- The May 2022 rule proposals are largely in response to SEC concerns about greenwashing in the context of the great popularity of ESG investing
- But **greenwashing has always been prohibited by the federal securities laws**
  - basic anti-fraud provisions, advertising/marketing rules
  - funds and advisers have always been required to have controls requiring truth telling
  - fiduciary duties require advisers to act in best interests of clients
  - Commissioner Pierce has said this repeatedly
    - including in the May 2022 open meeting
    - she voted against the rule proposals
    - and advocated for the SEC's existing materiality and fiduciary standards

BOARD CONSIDERATIONS

Board Considerations

- Funds and advisers should
  - make sure they meet the expectations articulated in the April 2021 ESG Risk Alert
  - evaluate how fund names, disclosures and/or compliance policies and procedures would have to change if the May 2022 rule proposals were adopted as proposed
    - ideally there should not be substantive changes driven by the rules, just adjustments to meet new technicalities (other changes may be business driven)
- Boards overseeing registered funds should work with counsel and the Fund CCO and adviser to understand the overall approach to ESG investing in the fund complex
    - are there integrated ESG funds? ESG-focused funds? Impact funds?
      - what funds in the complex have ESG strategies/names?
      - to which funds in the complex does the adviser's ESG investment approach apply?

Board Considerations

- are internal or third-party ESG rating/scoring systems or frameworks employed?
- what are the primary financial and other risks of the adviser's overall approach and of specific ESG strategies?
- what additional fees do shareholders pay for the adviser's ESG approach?
- how does the adviser believe its approach to ESG investing serves the best interests of fund shareholders?
- what controls are in place to comply with the April 2021 ESG Risk Alert?
- how fund names (not just ESG names), disclosures and/or compliance policies and procedures would have to change if the May 2022 rule proposals were adopted as proposed?

- Board Approvals would likely be required for
  - *changes to fund names and investment strategies and policies* driven by the Names Rule amendments
  - *other ESG-related fund initiatives and any material disclosure revisions* arising from the fund disclosure proposals

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