SEC Proposes New ESG Disclosures and Naming Rules for Investment Advisers and Funds

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On May 25, 2022, the Securities and Exchange Commission (SEC) approved proposals to the "Names Rule" (Rule 35d-1) under the Investment Company Act of 1940 (1940 Act), hereinafter referred to as Proposal One, and to the rules and forms under both the Investment Advisers Act of 1940 and the 1940 Act, hereinafter referred to as Proposal Two. The proposals seek to address public concern over environmental, social, and governance (ESG) funds "greenwashing"—a deceptive practice whereby entities or individuals exaggerate or manipulate their environmentally-friendly initiatives for gain—by expanding the scope of the Names Rule (Proposal One) and by imposing additional disclosure requirements on registered investment companies, business development companies (together with registered investment companies, "funds"), registered investment advisers, and certain unregistered advisers (together with registered investment advisers, "advisers") (Proposal Two).

PROPOSAL ONE: AMENDMENTS TO THE FUND NAMES RULE

Under the Names Rule, registered investment companies whose names suggest a focus on a particular type of investment are required to invest at least 80% of the value of their assets in those investments. As it stands, the Names Rule applies to registered funds and business development companies (BDC). The proposed set of amendments to the Names Rule would expand its scope to apply to any fund whose name suggests the fund focuses its investments on particular characteristics—such as "growth," "value," or names indicating the incorporation of ESG factors. The amendments would modernize the 80% requirement by imposing the requirement on those particular funds. The proposal would also require a fund to use a derivatives instrument's notional amount, rather than its market value, for purposes of determining the fund's compliance with the 80% requirement. The proposal does acknowledge circumstances whereby the fund may depart from the 80% requirement—such as sudden changes in the market value of the underlying investments—and sets forth specific time frames when the fund must return to its 80% threshold.

The proposal would also prohibit a registered close-end fund or BDCs whose shares are not listed on a national security exchange from changing its 80% investment policy without a shareholder vote. This ensures that shareholders can vote on a change in their investment policy given their limited options to exit their investments.

Finally, the proposal would enhance prospectus disclosure, reporting and recordkeeping by requiring fund prospectus disclosure to define the terms used in the fund's name, by amending Form N-PORT to allow for greater transparency on how the fund's investments match its focus, and by requiring funds to keep certain records regarding how they comply with the rule or why they think they are exempted from it.

PROPOSAL TWO: ESG DISCLOSURES FOR INVESTMENT ADVISERS AND INVESTMENT COMPANIES

Proposal Two acknowledges the growing profitability and significance of ESG considerations for investment advisers and investment companies. With the investing public's growing interest in ESG considerations, Proposal Two seeks to increase disclosure requirements by:

1. Necessitating additional disclosure requirements regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures
2. Implementing a layered, tabular disclosure approach for ESG funds to allow investors to compare ESG funds
3. Requiring environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their investments

The amendments under this proposal separate funds that consider ESG factors into three categories (with advisers being required to make generally similar disclosures):

1. **Integration Funds:** Funds that consider and/or integrate ESG factors alongside non-ESG factors in their investment decisions. These funds would be required to describe how ESG factors are incorporated into their investment decisions. If these funds consider environmental factors (the "E" in ESG), they would be required to report how the fund considers GHG emissions. Under the proposed changes to the Names Rule, these funds would not be permitted to use ESG related terms in their name since ESG considerations do not play a significant enough role for the fund.
2. **ESG Focused Funds:** Funds in which ESG are a significant or main consideration. These funds would be required to provide detailed disclosure. If these funds consider environmental factors (the "E" in ESG),

they would be required to report the GHG emissions, carbon footprint, and the weighted average carbon intensity associated with its portfolio. Under the proposed changes to the Names Rule, ESG-Focused Funds that invest the remaining 20% of the value of their assets in investments that are in direct juxtaposition to their E, S, or G focus would be barred from using ESG terms in their name.

3. Impact Funds (a subset of ESG-Focused Funds): Funds in which ESG factors are not only significant or main considerations but the overall goal is to achieve a particular E, S, or G impact. In addition to the requirements above, these funds would also be required to disclose how it measures progress on its objective.

Exempt reporting advisers and registered investment advisers would be required to make similar disclosures in their Form ADV Part 1, in addition to providing information on whether they conduct other business activities as ESG service providers or consultants. Registered investment advisers who consider ESG factors in connection with their analysis or investment strategies would also be required to make additional disclosures to their ADV Part 2 brochures. These include, but not limited to: applying the same layered approach discussed above by providing an explanation of how the adviser employs ESG-integration, ESG-Focused, or ESG-Impact funds; a description of the ESG methodology used in their investment criteria; a description of the ESG factors considered; and for advisers that have specific voting policies in place that include ESG factors, a description of those factors and how they are used to vote securities.

CONSIDERATIONS AND IMPLICATIONS OF THE PROPOSALS

- Refinitiv Lipper data shows that globally, ESG funds received $649 billion in 2021 through November 30, a 56% increase from the $285 billion received in 2019. The proposals seek to address the concerns of the investing public that certain funds are exaggerating their ESG efforts in order to take advantage of the increased interest and higher fees associated with ESG funds.
- These proposals follow the SEC's March 2022 proposals that require publicly traded companies to disclose how climate change impacts their business.
- These proposals would impose challenges and restrictions on ESG Funds that build a stake in companies that run contrary to their E, S, or G mission with the intention of winning seats on the board or forcing proxy votes to pressure the board to reduce its negative E, S, or G impact.
- The proposed increased disclosure requirements could place pressure on funds to take actions that limit their profitability in order to appease activist investors' wishes.
- ESG funds should describe in their prospectus and proxy statements how they define "ESG," "sustainable," "low-carbon," and other related terms and whether that means investing in entities that are actively working to achieve such or have already achieved such.

- Impact Funds that place a substantial portion of their assets in corporations that have significant international supplier/vendor contracts should work to ensure that those companies have policies in place to prevent their international suppliers or vendors from outsourcing their work to third-parties who violate the ESG requirements put in place by the company.

Public comment on both proposals is expected to run for 60 days after publication in the Federal Register. For review of the proposals, please visit Proposed rule: Investment Company Names and Proposing Release: Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices.

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