



ALERTS

SEC Proposes Disclosures For Funds And Asset Management Advisors Making ESG Investment Claims

August 12, 2022

Highlights

The proposed SEC regulations will apply to funds and investment advisors making ESG related claims. The public comment period closes Aug. 16.

The SEC is concerned that investors need more disclosure about ESG claims

The extent of required disclosures will vary depending on the ESG claims made by funds and advisors

A proposed U.S. Securities and Exchange Commission (SEC) rule that covers [regulating environmental, social and governance-related practices](#) of registered investment companies, business development companies and private funds managed by registered investment advisers departs from prior SEC practice. This proposed rule, issued May 25, 2022, is another signal the SEC is aiming for transparency in the information provided to investors regarding ESG.

The proposed ESG rule can be seen as a companion piece to the [corporate climate disclosure regulations](#) proposed in March 2022, as it

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recommends additional disclosure requirements related to any greenhouse gas (GHG) emissions components of ESG-related statements and disclosures. The SEC stated in a news release that its objective is to “create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry.”

If adopted, the rule would take effect approximately one year following the date of publication.

The comment period for the proposed ESG rule remains open until August 16, 2022. Examining the rule is useful for a broader audience than merely those individuals and entities potentially subject to it because it provides insight into the SEC’s core concerns about ESG-related claims. Ultimately, these core concerns may affect SEC activities concerning other industries and business sectors. Moreover, the proposed rule indicates the SEC’s views on achievable communications and calculations, data tracking, and reporting for investment advisers and funds with respect to general ESG disclosures.

At a high level, the Proposed ESG Rule indicates SEC’s concern that investors need additional disclosures to adequately compare funds and to identify firms that may be engaged in so-called “greenwashing” – a practice whereby investment advisers make overstated and/or unsupported ESG-related claims regarding investment selection, generally in marketing or advertising materials. In the introduction, the SEC describes the rationale for the Proposed ESG Rule:

“These changes also would allow investors to identify funds more readily and advisers that do or do not consider ESG factors, differentiate how they consider ESG factors, and help inform their analysis of whether they should invest..... We believe that these requirements would provide improved transparency and decision-useful information to investors assisting them in making an informed choice based on their preferences for ESG investing.”

While prescriptive on a number of topics, the proposed rule notably fails to define the key term “ESG,” in addition to failing to define the separate “E,” “S,” or “G,” components. These missing definitions may create ambiguity for advisers seeking to interpret and comply with the proposed rule.

SEC Commissioner Hester Peirce [highlighted similar concerns](#) in her dissent to the Proposed ESG Rule. Peirce acknowledged the reality of greenwashing, but noted the SEC has previously acted on the issue based on existing guidance, citing, for instance, recent SEC enforcements. Peirce also took issue with the proposed rule’s prescriptive approach, including requirements specifying the level of detail employees must disclose concerning engagements with issuers on ESG matters.

Is the Proposed Rule Necessary?

The SEC and other U.S. financial regulators have imposed other requirements and taken enforcement actions against individuals and firms with respect to ESG claims.

- In March 2021, the SEC [launched the Climate and ESG](#)



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Task Force within the Division of Enforcement with the goal of developing initiatives to identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment.

- In March 2022, the SEC's Office of Compliance Inspections and Examinations listed ESG-related issues as one of its primary **priorities for 2022 examinations of registered investment advisers**.

The SEC's focus on ESG-related issues is shared by numerous other financial regulators around the globe. Perhaps most notably, in 2021 the European Union adopted the Sustainable Finance Disclosure Regulation (EU SFDR). The Commission Delegated Regulation (EU) 2022/1288, consisting of the regulatory technical standards under the EU SFDR, became effective on August 14, 2022 and will apply beginning on January 1, 2023. Like the proposed ESG rule, this regulation was designed to provide investors additional transparency and standardized disclosure on financial products that have environmental and/or social characteristics, invest in sustainable investments, or have sustainability objectives.

Highlights of the Proposed Rule

At a very high level, the proposed ESG rule imposes three tiers of increased disclosure requirements on funds and advisers based on the distinction between 1) a fund or adviser considering ESG as integrated into an overall investment strategy 2) focusing more specifically on an ESG investment strategy or 3) seeking to achieve an ESG objective via investments made. Based on this spectrum, different funds or advisers will be required to provide investors with corresponding ESG information, data, metrics, and strategies. In addition, ESG-related information involving GHG emissions would require further disclosures, including specific information about calculations and estimations.

Integration Funds

These funds consider ESG factors, among other factors, in selecting investments for the fund. Under the proposed rule, the ESG factor(s) must not override or be particularly more important than other factors considered in the investment decision.

In addition, an Integration Fund will be required to summarize how the fund incorporates ESG into the selection process, including which particular ESG factors the fund considers. The fund also will be required to describe the relative weighting given to these ESG factors. The proposed rule places an additional disclosure obligation on any reference to GHG emissions as a particular ESG factor, requiring the fund to explain how it considers GHG emissions in its portfolio.

Focused Funds

These funds include those that track ESG-focused indices, apply ESG factors as a screen to either include or exclude a particular investment in the relevant portfolio, or have policies relating to engagement with management of issuers or proxy voting in support of ESG-related activities.

The proposed rule will require each Focused Fund to use a tabular format

to report how the fund incorporates ESG factors into its investment strategy, including both “check the box” and narratives disclosures. These funds also will be required to disclose whether they use proxy voting or issuer engagement as a significant part of their ESG strategies. Other ESG strategies adopted by a Focused Fund must be disclosed even if they are not significant a part of the overall investment strategy. A narrative description is required to accompany the disclosure of the use of particular ESG strategies.

In addition, Focused Funds will be required to disclose two different GHG emission calculations, unless there is a statement that the fund does not consider issuers’ GHG emissions as part of its investment strategy: 1) Focused Funds must calculate and disclose the total carbon footprint of the fund’s portfolio and 2) They will be required to perform a second GHG emission calculation for the fund portfolio’s weighted average carbon intensity (WACI).

Under the proposed regulations, the carbon footprint is a measurement of the absolute GHG emissions that a fund portfolio finances through equity ownership and debt investments normalized by the size of the fund according to tons of CO₂ per million dollars invested. A Focused Fund must calculate the carbon emissions associated with each portfolio holding and divide the resulting amount by the current asset value of the portfolio to derive the fund’s carbon footprint.

WACI is a calculation that examines a fund’s exposure to carbon-intensive companies as expressed in tons of CO₂ per million dollars of a portfolio company’s total revenue. Each portfolio company’s Scope 1 and Scope 2 GHG emissions divided by the portfolio company’s revenue provides the WACI figure for that particular portfolio holding. The fund would add up all of the calculated WACI figures to get the overall WACI figure for the fund.

For purpose of calculating the GHG emissions of portfolio companies, portfolio companies cannot reduce the calculated amount of emissions by the portfolio company’s use of purchased or generated carbon offsets (though a fund could report that particular portfolio companies have purchased or generated carbon offsets). There are additional specifics for making calculations if a fund holds derivatives or holds assets in other funds that hold portfolio company investments. Money market funds would not be required to calculate GHGs.

Funds will need to use a portfolio company’s financial information from SEC filings, if available, or otherwise obtain the information from the portfolio company. Similarly, Focused Funds will need to obtain GHG Scope 1 and 2 information from a portfolio company’s SEC-required reports. If such data is unavailable, the fund must obtain GHG data from other publicly available reports about the portfolio company. If there is no publicly available Scope 1 and 2 data for a portfolio company, the Focused Fund would be required to estimate Scope 1 and 2 GHG data for the company. Focused Funds will be required to disclose the percentage of its aggregate portfolio company emissions, which are estimates, and provide information about the details of the estimation process. Finally, if a portfolio company reports Scope 3 emissions (all other indirect emissions that occur in a company’s value chain upstream and downstream of the company), then the Focused Fund must separately report on Scope 3 emissions, but does not have to estimate

Scope 3 emissions for portfolio companies that do not report such emissions.

Impact Funds

These funds are a subset of the ESG-focused funds and the proposals in the new rule go the furthest on the ESG scale in that they make investment selections that seek to achieve a specific ESG impact.

An Impact Fund will be required to make all of the disclosures applicable to Focused Funds plus additional disclosures. For instance, an Impact Fund must disclose what impact the fund seeks to achieve and how the fund plans to achieve its stated impact. Impact Funds must also identify how they measure progress towards the specific impact they seek to make, as well as the time horizon and the relationship between the fund and the fund's financial returns.

Form ADV Parts 1A and 2A

In addition to requiring different levels of disclosures with respect to their private funds or separately managed accounts that meet the criteria for Integration Funds, Focused Funds or Impact Funds, the proposed rule requires advisers to ESG funds to provide different levels of ESG-related disclosures in their Form ADVs. These disclosures are intended to inform investors about the role ESG strategies play in the relevant investment considerations and the advice provided by advisers.

- Advisers to Integration Funds (or similar products) must disclose the ESG factors they considered but that do not outweigh other factors in advising on investments.
- Advisers to Focused Funds (or similar products) must disclose each significant ESG factor considered by the adviser and how it is incorporated into the adviser's investment advice.
- Impact Fund advisers (or similar products) must identify the impact the adviser is seeking to achieve by advising the fund, as well as how the adviser is seeking to achieve its targeted impact. Under the proposed regulations, there appears to be a risk that an adviser to an Impact Fund may become subject to the Focused Fund category's set of disclosures if the adviser appears to give weight to particular ESG factors.

Compliance Dates

The proposed ESG rule would go into effect 60 days after the final rule is published in the Federal Register. The compliance date is one year after the date of publication of the final rule.

Implementation Considerations

Funds and advisers who do not wish to be subjected to the more extensive disclosure requirements imposed on Focused Funds or Impact Funds must take care when communicating with investors about their reliance on ESG factors in making investment decisions. The proposed

regulations encourage advisers to implement compliance policies and procedures when they incorporate ESG factors into their investment and advisory decisions. The SEC cautions advisers to avoid making false or misleading statements. In particular, the proposed regulations emphasize the importance of providing additional disclosures concerning GHG emissions as compared with any other elements of ESG.

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