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SEC proposes new rules for funds with ESG characteristics

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The Securities and Exchange Commission has proposed a set of new rules for funds in an effort to promote clarity and transparency for the growing environmental, social, and governance market.

The proposed rules and form amendments are designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating transparency. The scope would apply to certain registered investment advisers, advisers exempt from registration, registered investment companies, and business development companies.

- If adopted, the new SEC rules will put significant disclosure requirements on certain types of funds.
- The rules use a combination of TCFD and SDFR disclosure frameworks.
- The requirements will bring disclosures for ESG and impact funds roughly in line with other jurisdictions.

Providing additional information on ESG investment practices

The first set of amendments to rules under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 seeks to oblige both open-end funds (including ETFs) and closed-end funds (including BDCs) that incorporate one or more environmental, social, and governance (**ESG**) factors into their investment selection process, to provide additional information regarding ESG investment practices.

At present, disclosure requirements for funds and registered advisers are concentrated around investment strategies. Funds must provide disclosures concerning material information on investment objectives, strategies, risks, and governance, while management must provide a discussion of fund performance in the fund's shareholder report. General disclosures about

ESG-related investment strategies fall under these requirements, however, there are no specific requirements about what a fund or adviser following an ESG strategy must include in its disclosures.

Preventing greenwashing in funds marketing

The second set of rules aims to amend Rule 35d-1 (the so-called Names Rule) under the Investment Company Act of 1940, to expand scope and apply such rule to **any fund name** with terms, suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics. This would also include fund names with ESG and similar terminology. In practise, a fund's 80% investment policy would have to be aligned with ESG criteria in order to be able to use such terminology in its name. In addition, the Securities and Exchange Commission (**SEC**) is proposing that funds' prospectus disclosures would need to define the terms used in its name, including the criteria the fund uses to select the investments that the term describes. This enhancement is aimed towards the prevention of greenwashing in fund names.

Both proposals aim to help investors, and those who provide advice to investors, make more informed choices regarding ESG investing and better compare funds and investment strategies. The proposed amendments create a framework for disclosures regarding a fund or adviser's ESG-related strategies and hope to enhance the quantitative data for environmentally focused fund strategies.

A proposed new fund taxonomy

The proposed ESG-related disclosure and reporting requirements for registered funds focus on prospectuses, annual shareholder reports, and Form N-CEN. The specific disclosures and level of detail required would depend on the extent to which a fund considers ESG factors in its investment processes.

To facilitate this framework, the SEC proposed a new fund taxonomy consisting of three categories of ESG funds, each with accompanying disclosure requirements:

1. **Integration Funds** would cover funds that consider one or more ESG factors along with other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in including or excluding any particular investment in the portfolio, would be required to follow streamlined disclosure. The streamlined disclosure would include a short summary of what ESG factors the fund incorporates and how those factors are integrated into the investment selection process. In addition, if an Integration Fund considers greenhouse gas (**GHG**) emissions of its portfolio holdings, it would be required to also disclose its methodology for the calculation of this metric.

2. **ESG-Focused Funds** or strategies focused on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies. An ESG-focused strategy would include funds that apply inclusion or exclusion screens, funds that focus on ESG-related engagement with the issuers, and funds that seek to achieve a particular ESG impact and would be required to make minimum disclosure. These factors could include, for example, screens for carbon emissions, board or workforce diversity and inclusion, or industry-specific issues. ESG-focused strategies could also include engagement with management of the issuers in which the fund or adviser invests through proxy voting or direct engagement. Similarly to the Integration Funds, those ESG-Focused Funds that consider environmental factors would be required to disclose two GHG emissions metrics for the portfolio, namely carbon footprint and weighted average carbon intensity, in funds' annual reports.
3. **Impact Funds** are those which seek to achieve specific ESG-related benefits. These funds would be required to disclose on an annual basis both qualitative and quantitative metrics of the impact achieved, and also cover the key factors that materially affect the fund's ability to achieve the impact(s). Impact Funds would be treated as a sub-set of ESG-Focused Funds and therefore they would be subject to their disclosures.

In addition, a fund for which proxy voting or other engagement with issuers is a significant means of implementing its strategy should also disclose information regarding how it voted proxies relating to portfolio securities on particular ESG-related voting matters and information regarding its ESG engagement meetings.

Specific disclosure requirements regarding ESG strategies would need to be made to investors in fund registration statements, the management discussion of fund performance in fund annual reports, and adviser brochures.

The proposal was subject to comment for 60 days from their publication in the Federal Register, and the rules are still subject to change.

Registered funds' disclosures			Investment advisers
Fund	**Annual report disclosure**	**Statutory prospectus**	**ADV Part 2A**
			For each strategy, describe how ESG factors

Integration Fund	No disclosure needed.	Describe how the fund incorporates ESG factors into its investment process, and the factors considered.	Describe how the fund incorporates ESG factors into its investment selection process. Funds consider GHG emissions as a factor must describe the methodology.	are incorporated. Explain whether and how ESG factors are considered alongside other non-ESG factors. Describe any criteria or methodology used to evaluate, select, or exclude investments based on the consideration of ESG factors (for example, screens).
	Disclose proxy voting information (if proxy		Describe how the fund incorporates ESG into its investment selection process, including: i. the index methodology for any index the fund tracks ii. any internal methodology	For each strategy, describe how ESG factors are incorporated, and which factors are

ESG Fund	voting is important to the fund's strategy). Engagement policy and engagement results (if it is a significant part of the fund's strategy). If the fund considers environmental factors, disclose GHG emissions of the portfolio.	Provide key information about the consideration of ESG factors in a standardised form.	used iii. the scoring or rating system of any third-party used iv. the factors applied by any inclusionary or exclusionary screen v. a description of any third-party ESG framework used, and vi. a description of the objectives of any engagement activities, whether by voting proxies or otherwise	considered. Explain whether and how the strategy focuses on one or more ESG factors. Describe any criteria or methodology used to evaluate, select, or exclude investments based on the consideration of ESG factors (ie, internal or third-party method)
	Disclose proxy voting information (if proxy voting is important to the fund's strategy).	Provide key information about the consideration of ESG factors, disclosed in a standardised form. Describe how		

Impact Fund	Engagement policy and engagement results (if it is a significant part of the fund's strategy). If the fund considers environmental factors, disclose GHG emissions of the portfolio. Discuss the fund's progress toward achieving its impact(s) in both qualitative and quantitative terms.	the fund will achieve its ESG objectives. Disclose: i. how the fund measures progress toward the stated impact(s) ii. the time frame used to measure that progress, and iii. the relationship between the impact(s) sought and the fund's financial return	Same as ESG Fund.	Same as ESG Fund, plus an overview of the impact(s) the adviser seeks to achieve and the methods used to achieve them. Also, the impacts' relationship with financial returns.

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Our experienced SI specialists can also assist with the measurement and approach for portfolios, reporting and independent verification, and work closely alongside the global legal team at Ogier's Sustainable Investment and Impact Funds practice.

If you are interested in any of our services or would like to arrange a consultation, please contact a member of our team.

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