SEC FOLLOWS THE LEAD OF EUROPEAN REGULATORS IN FOCUSING ON ESG DISCLOSURES BY INVESTMENT FUNDS AND ADVISERS

In an effort to address "greenwashing" in the investment space, the SEC has proposed new rules that would apply to investment funds and investment advisers that consider ESG factors in their investment strategies. Specifically, the new rules would apply to registered investment companies and business development companies ("funds") as well as registered investment advisers and so-defined "exempt reporting advisers" under Section 203(l) and (m) of the Investment Advisers Act ("advisers") that take account of ESG factors, and would mandate new ESG disclosure in fund registration statements, management's discussion of fund performance in annual reports and adviser brochures. The SEC has proposed a layered disclosure approach for funds as well as specific GHG emissions data associated with portfolio investments by certain environmentally focused funds.

The underlying rationale for the rulemaking is that the absence of consistent, reliable and comparable information tailored to ESG investing makes it difficult for investors to find decision-useful disclosure and to determine whether a fund's or adviser's ESG statements "translate into concrete and specific measures" to achieve ESG goals and portfolio allocations. The current disclosure regime also makes it difficult for investors to assess how ESG-related strategies will be implemented over time.

At the same time, the SEC also proposed amendments to modernize its names rule.

Proposed Requirements Applicable to Funds

Prospectus requirements

The proposed rules identify three categories of ESG funds:

- ***Integration Funds***, which are funds that integrate ESG factors alongside non-ESG factors in their investment decisions; for these funds, ESG factors are no more significant than other factors and are unlikely to be determinative. These funds would be required to describe ("in a few sentences") how ESG factors are incorporated into their investment selection process, including what ESG factors they consider. Open-end funds would include the required disclosure in the summary section of their prospectuses, while closed-end funds would include the disclosure as part of the general description of the fund.

  Integration Funds that consider GHG emissions would be required to provide more detailed information, namely how they consider the emissions of their portfolio holdings. This would include a description of the methodology used. In its request for comments, the SEC asks whether these funds should disclose quantitative information or other GHG metrics in addition to, or in lieu of, narrative disclosures.

- ***ESG-Focused Funds***, which are funds for which ESG factors are a significant, or the main, consideration in selecting investments or in their engagement strategies with their portfolio companies. These funds, which would include, for example, those that apply inclusionary or exclusionary screens, that focus on ESG-related engagements with their portfolio companies or that seek to achieve a particular ESG impact, would be required to provide detailed disclosure, including a standardized "ESG Strategy Overview" table. Any fund whose name indicates it incorporates one or more ESG factors in investment decisions or whose advertisements or sales literature indicates its decisions incorporate one or more ESG factors by using them as a significant or main consideration would be deemed an ESG-Focused Fund.

ESG-Focused Funds would be required to provide key information about their consideration of ESG factors in a tabular format in the ESG Strategy Overview table. An open-end fund would be required to provide the disclosure at the beginning of its "risk/return summary," the section of the prospectus that summarizes key information about the fund's investments, risk and performance, while a closed-end fund would provide the table at the beginning of the discussion of the fund's organization and operation. There would be three rows of tabular information:

  - an overview of the strategy (that also includes a series of boxes to check);
  - how the fund incorporates ESG factors in its investment decisions; and
  - how the fund votes proxies and/or engages with companies about ESG issues.

- ***Impact Funds,*** which are a subset of ESG-Focused Funds that seek to achieve a particular ESG impact. These funds would be subject to additional disclosure requirements, namely:
  - how they measure progress towards 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 return(s).

  Impact Funds would also need to disclose in their investment objectives the ESG impact that they seek to generate with their investments.

Annual shareholder report requirements

In addition to the foregoing, which would be included in fund prospectuses, certain funds would be required to include disclosure in their annual shareholder reports. This disclosure would include:

- ***Impact Funds***: in addition to the disclosure required of ESG-Focused Funds (described below), the progress made in achieving their stated impact objective(s), in quantitative and qualitative terms, including factors that materially affected their ability to achieve their impact.

- ***ESG-Focused Funds***: that check the box for proxy voting or company engagement in the ESG Strategy Overview table in their prospectuses would be required to provide annual disclosure on ESG aspects of their proxy voting (how they voted portfolio company securities on ESG-related voting matters) and their engagement activities.

  ESG-Focused Funds that consider environmental factors as part of their investment strategies (but do not affirmatively state that they do not consider portfolio company

GHG emissions as part of their investment strategy disclosed in their ESG Strategy Overview table) ("environmentally focused funds") would be required to disclose two GHG emissions metrics for their portfolios – the carbon footprint and the weighted average carbon intensity ("WACI") of the portfolios. These disclosures are intended to be aligned with TCFD and Partnership for Carbon Accounting Financials ("PCAF") frameworks, based on emissions data consistent with the GHG Protocol framework.

Proposed Requirements Applicable to Advisers

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 annual filings with the SEC.

Among other requirements:

- An adviser would need to provide a description of the ESG factor(s) it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors.

  Similar to the proposal for registered funds, the SEC is not proposing to define "ESG" or similar terms. Instead, it would require an adviser to provide a description of the ESG factor(s) it considers, and disclose to clients how it incorporates these factors when providing investment advice, including when recommending or selecting other investment advisers. The SEC is proposing definitions for ESG integration, focused and impact strategies, which are similar to the way it proposes to define them for funds.

  An adviser would be required to explain what it means when it states that it incorporates ESG factors in its investment recommendations, including describing the ESG factors. This would require an explanation of whether and how the adviser incorporates a particular ESG factor (E, S, or G) and/or a combination of factors. In addition, similar to funds, the proposed disclosure would include an explanation of whether and how the adviser employs integration and/or ESG-focused strategies, and if ESG-focused, whether and how the adviser also employs ESG impact strategies.

  An adviser that considers different ESG factors for different strategies would include the proposed disclosures for each strategy. If an adviser uses, for any significant strategy, criteria or a methodology to evaluate, select or exclude investments based on the consideration of ESG factors, it must describe those criteria and/or methodologies and how it uses them. An adviser that employs different criteria or methodologies for different strategies would include the proposed disclosures for each significant strategy.

  The proposed requirements would provide a non-exclusive list of criteria and methodologies to address, as applicable, including an adviser's use of:

  - 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 quality of relevant third-party data;

  - 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 screen; and
  - 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.

- Separately, an adviser would be required to describe any relationship or arrangement, which is material to the adviser's advisory business or to its clients, that the adviser or any of its management team have with any related person that is an ESG consultant or other ESG service provider (such as an ESG index provider or ESG scoring provider).
- An adviser that has specific voting policies or procedures that include one or more ESG considerations when voting client securities would be required to include a description of which ESG factors it considers and how it considers them. 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 generally should describe those differences.

GHG Emissions Data

Mindful of the issues presented by requiring Scope 3 data, the SEC's alignment with the PCAF approach is important. Under the PCAF global carbon accounting and reporting standard issued in November 2020, which subsequently was endorsed by the TCFD, financial institutions (including funds) are to measure and report Scope 1 and Scope 2 emissions of investments separately from Scope 3 emissions. PCAF follows a phased-in approach to Scope 3 reporting, with Scope 3 emissions to be reported only for certain select sectors that provide Scope 3 data.

An "environmentally focused fund" would be required to disclose the carbon footprint and the WACI of the fund's portfolio in the MDFP or MD&A section of its annual report. Carbon footprint is the total carbon emissions associated with the fund's portfolio, normalized by the fund's NAV and expressed in tons of CO_{2e} per million dollars invested in the fund. (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.)

To calculate the fund's carbon footprint, a fund first would calculate the portfolio companies' individual enterprise values (equity value plus total debt). It then would calculate the carbon emissions associated with each portfolio company by dividing the current value of the fund's investment in the portfolio company by the portfolio company's enterprise value, and then would multiply the resulting amount by the portfolio company's Scope 1 and Scope 2 GHG emissions. Finally, the fund would add up the carbon emissions associated with each portfolio company and divide the resulting amount by the current NAV of the portfolio to derive the fund's carbon footprint.

By way of example, portfolio company has an enterprise value of $100 million and the fund owns equity securities equal to 10% of the company's enterprise value. If a company's

Scope 1 and 2 emissions total 2 metric tons of CO_{2e} in the last year, the emissions attributable to the fund for this calculation would be 10% of 2 metric tons of CO_{2e} (or 0.2 metric tons of CO_{2e}). The fund would repeat this calculation for each of its portfolio companies and then add up the resulting values for all of its portfolio companies. The fund would then divide the resulting amount by the fund's NAV to derive the fund's carbon footprint.

WACI is the fund's exposure to carbon-intensive companies, expressed in tons of CO_{2e} per million dollars of the portfolio company's total revenue. For example, if 10% of the fund is invested in a portfolio company, the fund would determine the portfolio company's carbon emissions per million dollars of revenue by dividing the portfolio company's Scope 1 and 2 GHG emissions by the portfolio company's total revenue. These emissions would then be attributed to the fund in proportion to the weight of the investment in the fund's portfolio: 10% of the emissions would be attributable to the fund because the holding represents 10% of the fund's NAV.

To calculate the fund's WACI, as reflected in the example above, a fund would first calculate the portfolio weight of each "portfolio holding" by dividing the value of the fund's investment in the portfolio company by the current NAV. The fund would then calculate the carbon emissions of each portfolio company by dividing the portfolio company's Scope 1 and Scope 2 GHG emissions by the portfolio company's total revenue. These emissions would then be attributed to the fund in proportion to the weight of the investment in the fund's portfolio, that is, if the fund's investment represents 10% of the fund's NAV and the company's Scope 1 and 2 GHG emissions divided by revenue is 1 million metric tons of CO_{2e}, the emissions attributable to the fund under this calculation would be 10% of 1 million. The fund would perform this calculation for each portfolio company in its portfolio and the sum of the emissions attributable to the fund would be the fund's WACI.

For both the carbon footprint and WACI measures, a fund would be precluded from reducing the GHG emissions associated with a portfolio company as a result of the company's use of purchased or generated carbon offsets.

The proposal would define CO_{2e} to mean the common unit of measurement to indicate the global warming potential ("GWP") of each greenhouse gas, expressed in terms of the GWP of one unit of carbon dioxide, and would define GHG emissions to mean the direct and indirect GHGs expressed in metric tons of CO_{2e}. The proposal would also provide definitions for the types of emissions that should be calculated within financed Scopes 1, 2, and 3. For purposes of the definition of Scope 3 emissions, the proposal also defines "value chain" to mean, in part, the upstream and downstream activities related to a portfolio company's operations, including activities by a party other than the portfolio company.

Additionally, for both the carbon footprint and WACI measures, the fund would determine the GHG emissions associated with each portfolio company (or "portfolio holding"), defined as (a) an issuer that is engaged in or operates a business or activity that generates GHG emissions or (b) an investment company, or an entity that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act (a "private fund"), that invests in issuers described in clause (a), except for investments in money market funds. The definition would require a fund to take into account GHG emissions when the fund invests in other funds or private funds to avoid a fund investing in portfolio companies through such a fund structure without reflecting the associated emissions in the investing fund's GHG metrics.

If the underlying fund itself were an environmentally focused fund required to report its carbon footprint and WACI, the investing fund could determine the GHG emissions associated with the investment for purposes of calculating the investing fund's carbon footprint and WACI by taking its pro rata share of the underlying fund's GHG emissions. If the underlying fund was not required to disclose that information, the investing fund could look through its investment in the fund/private fund and take the investing fund's pro rata share of the emissions of the portfolio holdings of the fund or private fund. If a fund obtains its exposure to a portfolio company by entering into a derivatives instrument, the derivatives instrument for purposes of the GHG metrics calculations would be treated as an equivalent position in the securities of the portfolio company that are referenced in the derivatives instrument.

The SEC did not propose requiring that funds use a particular estimation method. A fund that uses estimates would need to disclose the percentage of the aggregate portfolio GHG emissions calculated using the fund's good faith estimation process. The fund also would be required to provide a brief explanation of the process it used to calculate its good faith estimates of its portfolio company GHG emissions, including the data sources the fund relied on to generate these estimates. A fund would provide additional information on Form N-CSR regarding any assumptions and methodologies it applied in calculating the portfolio's GHG emissions, and any limitations associated with the fund's methodologies and assumptions, as well as explanations of any good faith estimates of GHG emissions the fund was required to make.

An environmentally focused fund would also be required to disclose the Scope 3 emissions of its portfolio companies, to the extent that Scope 3 emissions 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, and would be calculated using the carbon footprint methodology discussed above.

Proposed Modifications to the Names Rule

The so-called fund "names rule" currently requires funds with certain names to adopt a policy to invest at least 80% of their assets in the investments suggested by that name. The proposal would expand this requirement to apply to any fund name with terms suggesting that the fund focuses on investments that have, or investments whose issuers have, particular characteristics. This would include, for example, fund names with terms such as "growth" or "value" and those indicating that the fund's investment decisions incorporate one or more ESG factors.

Under the proposal, a fund that considers ESG factors alongside, but not more centrally than other, non-ESG factors in its investment decisions would not be permitted to use ESG or similar terminology in its name. Doing so would be defined to be materially deceptive or misleading. For such Integration Funds, the ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.

Concluding Thoughts

The SEC is making up for lost time relative to the efforts of the European Union, including the Sustainable Finance Disclosure Regulation (which came into effect last year) (the "SFDR") and the EU Taxonomy Regulation (and related delegated acts)(*see* my prior briefing note, available here), and relative to the efforts of the UK government (*see* my prior briefing note, available here). Unfortunately, cross-border efforts to harmonize disclosure and reporting standards that had begun to evolve in the early 2000s fell victim to the global financial crisis. While there are institutional mechanisms (namely IOSCO) for coordinated action and growing convergence in accepting baseline standards such as the TCFD recommendations and the PCAF standards, the reality is that each of the European Union, the United Kingdom and the United States are proceeding separately when it comes to ESG reporting, whether for public reporting companies or financial intermediaries/investment products.

The SEC's rules cover ESG (admittedly though the more detailed disclosures are tied to the "E"), while the SFDR focuses on sustainability. The SFDR has broader coverage beyond funds and advisers, as it applies to advisers and "financial market participants." The SFDR covers both entity-level disclosures as well as product-level disclosures. Those subject to the SFDR disclose alignment against a set of economic activities deemed to contribute to one of six defined environmental objectives (environmentally sustainable) that are determined in accordance with the Taxonomy Regulation (and its delegated acts).

All to say that in the short-term, funds and advisers that are subject to rules outside the United States will need to be mindful of evolving standards in multiple jurisdictions.

One final thought: the SEC has long been far more aggressive than its peers elsewhere in enforcing the securities laws, and while the SEC in effect is playing catch up on the disclosure front, it can be expected to pursue enforcement cases with the same vigor it has approached other areas, whether securities fraud or compliance matters. In April, the SEC brought an action against Vale S.A. (*see* my prior briefing note, available here) and, last month, the SEC brought an action against BNY Mellon Investment Advisers for failing to act in accordance with its ESG disclosures (thereby having made misleading statements that suggested that ESG quality reviews were conducted for all of its investment decisions) and to maintain adequate written policies and procedures reasonably designed to prevent misleading disclosures. While the SEC's proposed rulemaking ostensibly is about disclosure, it will provide the SEC with yet more tools to target funds and advisers as they navigate a fast evolving, and fast growing, ESG investment landscape.

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June 3, 2022