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The SEC is beginning to pay increased attention to this area, and more ESG-related enforcement actions may follow over the coming years. As noted above, the SEC launched a Climate and ESG Task Force within its Division of Enforcement in March 2021. The Task Force will develop initiatives to proactively identify ESG-related misconduct and will coordinate the effective use of agency resources to identify potential violations.

Note

1. *https://www.sec.gov/news/press-release/2022-72.*

The SEC Proposes ESG Rules for Certain Funds and Advisers

By Adam D. Kanter and J. Paul Forrester

At an open meeting on May 25, 2022, the US Securities and Exchange Commission (SEC or Commission) approved two new proposals that will impact the fund and investment management industry. One of the proposals is directed solely at registered funds and business development companies (BDCs), while the other applies to registered funds, BDCs, registered investment advisers (RIAs) and exempt reporting advisers (ERAs). This article discusses both proposals, which are quite lengthy (coming in at over 550 pages in total).

Proposal to Amend Rule 35d-1

The SEC voted to propose a set of amendments to Rule 35d-1 under the Investment Company Act of 1940 (the Names Rule), which applies to registered funds and BDCs, to expand its scope to apply to any fund name with terms suggesting that the fund focuses its investments in investments that have, or whose issuers have, "particular characteristics."[1]

In particular, the SEC focused on the importance of modernizing the "80 percent" requirement, whereby funds subject to the rule must invest at least 80 percent of their assets in accordance with the investment focus suggested by the fund's name—generally referred to as an "80 percent policy." The SEC placed particular emphasis on fund names that include terms such as "growth" or "value" (previously treated as out of scope of the Names Rule) as well as those that indicate the fund's investment decisions incorporate one or more environmental, social, or governance (ESG) factors, with terms such as "sustainable," "green" or "socially responsible." The amendment also seeks to clarify the rule's application to derivatives investments by stating that, in applying the 80 percent requirement, a fund should use a derivative investment's notional amount and not its market value.

The proposal specifies circumstances under which funds may depart from the 80 percent investment policy (such as sudden changes in market value of the underlying investments) and sets forth specific time frames wherein the fund must return to the 80 percent threshold (in most cases, 30 days). The proposal also retains the requirement that, in most cases, notice of any changes in the fund's 80 percent investment policy must be provided to shareholders and clarifies application of the rule to address funds that use electronic delivery methods to provide information to their shareholders.

The proposal also specifically addresses closed-end funds and BDCs whose shares are not listed on a national securities exchange, prohibiting such entities from changing their 80 percent investment

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policy without a shareholder vote—which could have a significant impact on the market segment of "private" BDCs, interval funds and tender offer funds.

In a preview of the other set of proposed amendments, the proposed amendment to the Names Rule also addresses the relationship between a fund's name and its underlying investments. Specifically, the proposal would require that all funds that must adopt an 80 percent policy under the Names Rule include fund prospectus disclosures that define the terms used in a fund's name, and amendments to Form N-PORT would require greater transparency on how a fund's investments match its stated focus. Additionally, there would be certain recordkeeping requirements related to a fund's ongoing compliance with the rule.

The rule also addresses so-called Integration Funds, which consider ESG factors *alongside* (but no more centrally than) other, *non*-ESG factors. In a departure from the rest of the rule, the proposal takes a more prescriptive approach to these funds. Specifically, the proposal would *prohibit* Integration Funds from using ESG terminology in the fund's name on the basis that doing so would be materially deceptive or misleading because the ESG factors would not be determinative in decisions to include or exclude any particular investment in the portfolio.

Last, the proposal would modernize the Names Rule's notice requirement related to changes in the 80 percent policy, requiring disclosure to be provided electronically.

This proposal passed by a 3-1 vote, with Commissioner Peirce raising concerns about the subjectivity involved in the determination of "particular characteristics," the strict 30-day time limit for temporary departures from an 80 percent policy and the potentially bizarre impact on Integration Funds when this proposal (prohibiting them from using ESG names) is viewed together with the disclosure proposal discussed below, which would increase these funds' obligations to disclose their ESG policies.[2]

ESG Disclosure Proposal

The proposal is aimed at the growing significance of and focus on ESG considerations in the context of registered funds, BDCs, RIAs and ERAs. The SEC noted that as ESG considerations have grown in importance among the investing public, the importance of ensuring that claims made by funds and advisers tracked investors' expectations has also increased.[3] The proposed amendments seek to further this goal by increasing disclosure requirements for funds and advisers in a few areas:

- By requiring additional disclosure regarding a fund's or adviser's ESG strategies;
- By implementing a layered, tabular disclosure approach for ESG funds to allow investors to better compare like investments across like funds; and
- By requiring certain environmentally focused funds to disclose greenhouse gas (GHG) emissions associated with their investments.

The "layered" approach to ESG disclosure contemplates three types of ESG funds/strategies: (1) "Integration Funds," (2) "ESG-Focused Funds" and (3) "Impact Funds." Under this approach, registered funds and BDCs that are Integration Funds—which, as noted above, integrate both ESG and non-ESG considerations—would be required to describe in their prospectus how ESG factors are incorporated into the investment process.

Registered funds and BDCs that are ESG-Focused Funds (and Impact Funds, which are a subset of ESG-Focused Funds), in contrast, would be subject to a higher level of disclosure requirements. ESG-Focused Funds are defined as those funds that use one or more ESG factors as significant or main considerations in selecting investments or in the engagement strategy applied to the companies in which a fund invests. (Examples include funds that track an ESG-focused index or screen investments in particular industries based on ESG factors.)

The rules for these types of funds would require detailed disclosure of which and how ESG factors are used in determining a fund's investments, as well as a

standardized summary overview (the "ESG Strategy Overview Table") whereby investors could perform a snapshot comparison of a given fund's ESG priorities vis-à-vis a prospective competitor fund. Finally, the even more specialized "Impact Funds"—funds that seek not only to invest generally in ESG areas but to achieve a particular E, S or G objective—would be required under the proposed rule to disclose how progress on this objective is measured.

RIAs and ERAs would also be required to make related disclosures in their Form ADV Part 1 (covering both managed accounts and private funds for RIAs and private funds for ERAs) and Part 2A (RIAs only), applying the same "layered" approach of Integration/Focused/Impact.

Although not *directly* embedded in any new rule or amendment, an SEC expectation is clearly set out in the proposal: that funds and advisers would adopt new compliance policies and procedures regarding their ESG-related strategies in order to help ensure the accuracy of the various prospectus and brochure disclosures.

The proposed rule also imposes additional disclosure requirements for funds that use proxy voting or engagement with issuers as a significant means of implementing ESG strategy and for ESG-Focused Funds that consider environmental factors in their investment strategies. RIAs would also have similar disclosure obligations in their Form ADV Part 2A regarding ESG considerations in voting proxies on behalf of client accounts.

Under the proposed rule, ESG-Focused Funds that consider environmental factors would be required to disclose certain metrics related to their carbon footprint and the weighted average carbon intensity of their portfolio. The proposal allows an exception, however, for funds that specifically state that they do not consider GHG emissions in their investment strategy.

In line with the other requirements for Integration Funds, such funds that consider GHG emissions in their strategy are required to disclose additional information about how the fund considers these emissions, including what methodology and data sources the fund uses as part of this consideration.

Finally, the proposal includes an amendment to Form N-CEN that would require all index funds to report the name and legal entity identifier (LEI), if applicable, or provide any other identifying number of the index the funds track.

This proposal, too, passed by a 3-1 vote, with Commissioner Peirce dissenting and noting her concern that the proposal was too prescriptive and that it would counteract the market's inherent efficiency and ability to self-regulate.[4]

The comment period for both proposals is open to the public until 60 days after publication in the *Federal Register*.

Notes

1. *https://www.sec.gov/rules/proposed/2022/ic-34593.pdf*.
2. Commissioner Peirce's dissenting statement is available at *https://www.sec.gov/news/statement/peirce-fund-names-statement-052522*.
3. *https://www.sec.gov/rules/proposed/2022/ia-6034.pdf*.
4. Commissioner Peirce, *supra* n.2.