

## Securities and Exchange Commission's Environmental, Social and Governance Factors

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### OVERVIEW

On May 25, 2022, the Securities and Exchange Commission (Commission) announced a proposal to enhance disclosures by certain investment advisers and investment companies regarding Environmental, Social, and Governance (ESG) factors. The proposal would apply not only to certain registered advisers, but also advisers exempt from registration, registered investment companies, and business development companies. If adopted, it would establish disclosure requirements for funds and advisers that market themselves as having an ESG focus. These disclosure requirements would be disclosed in fund prospectuses, annual reports, and adviser brochures which would further require certain ESG reporting, primarily on Forms N-CEN for registered investment companies, and also for registered advisers and exempt reporting advisers on ADV Part 1A and Part 2A.

### BACKGROUND

Since 1995, the U.S. sustainable investment universe has increased more than 25 times from \$639 billion to a space of \$171 trillion. Investors and other market participants increasingly demand access to ESG-related investment services, products, and data. According to one survey done by Morningstar, 42% of institutional investors say they consider ESG factors when making an investment decision. However, no specific requirements for disclosures are in place. The Commission is concerned that many funds marketing themselves as "ESG," "green," or "sustainable," and are doing so to attract investors or clients. These funds, however, may actually be limited in their ESG-related strategies. This would ultimately impede informed decision-making by investors who could end up paying higher fees for "sustainable" strategies that do not meet their actual expectations for ESG investing. Allowing this space to continue without the proper disclosures could potentially frustrate investors and make them question to what degree are certain ESG funds appreciably different than other fund types. The new proposal would reduce the risk of exaggerated claims, therefore increasing the efficiency and reliability with which investors seeking an ESG strategy can find a fund or advisor that meets their individual preferences, better protecting and serving ESG-related investing as a whole.

### PROPOSAL

In a brief description, the proposal being suggested by the Commission would provide several broad things with respect to investment funds:

- (1) It would require funds that claim to consider ESG factors to provide investors with information in the prospectus regarding what ESG factors they consider, along with the strategies they use. For example, whether a fund tracks an index, excludes or includes certain types of assets, uses proxy voting or engagement to achieve certain objectives, or aims to have a specific impact.
- (2) A subset of those funds – ESG- focused funds – also would need to disclose details about criteria and data they use to achieve their investment goals, as well as more specific information about their strategies. These disclosures would enable investors to dig into the details of the fund's strategy.
- (3) It would require particular types of ESG-focused funds to disclose relevant metrics. For example, certain funds would be required to

report greenhouse gas emission metrics of their portfolios, and an impact fund would be required to disclose metrics about annual progress towards its ESG goals.

Additionally, certain investment advisors would likely be required to disclose similar information as registered investment companies regarding their ESG factors and strategies in their client brochures. These disclosures would be tailored to help the clients make better informed decisions about whether to engage an adviser and how to manage a relationship.

## COMPLIANCE POLICIES AND PROCEDURES

The Commission believes it would be appropriate and beneficial to reaffirm existing obligations under the compliance rules when advisers and funds incorporate ESG factors. Advisers and funds should address portfolio management processes to ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund. Two of the largest compliance changes would be to the Form N-CEN and ADV Part 1A.

### FORM N-CEN

The proposal would amend the Form N-CEN to add the proposed Item C.3(j), which asks questions tailored specifically to an ESG fund's strategies and processes, including: ESG factors it considers, ESG strategies employed, and whether the fund engages in proxy voting or engagement with issuers to implement ESG strategies. Form N-CEN would also collect information regarding whether a fund considers ESG-related information, or scores provided by ESG providers when implementing investment strategies.

Among many potential benefits the Commission foresees with this change, the most relevant is the structured nature of the information on Form N-CEN. It would enhance the ability of the Commission, investors, and other market participants to more effectively analyze data reported.

However, the Commission's greatest concern is to the extent that the proposed amendments to Form N-CEN would require additional data elements not required in investor facing disclosures, the compliance costs of the proposed Form N-CEN amendments would increase, which could ultimately be passed on to investors to some degree in the forms of higher expenses or fees. For instance, all index funds would incur costs to provide the information about what index it tracks.

### ADV PART 1A and PART 2A

The proposed amendments to Form ADV Part 1A are designed to collect information about an adviser's uses of ESG factors in its advisory business. Specifically, these proposed amendments would expand the information collected about the advisory services provided to Separately Managed Account (SMA) clients and private funds.

Much like the benefits of Form N-CEN, the Commission believes collecting this information would provide the Commission and investors with important information about advisers' considerations of ESG factors in their advisory businesses, including: the specific factors they consider, the types of ESG-related strategies they employ, the use of voluntary third-party frameworks, and whether they conduct other business activities as ESG providers or have related persons that are ESG providers that could indicate potential conflicts of interest. This information would increase comparability across advisers and advance the Commission's regulatory goal of gaining a more complete understanding of advisers' consideration of ESG factors in their SMA and private fund management business.

However, much like the Form N-CEN, there are costs to implementation. Investment advisers that incorporate ESG factors into their investment strategies would incur costs associated with the proposed amendments to Form ADV Part 1A. To the extent that advisers

incur higher costs, the increased costs would be, at least in part, passed on to clients of SMAs and private funds, thus investors. For Form ADV Part 2A, the changes are less substantial compared to the two other compliance updates. Under the proposal, the adviser would be required to provide a description, in its Brochure, of each ESG factor it considers and how it incorporates those factors in the advice it provides to clients, including clients that are private funds.

## CONCLUSION

Currently, the proposal has been released and will be published on the Federal Register but has 60 days from the announcement date until it is voted on or approved. If approved, the Commission recognizes that it will take time for funds and advisers to come into compliance with these new requirements. Therefore, in order for registrants, especially smaller registrants, to come into compliance, the Commission is suggesting phased-in dates. Assuming the proposal is adopted in December 2022 and a registrant has a December 31st fiscal end year, the earliest a large accelerated filer needs to have an updated filing with ESG factors disclosed should not be until 2024.

Specifically, one important point to note is that the Commission has not defined the terms E, S, or G, or what constitutes an "ESG strategy." This may have unintended consequences causing certain private fund strategies to be categorized as integration strategies under the new proposal. An integration strategy, for the purpose of ESG, is the practice of incorporating ESG information into investment decisions to help enhance risk-adjusted returns, regardless of whether a strategy has a sustainable mandate. Private fund advisers should take this opportunity to review their strategies to determine if they use ESG investment practices and put new compliance programs in place to align with the proposal. In addition, private fund advisers may want to review their compliance programs to confirm that they address the Commission's hot button issues including marketing, portfolio management processes and investor disclosures regarding firm ESG practices.

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