

THOUGHT LEADERSHIP

SEC Proposes Additional Disclosures on ESG Frameworks from Investment Advisers

Key Takeaways from SEC's Proposed Rule and Form Changes for Registered Investment Advisers and Investment Companies on ESG Information Disclosure

By Third Economy Staff, August 2022

2022 has proven to be a big year for disclosure proposals from the U.S. Securities and Exchange Commission ("SEC").

In an effort to promote consistent and reliable information on ESG investment practices, the SEC has proposed requiring investment advisers ("Advisers") and registered investment companies ("Registered Funds") to produce standardized ESG disclosures, allowing for increased investor visibility.

Most consequential in the proposal is a new mandate for advisers of ESG-focused funds; these funds would be required to disclose the ESG factors considered in their investment strategy, as well as the metrics used to evaluate progress towards the fund's objectives. The commission has created a new taxonomy of fund types ("Integration Funds", "ESG Focused Funds" and "Impact Funds") that guide the varying degrees of disclosure.

Also proposed is an amendment to the "Names Rule", which would extend the 80% investment policy requirement to funds that suggest that the fund focuses on investments with particular ESG characteristics.

OUR VIEW

The SEC's proposed updates provide crucial clarity for investors and clients who are interested in ESG-focused financial products. This increased transparency allows investors to better compare strategies across managers and ensure that funds that market "ESG" have a common set of standards.

While the definitions of E, S, or G are not expressly laid out in the SEC's proposal, the new taxonomy ("Integration Funds", "ESG Focused Funds" and "Impact Funds") proposed offers a straightforward roadmap for how and when additional disclosures would be required for funds of all focuses. The proposed categorization aligns closely with Third Economy's own investment framework, Via³, which defines sustainability across five key aspects for investors — values, impact, analysis of ESG, alignment and activism.

The SEC could go further with guidelines for private funds, to prevent "greenwashing", as they are largely exempt from these ESG disclosures. It remains to be seen whether the SEC and its staff will more closely examine unsubstantiated claims around ESG investing for private funds as well, under the general antifraud standards of the Advisers Act.



WHAT ARE THE SPECIFICS?

As drafted, the proposal would require registered and exempt investment advisers (“Advisers”), and registered investment companies (“Registered Funds”) to disclose information about the ESG strategies they pursue.

Advisers and Registered Funds have been categorized into three groups:

- **Integration Funds:** The SEC defines “Integration Funds” as registered funds that “consider one or more ESG factors in its investment decisions”, alongside other, non-ESG factors in their investment decision-making process. The “ESG factors are generally no more significant than other factors in the investment selection process;” for such funds, ESG factors would generally not be given greater weight or consideration than other non-ESG factors in the investment selection process. In Third Economy’s VIA³ model, this is what we would define as the ‘analysis’ of ESG
- **ESG-Focused Funds:** The SEC defines “ESG-Focused Funds” as funds that include “any fund that has a name including terms indicating that the fund’s investment decisions incorporate one or more ESG factors” and “any fund whose advertisements or sales literature indicates that the fund’s investment decisions incorporate one or more ESG factors”. ESG-Focused Funds include, for example, funds that apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement with issuers, and funds that track an ESG-focused index. In Third Economy’s VIA³ model, this is what we would refer to as ‘values-based’ or ESG related tilting or screening, and ‘activism’ (engagement and voting, also known as stewardship).
- **Impact Funds:** The SEC defines “Impact Funds” as a subset of ESG-Focused Funds that “seek to achieve a specific ESG impact” (e.g., advancing the availability of clean water). We would also refer to this as ‘impact’ in our VIA³ model.

Amendments to existing forms for registered funds and investment advisers include:

- Disclosure requirements in prospectuses on Forms N-1A and N-2, to include:
 - **Integration Funds:**
 - A few sentences on ESG factors that the fund considers.
 - **ESG-Focused Funds:**
 - Overview of the registered fund’s ESG strategy.
 - How the registered fund incorporates ESG factors in its investment decisions.
 - How the registered fund votes proxies.
 - **Impact Funds:**
 - All requirements for ESG-Focused Funds above.
 - How the fund measures progress toward the specific impact (including KPIs).
 - Time horizon of the fund.
 - Relationship between impact and financial return.
- Regulatory reporting on Form N-CEN, to include:
 - All **Registered Funds** that indicate that they incorporate ESG factors:
 - Type of strategy employed (integration, ESG-focus, or ESG impact).
 - ESG factor(s) considered.
 - Method(s) the registered fund uses to implement its ESG strategy.
- Disclosure requirements for UITs on Forms N-8B2 and S-6:
 - **Unit Investment Trusts** must explain how ESG factors were used to select portfolio securities.
- Disclosure requirements on Form ADV Part 2A, to include:
 - **Advisers** would be required to add the following disclosures to their brochures:
 - The ESG factor(s) considered and how they are incorporated into the adviser’s investment recommendations.
 - How the adviser employs ESG integration, ESG-focused strategies, or ESG impact strategies.
 - A description of any ESG criteria or methodology used in investment evaluation or selection.
 - A description of any relationship that the adviser or its management persons have with any related person that is an ESG consultant or service provider.

- A description of voting policies or procedures that include ESG considerations and how they are considered in voting client securities.
- An explanation of whether they review, or whether a third-party reviews, portfolio managers' application of relevant ESG factors and the nature of such review, or an affirmative statement that no such review occurs.
- Regulatory reporting on Form ADV Part 1A, to include:
 - Advisers would be required to add the following to annual reports:
 - **ESG Data for SMAs.** Advisers must indicate using “Yes”/“No” responses whether ESG factors are considered when managing SMA client accounts and, if yes, the type of strategy and the specific factors considered (i.e., environmental, social, and/or governance). Advisers would also be required to disclose whether they follow any third-party ESG frameworks (e.g., UN PRI) in connection with their advisory services, and list any such frameworks by name.
 - **ESG Data for Private Funds.** Similar to the proposed reporting for SMA clients, advisers and exempt reporting advisers would be required to disclose information about the use of ESG factors in managing each reported private fund, including the type of strategy and specific factors considered.
 - **ESG-Related Activities and Related Persons.** Advisers and exempt reporting advisers would also be required to disclose whether they conduct other business activities as, or have related persons that are, ESG consultants or other ESG service providers.

WHO IS AFFECTED?

- Registered Investment Advisers
- Registered Funds
- Investors & Clients

WHEN WOULD THIS GO INTO EFFECT?

If the proposed amendments are adopted, registered funds and advisers would be required to comply within one year of the publication of the final rules.

ADDITIONAL RESOURCES:

- SEC Press Release: <https://www.sec.gov/news/press-release/2022-92>
- SEC Rule Proposal:
 - Enhanced Disclosures: <https://www.sec.gov/rules/proposed/2022/ia-6034.pdf>
 - Investment Company Names: <https://www.sec.gov/rules/proposed/2022/ic-34593.pdf>
- Third Economy's Via³ Model: <https://www.thirdeconomy.com/ratings/>



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