Katten

FINANCIAL MARKETS AND FUNDS ADVISORY

SEC Proposes Additional ESG Disclosure Requirements for Regulated Funds and Related Expansion of Investment Company Act "Names Rule"

June 23, 2022

KEY POINTS

- The Securities and Exchange Commission (SEC) recently proposed two sets of rule amendments impacting BDCs and registered investment companies that utilize Environmental, Social, or Governance (ESG) factors as part of their investment strategies.
- The first set of proposed amendments would require business development companies (BDCs), registered investment companies and their investment advisers to include additional disclosure in their SEC filings depending on the extent to which ESG factors play a role in their investment decision-making processes.
- The second set of proposed amendments would, among other things, subject BDCs and registered investment companies that include ESG-related language in their names to additional disclosure requirements.
- The proposed amendments are only part of the SEC's recent activity in the ESG space, and signal a need for BDCs, registered investment companies and investment advisers to evaluate how the SEC's focus on ESG may impact their investment strategies, operations and disclosure going forward.

On May 25, the SEC released a pair of proposals impacting business development companies and registered investment companies (together, "regulated funds") that utilize ESG factors as part of their investment decision-making processes.

The first set of proposed amendments would require investment advisers and funds that consider ESG in their investment processes to include related disclosure in SEC filings, the extent of which would vary based on how ESG factors are incorporated into an investment strategy. Disclosure would be included in the prospectuses and annual reports of regulated funds and in Form ADV for registered investment advisers (RIAs) and exempt reporting advisers (advisers).

At the same meeting, the SEC also proposed amendments to Rule 35d-1 under the Investment Company Act of 1940, as amended (the Names Rule). The Names Rule currently requires a regulated fund whose name suggests either a focus on a specific type of investment, a focus on investments in a specific industry, or a geographic focus, to adopt a policy to invest at least 80 percent of the value of its assets in those investments suggested by

its name. The SEC proposed to expand the scope of the Names Rule to, among other things, implement specific requirements for regulated funds that include ESG-related language in their names.

The proposals are part of a larger undertaking at the SEC to protect investors in ESG funds from the harms of "greenwashing." Greenwashing is the concern that funds are misleading investors by representing themselves as "sustainable" or "green" without significantly altering their investing practices. Chairman Gensler explained that "ESG encompasses a wide variety of investments ... investors should be able to drill down to see what's under the hood of these strategies," and noted that this goal "... gets to the heart of the SEC's mission to protect investors, allowing them to allocate their capital efficiently and meet their needs."

Proposal 1: ESG Disclosure Requirements for Funds and Investment Advisers

Fund Disclosure

The proposed disclosure requirements require funds that utilize ESG factors in their investment processes to release additional information. The extent of the required disclosures will vary based on how vital ESG considerations are to the fund's investment strategy. The SEC explained its reasoning for this proposal, noting that "comparable consistent and reliable information from all funds and advisers... [will] increase the efficiency and reliability with which investors seeking an ESG strategy can find a fund or adviser that meets their investing preferences."

To that end, the SEC proposed three new classifications of ESG funds, each of which would be subject to varying disclosure requirements: Integration Funds, ESG-Focused Funds and Impact Funds.

1. **Integration Funds** consider ESG as one non-dispositive factor, among many other factors (such as price-to-earnings ratios or macroeconomic trends), which investment professionals may use to make investment decisions. The proposed amendments would require an Integration Fund to disclose in a "brief narrative" how it incorporates ESG factors into its investment analysis. For example, a fund may disclose that it incorporates climate change risk into its investment analysis, but include a caveat that the fund's consideration of emissions released by a prospective portfolio company would not necessarily automatically result in the company being included or excluded from the fund's portfolio. Open-end funds would include this information in their summary prospectus, while closed-end funds would include this information as part of the prospectus's general description of the fund. Both open-end and closed-end funds would be required to add a lengthier description of how they factored ESG into their respective models. Additionally, if the fund utilized Greenhouse Gas (GHG) emissions data, the fund would be required to disclose the corresponding methodology it relied on.
2. **ESG-Focused Funds** include any fund that utilizes ESG considerations as the main factor or consideration in selecting an investment strategy or in its engagement strategy with companies in which it invests. Specifically, an ESG-Focused fund will include a fund: a) with a name that indicates the fund takes ESG considerations into account; b) whose advertisements or marketing materials are explicit in using ESG as a "significant or main consideration;" c) that tracks an ESG focused index; d) that applies a screen to include or exclude certain stocks based on ESG consideration; or e) that has a policy of voting proxies in a way that would consider or encourage ESG-related goals or considerations. An ESG-Focused Fund would be required to provide an ESG Strategy Overview Table in its prospectus. Additionally, if the fund utilizes proxy voting to implement its ESG Strategy, the fund will be required to disclose how it voted on ESG-related proxies in its annual report.
3. **Impact Funds** are funds that seek to achieve a specific outcome that is ESG-related. For instance, an Impact Fund may include a fund that invests intending to profit while "financing the construction of affordable housing units" or to "advance the availability of clean water". Impact Funds will be subject to the same disclosure requirements as ESG Focused Funds, including to provide an ESG Strategy Overview Table, and

they must also include information that states in qualitative and quantitative terms: a) the progress made towards the fund's stated impact; b) the time horizon that the fund utilizes to measure its impact; and c) the relationship between the impact the fund is trying to achieve and its financial returns.

Investment Adviser Disclosure

The proposed rules also require advisers that consider ESG factors in their investment analysis to include certain additional information as a part to their Form ADV.

In Form ADV Part 1A, advisers would be required to report census-like information concerning their ESG-related strategies in a check-the-box format. Information would be reported separately for each private fund client and in the aggregate for all separately managed account (SMA) clients.

In Form ADV Part 2A (more commonly known as the "brochure"), an RIA will be required to include further explanation of whether it employs an ESG strategy for any of its clients, and if so, whether it is an ESG Integration Strategy, ESG Focused Strategy or ESG Impact Strategy (as defined and discussed in more detail above). Moreover, the RIA would be required to include ESG factors it considered, how those factors are incorporated into its decision-making process alongside non-ESG factors, and what methodology was used to include or exclude investments based on ESG-related criteria. Additionally, if an RIA utilizes proxy voting to implement its ESG Strategy, the RIA will be required to share how it voted on ESG-related proxies, and disclose any material relationship between management and an ESG consultant or third-party service provider.

Proposal 2: Expansion of Investment Company Act "Names Rule"

The SEC also considered a proposal to update the Names Rule. Chairman Gensler explained that "a fund's name is often one of the most important pieces of information that investors use in selecting a fund." The proposal's aim is to "modernize the names rule" for today's markets. The Names Rule requires that a regulated fund name that indicates a focus on a specific investment type, industry, or geography must have policies that ensure it invests 80 percent of the value of its assets in portfolio companies that match its name.

To expand the rule, the SEC proposed to:

1. expand the 80 percent investment policy requirement to apply to any regulated fund name with terms suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics (for example, "growth" or " value");
2. narrow the circumstances in which a regulated fund is permitted to depart from its 80 percent investment policy, and when a fund does deviate from the requirement, adding restrictions that would require the fund to revert into compliance in a timely manner;
3. require that any unlisted regulated fund obtain a shareholder vote before changing its 80 percent investment policy;
4. impose specific guidelines on the use of ESG terms in regulated fund names (specifically requiring ESG-related fund names such as "green", "ethical" or "sustainable" would be subject to the 80 percent requirement, and specify that Integration Funds cannot use ESG-related terms in their names;
5. require that any terms used in a fund's name that suggest either an investment focus or tax-exempt status must be consistent with those terms' plain English meaning or established industry use; and
6. require funds to implement related reporting, notice and recordkeeping requirements (including, for registered investment companies, on Form N-PORT), including to define how the fund uses a term that is in its name and describe how it selects investments that comport with its name.

Takeaways

The additional disclosure rules follow the SEC's much-heralded proposed rule which would require public companies to disclose their climate related risks and GHG emissions in March (the Enhancement and Standardization of Climate-Related Disclosures). The proposed regulations, along with myriads of public statements, investor bulletins and enforcement actions, demonstrate the SEC's legitimate focus on ESG under the leadership of Chairman Gensler. Additionally, the SEC has created a Climate and ESG Task Force (Task Force) within the Division of Enforcement. The Task Force will aim to proactively identify and pursue ESG-related misconduct, and will initially focus on identifying material gaps and misstatements in climate risk disclosure.

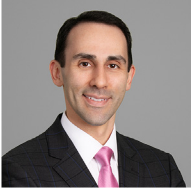
Funds and advisers should evaluate how the proposed amendments and the SEC's focus on ESG will affect them and take tangible actions to ready themselves for a version of the proposed amendments to pass.

1. **ESG Strategies.** Funds considering ESG as part of their investment strategies should assess what classification they would qualify under based on the proposal and how they would implement the necessary disclosures and the associated compliance costs.
2. **ESG Enforcement.** The SEC has displayed its willingness to take enforcement actions against funds whose ESG-related disclosures and stated investment objectives are inconsistent with their investments. As a result, funds should carefully review their investments and compliance practices to ensure disclosures, marketing materials, inclusions and exclusions of assets, and ESG frameworks are consistent with their respective investment strategies.
3. **Fund Names.** Funds with names that suggest a particular characteristic, such as "growth", "value," "green" or "governance" should consider removing words from their names to ease the compliance burden that a modified Names Rule might impose. Funds with similar names should also consider how they will comply with the 80 percent requirement and ensure that their portfolio allocation can adhere to the rule.

The comment period for each set of proposed amendments will remain open for 60 days after publication in the *Federal Register*. If adopted, the compliance date would fall one year after the amendments become effective.

CONTACTS

For more information, please contact any of the following members of Katten's Financial Markets and Funds practice.



Vlad M. Bulkin
+1.202.625.3838
vlad.bulkin@katten.com

Richard D. Marshall
+1.212.940.8765
richard.marshall@katten.com

Allison C. Yacker
+1.212.940.6328
allison.yacker@katten.com

Jennifer L. Howard
+1.202.625.3696
jennifer.howard@katten.com

Jacob C. Setton, a law clerk in the Financial Markets and Funds practice, contributed to this advisory.

Katten katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2022 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at kattenlaw.com/disclaimer.

06/21/22