

Perspectives

Make Ready for Long-Awaited ESG Rules

A Key Challenge for Investment Companies & Investment Advisers

January 2023

Since the launch of the first ESG fund, fund managers' approach to managing environmental, social and governance (ESG) funds has changed dramatically due to many factors, including shifting historical views in the areas of pollution reduction, safety related matters and corporate social responsibility. In addition to these changes, there has been a significant increase in regulatory focus on ESG funds, including, most recently, the Securities and Exchange Commission's (SEC) proposal to enhance fund related ESG disclosures, and also the SEC's proposed amendments to Rule 35d-1 (the "Names Rule") under the Investment Company Act of 1940 (the "Act"). Both proposals are intended to increase transparency for shareholders of ESG funds, including open-end funds, closed-end funds, and business development companies.

Under the proposed disclosure rule, investment companies and investment advisers that employ ESG investment strategies and processes would be required to make certain ESG related disclosures. In the case of an investment company, ESG disclosures would be required to be included in fund regulatory filings (e.g., annual report, prospectus, N-PORT, N-CEN), and in the case of an investment adviser, the Brochure (Form ADV, Part 2A) would have to be updated reflecting the ESG practices of the investment adviser. In addition to understanding the impacts to regulatory filings and revisions that would need to be made to the Brochure, as applicable, fund managers should understand how their existing funds may be impacted by the proposed categorization of ESG strategies, including the following:

- *Integration funds*—consider one or more ESG factors alongside other non-ESG factors (e.g., price-to-earnings ratio); these funds may be subject to limited ESG-related disclosure requirements so as not to overemphasize ESG strategies; which may have a greenwashing effect.
- *Focused funds*—focus significantly on ESG factors (e.g., screening for carbon emissions, board of directors and/or workforce diversity) as their main considerations; these ESG funds may also be required to include key technical information in their prospectus in a tabular format (i.e., ESG strategy overview table).

- *Impact funds*—considered a sub-set of focused funds, these ESG funds seek to achieve specific ESG impacts that generate specific ESG-related benefits; these ESG funds seek to target portfolio investments that drive specific ESG outcomes and would require specific disclosures.

In addition to these considerations, and as mentioned above, fund managers should also be contemplating the proposed amendments to the Names Rule. Under the Names Rule, which was originally adopted in 2001, fund names that suggest a focus on a particular type of investment are required to invest at least 80% of their net assets¹ in those investments. In a departure from its prior approach, the proposed amendments to the Names Rule would apply to any fund whose name suggests that a fund focuses on certain characteristics, including “growth,” or “value” or names indicating a fund’s use of ESG factors. For example, funds would not be able to include ESG in its fund name if the ESG factors that are being employed by that fund are not determinative of the investment decisions of that fund or if the fund makes substantial investments that are contrary to its ESG factors.

Key takeaways

As highlighted above, firms will likely experience broad impacts to their business operations upon adoption of the above proposals by the SEC. In addition to these considerations, firms should be considering gaps in knowledge, controls, and technology—areas for consideration include:

- Taking steps to understand the extent to which funds may be impacted in the areas of metrics requirements, including greenhouse gas emissions (i.e., carbon footprint, weighted average carbon intensity)
- Understanding gaps in current data sources that may need to be enhanced or revised
- Determining revisions that may need to be made to certain ESG fund disclosures (i.e., annual report, prospectus, N-PORT, N-CEN)
- Understanding potential impacts to fund shareholders and fund boards (e.g., board reporting materials)
- Ensuring the ability to obtain information necessary to calculate a portfolio company’s enterprise value and the portfolio company’s total revenue

¹ Assets under Rule 35d-1(d) include borrowings that are for investment purposes



- Determining which portfolio companies do not report greenhouse gas emissions and may not otherwise make that information publicly available
- Inventorying compliance systems to determine the capabilities of compliance tracking that reflect being out of compliance and whether there are policies and procedures for coming back into compliance
- Understanding vendor capabilities and timelines (e.g., data sources, fund administration, regulatory administration, printer)
- Considering ESG related language (e.g., sustainable, green, low carbon) and truth-in-advertising (i.e., reduce the likelihood of investors being misled)

Our experience

We have helped many organizations with regulatory and fund operations matters relating to ESG considerations, and disclosure obligations for both investment advisers and funds. Our team is bolstered by professionals who have a long history of serving investment management firms with process assessments to bring tangible, practical and scalable outcomes.

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