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# SEC Issues Rule Proposal Related to Certain Investment Advisers' and Funds' Disclosures About ESG Investment Practices

Authored by Julien Bourgeois, Brenden P. Carroll, Mark D. Perlow, Anthony H. Zacharski, Nicholas DiLorenzo, Morgan Willard and J.D. Williams

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## Overview

The Securities and Exchange Commission, by a vote of three-to-one, proposed for public comment on May 25, 2022, a long-anticipated framework requiring certain registered funds and certain investment advisers to disclose their environmental, social and governance (ESG) investment practices (Proposal).<sup>1</sup> The Proposal, which is a companion to a separate release issued the same day proposing changes to Rule 35d-1 under the Investment Company Act of 1940 (Names Rule),<sup>2</sup> would amend rules and forms under both the Investment Advisers Act of 1940 and the Investment Company Act. The Proposal comes in the wake of substantial scrutiny by the SEC and its Staff regarding disclosure practices involving ESG investments.

The Proposal is intended to promote “consistent, comparable, and reliable” information to facilitate informed decision-making related to ESG investment product and strategy offerings. In particular, the Proposal would seek to change existing disclosure practices by (among other provisions):

- Expressly requiring specific ESG-related disclosures in fund prospectuses, annual reports and investment adviser regulatory filings (where applicable);
- Classifying funds across a spectrum of ESG investment strategies: “integration,” “ESG focused,” and “impact”;
- Implementing a standardized approach for certain types of ESG funds to disclose their ESG investing processes; and
- Requiring disclosure on greenhouse gas (GHG) emissions metrics for certain types of ESG funds.

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<sup>1</sup> See [Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices](#), Rel. Nos. IA-6034 & IC-34594 (May 25, 2022) (ESG Release). Unless otherwise specified, the term “fund” as used in this *Dechert OnPoint* refers to registered investment companies (*i.e.*, open-end funds, closed-end funds and unit investment trusts (UITs) and business development companies), and the term “investment adviser” refers to any investment adviser registered under the Advisers Act and exempt reporting advisers under Sections 203(l) and 203(m) of the Advisers Act. At times, this *OnPoint* tracks the ESG Release without the use of quotation marks. Terms not defined in this *OnPoint* have the meaning assigned to them in the ESG Release. This *OnPoint* provides an in-depth analysis of the topic first published on May 31, 2022 in a *Dechert NewsFlash*.

<sup>2</sup> [Investment Company Names](#), Release No. IC-34593 (May 25, 2022) (Names Rule Release). For further information on the Names Rule Release, please refer to the *Dechert NewsFlash*, [SEC Proposes Amendments to Rule Governing Fund Naming Conventions, Including Use of ESG Investing Practices](#).

Although not related specifically to ESG investing, the Proposal also would amend Form N-CEN to require index funds to provide certain identifying information about the index tracked.<sup>3</sup>

The Proposal, together with certain related considerations, are discussed in more detail below. Comments are due to the SEC on the Proposal by August 16, 2022.

## Background

While there has been increasing demand for ESG products and strategies in the United States and globally, U.S. financial regulators – including the SEC – have not previously taken formal steps to implement requirements specifically relating to ESG investing. The SEC believes that the absence of a common disclosure framework for ESG investing and the significant variation in ESG strategies and practices make it challenging for investors to: locate ESG disclosures; compare ESG investing approaches and products; understand how ESG investing strategies are implemented over time; and determine whether marketing statements translate into concrete actions to address stated ESG goals. As a result, the SEC believes that there are risks that fund/adviser ESG investing practices might not align with investor expectations and that fund/adviser statements about ESG investing might not adequately reflect the nature or extent of actual ESG investing practices.

Against this backdrop, the Proposal is intended to draw out distinctions in ESG strategies to help investors more easily compare ESG funds and strategies and make informed decisions regarding ESG investing.

## Definition of “ESG”

Currently, there is no uniform or universal definition of the phrase “ESG,” nor are there definitions for related terms in the context of ESG investing (e.g., sustainable, green). As a result, while industry norms are continuing to evolve in this space, advisers and fund sponsors have a certain degree of flexibility in determining what constitutes (or does not constitute) “ESG” in their respective investment process; provided that the determination is consistent with relevant client disclosures. The Proposal would not change this paradigm. Specifically, for almost all components of the Proposal, the ESG Release clarifies that the SEC is not proposing to define “E” “S” or “G” or related terms (although the SEC is proposing to categorize funds based on the degree to which they incorporate ESG factors). Instead, the Proposal would, in relevant part, require funds and advisers to disclose whether and how they incorporate ESG factors into the investment selection process (or investment strategies) and what those factors are. Within many sections of the ESG Release, the SEC requests comment as to whether this approach is appropriate or if the SEC should define ESG or related terminology as part of any final rulemaking.

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<sup>3</sup> For purposes of Form N-CEN, the term “index fund” is defined as “an investment company, including an Exchange-Traded Fund, that seeks to track the performance of a specified index.”

## Overview of Required Fund Disclosures

The Proposal would require funds<sup>4</sup> that consider ESG factors in their investment process to disclose additional information in registration statements and the management’s discussion of fund performance section of annual reports. The disclosure requirements would vary depending upon whether a fund is categorized as an “integration fund,” an “ESG-focused fund” or an “impact fund”. The SEC is proposing a layered disclosure approach, consisting of a short concise description in the summary prospectus<sup>5</sup> followed by a complementary, more detailed description in an open-end fund’s statutory prospectus or later in a closed-end fund’s prospectus. The purpose of this layered approach is to seek to ensure that a fund does not overemphasize the role of ESG factors in investment selection decisions, and thereby potentially mislead investors.

The following tables include, for each of the three categories of funds,<sup>6</sup> the category’s proposed definition and a summary of the proposed disclosure requirements. Additional information is provided in Appendix A.

### Integration Funds

<b>Definition</b>	An integration fund is a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.
<b>Summary Prospectus<sup>7</sup></b>	If ESG factors are part of the Item 9 principal investment strategies, briefly summarize how the fund incorporates ESG factors into the investment selection process, including what factors are considered.

<sup>4</sup> The proposed amendments in this section would apply to open-end funds (including ETFs) and closed-end funds (including BDCs) – but not UITs – that incorporate ESG factors into their investment processes. The Proposal also would amend Form N-8B-2 to require a UIT, if one or more ESG factors are used to select portfolio securities, to briefly describe how the factors are incorporated (including which factors are used). UITs would not be subject to the proposed annual report requirements, because a UIT is not required to provide a management’s discussion of fund performance section in its annual reports. The ESG Release requests comment as to whether the proposed disclosure requirements also should apply to insurance company separate accounts registered as management investment companies, insurance company separate accounts organized as UITs, and UITs operating as ETFs.

<sup>5</sup> Although this section uses terminology applicable to registration statements filed on Form N-1A, the Proposal includes parallel amendments to Form N-2. The ESG Release recognizes that Form N-2 does not impose a summary prospectus requirement.

<sup>6</sup> If the Proposal is adopted as proposed, fund sponsors should consider evaluating the nature and extent of alignment of classifications of fund strategies under the U.S. ESG fund classification regime and the European regime, including under the Sustainable Finance Disclosure Regulation. Actual or perceived differences may result in differences in marketing materials, portfolio management processes, or other consequences.

<sup>7</sup> Open-end funds would provide this information in the summary section of the fund’s prospectus, while closed-end funds, which do not use summary prospectuses, would disclose the information as part of the prospectus’s general description of the fund.

<p><b>Statutory Prospectus</b></p>	<p>Describe how the fund incorporates ESG factors into the investment selection process, including:</p> <ul style="list-style-type: none"> <li>● The ESG factor(s) considered, and</li> <li>● If the fund considers the greenhouse gas (GHG) emissions of its portfolio investments as part of its investment selection process, describe how it considers such information (including a description of the methodology the fund uses for this purpose<sup>8</sup>).</li> </ul>
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The required integration fund disclosures could be made through a brief narrative description or through an illustrative example of how ESG factors are considered alongside other factors.<sup>9</sup> In the absence of further guidance from the SEC or its Staff, however, it is not clear whether the integration of any ESG factor (or the general maintenance of an ESG investing policy applicable to funds) would trigger the “integration fund” classification – or if some higher standard instead would apply. For example, the consideration of the corporate governance of portfolio companies without considering environmental or social factors, is not treated by some investors as an ESG strategy. Similarly, the ESG Release does not address how the integration fund classification would be applied outside the direct investing or directly-managed context (i.e., funds of funds or sub-advised funds).

In addition to requesting comments as to whether the proposed definition of integration fund is appropriate and clear, the ESG Release asks whether the SEC should (among other topics): require integration funds to provide the tabular disclosure required for ESG-focused funds (discussed below); or address the use of text and design features on the front cover of a fund’s prospectus that could imply a focus on ESG factors, which could be materially misleading.

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<sup>8</sup> For example, an integration fund that considers “the GHG emissions of portfolio companies within only certain ‘high emitting’ market sectors ... would also be required to describe the methodology it uses to determine which sectors would be considered ‘high emitting,’ as well as the sources of GHG emissions data the funds relied on as part of its investment selection process.”

<sup>9</sup> The ESG Release provides the following example: “an Integration Fund might disclose that it invests in companies consistent with its objective of risk-adjusted return; that it considers ESG factors alongside financial, industry-related and macroeconomic factors; that the specific ESG factors it evaluates are the impact and risk around climate change, environmental performance, labor standards, and corporate governance; and that its consideration of these factors would not necessarily result in a company being included or excluded from the evaluation process but rather would contribute to the overall evaluation of that company.”

## ESG-Focused Funds (Including Impact Funds)

<b>Definitions</b>	<p>An ESG-focused fund is a fund that focuses on one or more ESG factors by using them as a significant or main consideration in selecting investments or in its engagement strategy with the companies in which it invests.<sup>10</sup></p> <p>An impact fund is an ESG-focused fund that seeks to achieve a specific ESG impact or impacts.<sup>11</sup></p>
<b>Summary Prospectus<sup>12</sup></b>	<p>Disclose information in a standardized tabular format<sup>13</sup> organized into three broad categories: an overview of the fund’s strategy with a “check-the-box” feature; how the fund incorporates E, S, and/or G factors in its investment decisions;<sup>14</sup> and how the fund votes proxies and/or engages with companies about E, S, and/or G issues.</p>
<b>Statutory Prospectus</b>	<p>Describe how the fund incorporates ESG factors into its investment process, including information related to: the index methodology for any index tracked; internal methodologies used and how they incorporate ESG factors; scoring or ratings systems of any third-party data provider used; factors applied in any inclusionary or exclusionary screen; description of any third-party frameworks followed and how they are used; and, with respect to engagement, a description of any specific engagement objectives and associated key performance indicators.<sup>15</sup></p>

<sup>10</sup> This would 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 sales literature or advertisements indicate that the fund’s investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. The ESG Release clarifies that mentioning ESG factors in an advertisement or marketing materials – but not as a “significant or main consideration” – would not cause a fund to be an ESG-focused fund (absent other factors).

The ESG Release indicates that the definition also would capture: funds that track an ESG-focused index and funds that apply inclusionary or exclusionary screens based on ESG factors (though the ESG Release does not suggest any ESG-related minimum characteristics the index or screen should have); funds that seek to achieve a particular impact; and funds that focus on ESG-related engagement (proxies or other management engagement) with the issuers in which they invest.

<sup>11</sup> Impact funds are a sub-set of ESG-focused funds. The ESG Release provides as examples of impact funds: a fund that invests with the goal of seeking current income while also furthering a disclosed goal of financing construction of affordable housing; or a fund that invests with the goal of seeking to advance the availability of clean water by investing in industrial water treatment and conservation portfolio companies.

<sup>12</sup> An open-end fund would be required to provide the disclosure at the beginning of its “risk/return summary,” while a closed-end fund would provide the table at the beginning of the discussion of the fund’s organization and operation.

<sup>13</sup> For additional information on the specific required tabular disclosures, see Appendix A.

<sup>14</sup> Additional specific disclosure requirements apply with respect to impact funds, including: how the fund measures progress towards the stated impact; the time horizon used to measure that progress; and the relationship between the impact the fund is seeking to achieve and the fund’s financial returns.

<sup>15</sup> Various aspects of the Proposal with respect to impact funds or strategies require disclosure of key performance indicators used. However, it is not clear whether or to what extent the SEC consulted with other U.S. financial regulators in connection with such requirements.

<b>Annual Report</b>	<p><b>ESG-Focused Funds:</b> To the extent applicable<sup>16</sup> disclose information related to:</p> <ul style="list-style-type: none"> <li>• Where proxy voting is a “significant” means of implementing the ESG strategy (i.e., funds that proactively use proxy voting with issuers as a means of implementing their ESG strategy): <ul style="list-style-type: none"> <li>– Disclose the percentage of ESG proxy voting-related matters<sup>17</sup> where the fund voted in favor of the initiative, and</li> <li>– Provide a cross-reference to the fund’s full proxy voting record filed on Form N-PX;</li> </ul> </li> <li>• Where engagement other than through proxy voting is a “significant” means of implementing the ESG strategy, disclose (i.e., funds that proactively use engagement with issuers as a means of implementing their ESG strategy): <ul style="list-style-type: none"> <li>– The fund’s progress on engagement strategies, and</li> <li>– The number or percentage of issuers with whom the fund held engagement meeting(s)<sup>18</sup> related to one or more ESG issues and the total number of such meetings; and/or</li> </ul> </li> <li>• Where an ESG-focused fund considers environmental factors as part of its investment strategy, disclose certain GHG emissions metrics for the fund’s portfolio<sup>19</sup> (carbon footprint and weighted average carbon intensity) unless the fund affirmatively states in the “ESG Strategy Overview” section of its tabular</li> </ul>
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<sup>16</sup> As a general matter, disclosure would be required if proxy voting or engagement is a “significant means” of implementing a fund’s ESG strategy. The ESG Release provides guidance on circumstances where proxy voting or engagement activities could be considered “significant.” The SEC noted in the ESG Release that whether the proxy voting or engagement activities of a fund are considered “significant” would depend on the facts and circumstances. However, the SEC further noted in the ESG Release that “a fund that regularly and proactively votes proxies or engages with issuers on ESG issues to advance one or more particular ESG goals the fund has identified ... would be using voting and engagement as a significant means to implement its strategy.”

<sup>17</sup> Funds would be permitted to limit the denominator of this calculation to matters involving ESG factors that the fund incorporates into investment decisions

<sup>18</sup> For this purpose, “ESG engagement meeting” would be defined as “a substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given period of time, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal.” The ESG Release clarifies that this definition is intended to exclude meetings where advocacy on ESG issues is “not a focus” and aspects of an ESG engagement strategy *not directed at a particular issuer*.

<sup>19</sup> The metrics would represent GHG emissions associated with investments in “portfolio companies” or indirect investments through certain derivatives. Portfolio companies would be defined for purposes of the Proposal as “(a) an issuer that is engaged in or operates a business or activity that generates GHG emissions; or (b) an investment company, or an entity that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act (a ‘private fund’), that invests in issuers described in clause (a), except for an investment in reliance on Rule 12d1-1 under the Investment Company Act (i.e., investments in money market funds).”

	<p>presentation that it does not consider GHG emissions as part of its investment strategy.<sup>20</sup></p> <p><b>Impact Funds:</b> Summarize the fund’s progress (quantitative and qualitative) in achieving the impacts disclosed in the fund’s prospectus, including key factors materially affecting results achieved.</p>
<b>Investment Objective</b>	<b>Impact Funds:</b> Where the fund first describes its investment objective or goal, disclose the ESG impact the fund seeks to generate with its investments.

The tabular format is intended to provide investors with “clear, comparable, and succinct summary of the salient features” of an ESG-focused fund’s implementation of ESG factors. Consistent with other elements of the Proposal, the tabular format also is intended to implement a layered approach to ESG-related disclosures. Specifically, while ESG-focused funds would be required to complete each row of the table with a brief disclosure, more detailed disclosure would be required later in the prospectus. Hyperlinks between the table and the more fulsome disclosure also would be required for electronic prospectuses.

In addition to requesting comments on whether additional distinctions should be made beyond the three categories of funds listed above, the ESG Release asks: whether a reference to engagement should be a means of identifying impact funds, rather than ESG-focused funds; whether there is any information included in the overview table that should be permitted but not required; and whether the SEC should require impact funds to describe the fund’s time horizon for progress on its impact objectives and key performance indicators, as proposed.

## Overview of Required Adviser Disclosures (Form ADV Brochures – Part 2)

The SEC also proposed to amend Form ADV Part 2A to require registered investment advisers that consider ESG factors as part of their advisory business to disclose information similar to that required in fund registration

<sup>20</sup> Both methodologies would require Scope 1 and Scope 2 emissions be included in the emissions calculation, but would not require Scope 3 emissions. However, Scope 3 emissions data would be required under the carbon footprint metric, but only if they are reported by a portfolio company. Scope 3 emissions would be disclosed separately from Scope 1 and 2 emissions and would be disclosed by sector. Funds would not be required to estimate Scope 3 emissions. The GHG emissions requirements would seek to leverage information that would be available under the SEC’s proposed climate-related disclosure requirements if those requirements are ultimately adopted. In fact, the ESG Release indicates that the SEC believes that the Proposal and the proposed climate-related disclosure requirements for issuers would “complement” one another if both are adopted. Whether, and to what extent, any such final rulemakings ultimately do complement each other cannot be known unless and until final rules are adopted. However, the timing and nature of the proposals could present certain practical challenges. For example, if the Proposal is adopted prior to the issuer climate disclosure requirements (or the former is not ultimately adopted), investment advisers would continue to operate ESG investment strategies without issuer disclosures on GHG emissions information provided under a common regulatory framework. It is not yet clear what climate disclosures the SEC will require of public company issuers, the timing of the SEC’s adoption of these requirements, or whether these requirements will survive likely court challenges. The specific impact this would have on the proposed GHG emissions metric requirements in the Proposal cannot be known. For further information regarding the climate disclosure proposal, please refer to *Dechert OnPoint*, [SEC Proposes Comprehensive Climate-Related Disclosure Rules](#).

The ESG Release indicates that the SEC believes that these metrics are “generally aligned with” recommendations from the Task Force on Climate-Related Financial Disclosures and Partnership for Carbon Accounting Financials framework and “based on” emission data consistent with those defined by the [GHG Protocol](#). Thus, the market may provide a certain degree of standardization of GHG emission data, which may assist ESG-focused funds in complying with the proposed disclosure requirements.



statements and annual reports. Specifically, the Proposal would require registered advisers to disclose: a description of the ESG factors considered in providing advisory services and how they are incorporated; and, if ESG factors are considered when selecting, reviewing or recommending portfolio managers, a description of the factors considered and how they are incorporated.

The new disclosures would appear in Items 8, 10, 17 and Appendix 1 (Wrap Fee Brochure). Specifically, these items would require:

***Methods of Analysis, Investment Strategies and Risk of Loss:***

The Proposal would require advisers to describe the ESG<sup>21</sup> factor(s) considered for each significant investment strategy or method of analysis where the adviser considers ESG factors, as well as how the factors are incorporated when providing investment advice. This would include a discussion of whether and how the adviser:

- Incorporates a particular ESG factor (E, S or G) or a combination of factors;<sup>22</sup> and
- Employs “integration” and/or “ESG-focused” strategies;<sup>23</sup> and
- Employs “ESG impact” strategies.<sup>24</sup>

For ESG impact strategies, the disclosure would include: the impact(s) the adviser intends to achieve and how the adviser seeks to achieve such impact(s) (including how the adviser measures progress towards a stated impact); key performance indicators the adviser analyzes; the time horizon the adviser uses to analyze progress; and the relationship between the impact sought and financial return(s). The ESG Release acknowledges that the definitions of ESG “integration,” “focused” and “impact” strategies for this purpose are similar to those used in classifying funds, while reflecting structural differences between funds and advisers.

In addition, if the adviser uses a criterion or a methodology to evaluate, select or exclude investments based on consideration of ESG factor(s) for any significant strategy, the adviser would be required to describe the criteria/methodologies and how they are used. Such disclosure would be required for each significant strategy. The ESG Release also provides the following non-exclusive list of criteria and methodologies for an adviser to address (if applicable):<sup>25</sup>

- The adviser’s use of an internal methodology, a third-party criterion or methodology such as a scoring provider or framework, or a combination of both (including an explanation of how the adviser evaluates the quality of relevant third-party data);

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<sup>21</sup> Under the Proposal, the term “ESG” (and related terminology) would not be defined for purposes of Form ADV Part 2A.

<sup>22</sup> Where an adviser considers different factors for different strategies, the required disclosure would be made for each strategy.

<sup>23</sup> The ESG Release clarifies that an adviser would use an ESG-focused strategy if the strategy focuses on one or more ESG factors by using them as a significant or main consideration in providing investment advice or in the adviser’s engagement strategy with the companies in which its clients invest.

<sup>24</sup> The ESG Release clarifies that an adviser would use an impact strategy if the adviser seeks to achieve a specific ESG impact(s) for the significant strategy.

<sup>25</sup> Where an adviser’s criteria or methodologies include following a third-party ESG framework, the adviser also would be required to describe the framework and how the adviser uses it.

- The adviser's use of an inclusionary or exclusionary screen (including an explanation of the factors the screen applies, such as particular industries or business activities it seeks to include or exclude) and, if applicable, what exceptions apply to the inclusionary or exclusionary screen; and
- The adviser's use of an index (including the name and a description of the index) and how the index utilizes ESG factors in determining its constituent elements.

### ***Other Financial Industry Activities and Affiliations***

The Proposal would require an adviser to describe any material relationship or arrangement that the adviser or any of its management persons have with any "related person" that is an ESG consultant or other ESG service provider.<sup>26</sup> This would require identifying the related person ESG provider, describing the relationship or arrangement, and, if the relationship or arrangement creates a material conflict of interest with clients, describing the nature of the conflict and how the adviser addresses it.

### ***Voting Client Securities***

The Proposal would require an adviser with specific voting policies or procedures that include one or more ESG considerations when voting client securities to provide a description of the ESG factor(s) the adviser considers and how those factors are considered.<sup>27</sup> If the voting policies and procedures differ by strategy, client or ESG-related matter, the adviser would be required to describe the differences.<sup>28</sup>

### ***Wrap Fee Brochure***<sup>29</sup>

The Proposal would require advisers sponsoring wrap fee programs to describe the ESG factors that are considered in the wrap fee programs and how these factors are incorporated under each program. Further, advisers would be required to describe the ESG factors and how such factors are considered when reviewing, selecting or recommending portfolio managers. The Proposal would require three specific disclosures to aid in the description of the ESG factors considered: (i) a description of any criteria or methodologies used to assess the portfolio managers' application of ESG factors into their portfolio management; (ii) an explanation of whether the adviser or a third party reviews portfolio managers' application of relevant ESG factors; and (iii) an explanation if neither the adviser nor a third party reviews the portfolio managers' application of relevant ESG factors, or if the application cannot be calculated (if applicable).

In addition to requesting comments as to whether the proposed amendment to Form ADV is appropriate, the ESG Release asks (among other topics): whether the brochure should be required to include different levels of disclosure for integration and ESG-focused strategies; and whether the SEC should create an additional separate disclosure requirement for an adviser's significant strategy for which it uses shareholder engagement to implement its ESG focus.

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<sup>26</sup> The Proposal states that the term "related person ESG provider" may include ESG index providers and ESG scoring providers, among other ESG consultants and ESG service providers.

<sup>27</sup> The Proposal notes that if an adviser has described the ESG factors it considers elsewhere in the brochure, the adviser would be required to provide only a cross reference to that description.

<sup>28</sup> As set forth in the ESG Release, this would include whether the adviser allows clients to direct their votes on ESG-related voting matters

<sup>29</sup> This requirement would apply only to advisers that sponsor wrap fee programs; such advisers are required to prepare specialized brochures that are delivered to their wrap fee clients.

## Regulatory Reporting on Form N-CEN and Form ADV Part 1A

The Proposal also includes proposed amendments to Forms N-CEN and Form ADV Part 1A for funds and advisers.

### **Form N-CEN**

The Proposal would add new Items C.3(b) and (j) to Form N-CEN. Specifically, these items would require:

- **Item C.3(b):** Disclosure of the index tracked by an index fund, including provision of an identifying number (such as a legal entity identifier code (LEI)).
- **Item C.3(j):** Information related to ESG funds' investment strategies and processes, including: the fund's ESG classification (i.e., integration, ESG-focused, impact); which E, S and/or G factors are considered; the method used to implement the fund's ESG strategy (i.e., tracking an index, applying an inclusionary/exclusionary screen, proxy voting, management engagement); whether affiliated or third-party ESG data sources or consultants are used (including names and LEIs of data sources and whether the source/consultant is an affiliated person); and whether the fund follows any third-party frameworks (including the name of any framework).

In addition to requesting comments as to whether the requirement to provide census-type information on Form N-CEN is appropriate, the ESG Release asks whether the SEC should (among other topics): define the term "ESG consultants or other ESG service providers"; and require index funds to report the name and LEI on Form N-CEN.

### **Form ADV Part 1A**

The Proposal would amend Form ADV Part 1A to require additional information about the advisory services provided to separately managed account clients and reported private fund clients. Specifically, the Proposal would:

- **Item 5.K. & Schedule D:** Require disclosure of whether ESG factor(s) are considered as part of one or more significant investment strategies or methods of analysis in providing advisory services to separate account clients or as part of advisory services when requested by such clients. If so, the adviser would be required to disclose whether it utilizes ESG integration, focused, and/or impact strategies and, for each significant investment strategy, whether E, S and/or G factor(s) are considered.
- **Item 5.M.:** Require disclosure of whether the adviser follows any third-party framework in connection with its advisory services. If so, the adviser would disclose the name of the framework(s).
- **Item 6, Item 7 & Schedule D:** Require disclosure of whether the adviser conducts business activities with ESG providers or has related persons that are ESG providers.
- **Schedule D (Private Fund Reporting):** Require disclosure of whether ESG factor(s) are considered as part of one or more significant investment strategies or methods of analysis in the advisory services provided to private funds. If so, the adviser would disclose whether it utilizes ESG integration, focused and/or impact strategies and, for each significant investment strategy, whether E, S and/or G factor(s) are considered.

Unlike other aspects of the Proposal, the amendments to Item 5 of Part 1A of Form ADV would not apply to exempt reporting advisers.

In addition to requesting comments as to whether the proposed amendment to Form ADV Part 1A is appropriate, the ESG Release asks whether the SEC should (among other topics): require additional information about ESG indexes used by advisers (e.g., name and LEI); and collect different amounts of data depending on whether or not ESG is considered a significant strategy.

## Impacts on Other SEC Forms

The Proposal also would modify Form N-CSR by adding proposed Item 7, which would require granular information about the process used for calculating and estimating the GHG emissions of a fund's portfolio.<sup>30</sup>

## Guidance on Compliance Policies and Procedures and Marketing

The ESG Release also contains guidance related to fund and adviser compliance policies, as well as marketing materials, in the ESG context. Unlike other sections of the ESG Release, the SEC did not request comments on this guidance.

Addressing compliance policies and procedures, the ESG Release highlights the SEC's current expectation that policies and procedures address the "accuracy of disclosures made to clients, investors and regulators, as well as portfolio management processes, including consistency of portfolios with investment objectives and disclosures by the adviser and/or fund." It then translates this obligation to the context of ESG, noting that "ESG strategies, including integration, ESG-focused and impact strategies, will necessarily require different levels and types of compliance policies and procedures." With this objective in mind, the SEC stated that policies and procedures "should address the accuracy of ESG-disclosures made to clients, investors and regulators .... [and] portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund."

The ESG Release provides specific examples of what the SEC deems to be "effective" ESG-related practices, including:

- If an adviser discloses to investors that it considers certain ESG factors as part of an integration strategy, the adviser's compliance policies and procedures should be reasonably designed to ensure the adviser manages the portfolios consistently with the manner in which the strategy was described to investors (e.g., actually considering the ESG factors in the way the adviser states that it considers such factors).
- If a registered fund discloses to investors that it adheres to a particular global ESG framework, its policies and procedures should include controls that help to ensure client portfolios are managed in accordance with that framework.
- If an adviser uses ESG-related positive and/or negative screens on client portfolios, the adviser should maintain adequate controls to maintain, monitor, implement and update those screens.
- If an adviser has agreed to implement a client's ESG-related investing guidelines, mandates or restrictions, the adviser's compliance policies and procedures should be designed to ensure these investment guidelines, mandates or restrictions are followed.

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<sup>30</sup> A proposed new Instruction 10 to Item 24 of Form N-2 would impose parallel disclosure requirements for BDCs on Form 10-K.

- If an adviser discloses to investors that ESG-related proxy proposals will be independently evaluated on a case-by-case basis, the adviser should adopt and implement policies and procedures for such evaluation.
- If an adviser advertises to its clients that they will have the opportunity to vote separately on ESG-related proxy proposals, the adviser must provide such opportunities to its clients to the extent applicable, and should maintain internal policies and procedures accordingly.

The ESG Release also explains the SEC's views on the application of current advertising requirements to the ESG context by indicating that "greenwashing" may represent a form of false or misleading statement.<sup>31</sup>

## Key Dates and Timing

The SEC proposed a one-year transition period for: the proposed disclosure requirements in prospectuses for registered investment companies and BDCs; the proposed disclosure requirements for UITs; the proposed regulatory reporting under Form N-CEN; and the proposed disclosure requirements and regulatory reporting under Form ADV Parts 1 and 2.

The SEC proposed an 18-month transition period for the proposed disclosures in shareholder reports and those filed under Form N-CSR.

The SEC also has requested comment on whether these dates are appropriate, and whether integration fund and ESG-focused fund compliance dates should differ.

Comments on the SEC's proposal are due on August 16, 2022 (60 days after publication in the Federal Register).

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<sup>31</sup> The SEC also affirmatively states in the release that "it generally would be materially misleading for an adviser materially to overstate in an advertisement the extent to which it utilizes or considers ESG factors in managing client portfolios."

## Appendix A: Required Tabular Disclosure for ESG-Focused Funds

The following table reproduces the format of the required tabular disclosure as contemplated in the ESG Release and, in the second column, summarizes guidance from the ESG Release related to the types of disclosure required in each category. The SEC requests comment on each aspect of the required tabular disclosure.

Required Category	Disclosure Considerations
<b>Overview of the Fund's ESG Strategy</b>	<ul style="list-style-type: none"> <li>● Provide a concise description of the ESG factor(s) that are a focus of the fund's strategy.</li> <li>● Provide the following list and select each category that applies to the fund (check each box that applies): <ul style="list-style-type: none"> <li><input type="checkbox"/> Tracks an index</li> <li><input type="checkbox"/> Applies an inclusionary screen</li> <li><input type="checkbox"/> Applies an exclusionary screen</li> <li><input type="checkbox"/> Seeks to achieve a specific impact</li> <li><input type="checkbox"/> Proxy voting</li> <li><input type="checkbox"/> Engagement with issuers</li> <li><input type="checkbox"/> Other</li> </ul> </li> <li>● Unlike the other categories in the required list above, "proxy voting" and "engagement with issuers" would be selected only if a "significant" means of implementing the ESG strategy.</li> <li>● If the fund desires to be exempt from the requirement to disclose certain GHG emissions information in annual reports, the fund must "affirmatively state" that it does not consider GHG emissions as part of its investment strategy.</li> </ul>
<b>How the Fund Incorporates ESG Factors in its Investment Decision</b>	<ul style="list-style-type: none"> <li>● Summarize how the fund incorporates ESG factors into its process for evaluating, selecting or excluding investments.</li> <li>● Provide specific information, in a disaggregated manner, for each "check-the-box" category selected under the "Overview of the Fund's ESG Strategy" section of the required tabular disclosure (i.e., the seven categories in the immediately preceding row of this table).</li> <li>● If the fund applies an inclusionary or exclusionary screen: <ul style="list-style-type: none"> <li>– Briefly explain the factors the screen applies and, if applicable, what exceptions apply to the screen.</li> </ul> </li> </ul>

	<ul style="list-style-type: none"> <li>– State the percentage of the portfolio (in terms of NAV) to which the screen applies and (if less than 100% excluding cash and cash equivalents) why the screen applies to less than 100%.</li> <li>• If the fund uses an internal methodology, third-party data provider, or a combination of those, in evaluating, selecting or excluding investments, describe how the fund uses the methodology and/or provider.<sup>1</sup></li> <li>• If the fund tracks an index, identify the index and briefly describe (i) the index and (ii) how it utilizes ESG considerations in determining its constituents.<sup>2</sup></li> <li>• If the fund is an ESG-focused fund, provide an overview of any third-party ESG frameworks the fund follows as part of its investment process.</li> <li>• If the fund is an impact fund, provide an overview of the impact(s) the fund seeks to achieve and how it seeks to achieve such impacts, including: (i) how the fund measures progress (including the key performance indicators used);(ii) the time horizon, and (iii) the relationship between the impact sought and financial return(s).</li> </ul>
<p><b>How the Fund Votes Proxies and/or Engages with Companies about ESG Issues</b></p>	<ul style="list-style-type: none"> <li>• Where the proxy voting/engagement with issuers category is selected under “Overview of the Fund’s ESG Strategy,” provide a brief narrative overview of how the fund engages with portfolio companies on ESG issues.<sup>3</sup></li> <li>• As part of that narrative, identify the method(s) – formal and informal – used to influence issuers, including: <ul style="list-style-type: none"> <li>– Whether the fund has specific or supplemental proxy voting policies that include ESG considerations and, if so, state the ESG considerations addressed.</li> <li>– If the fund engages with company management other than through proxies, provide an overview of the fund’s engagement objectives.</li> </ul> </li> <li>• If the proxy voting/engagement with issuers category is not selected, disclose that neither is a significant part of the fund’s investment strategy.</li> </ul>

<sup>1</sup> Disclosure outside the summary section of the prospectus would provide (if applicable) a more detailed description. Where an internal methodology is used, the more detailed disclosure would describe the methodology and how it incorporates ESG factors. Where a third-party data provider is used, the more detailed disclosure would describe the scoring/ratings system used and how the fund evaluates the quality of data.

<sup>2</sup> Disclosure outside the summary section of the prospectus would include a discussion of the index’s methodology (including any criteria or methodologies for selecting/excluding components of the index that are based on ESG factors).

<sup>3</sup> Additional detail would be provided outside the tabular format, related to the fund’s engagement strategy objectives (including the time horizon for progressing on those objectives and key performance indicators used to analyze or measure the effectiveness of engagement activities).

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