

CLIENT ALERT

# SEC Proposes ESG Rules and Amendments for Investment Advisers and Investment Companies

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## AUTHORS

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On May 25, 2022, the U.S. Securities and Exchange Commission (the “SEC” or the “Commission”) proposed rules and form amendments (the “Proposed Rules”) that would require registered investment companies, business development companies (“BDCs”) (together with registered investment companies, “funds”),<sup>1</sup> and registered and certain unregistered investment advisers (“advisers”) to disclose information about how funds and advisers incorporate environmental, social, and governance (“ESG”) factors into their investment strategies.<sup>2</sup> The Proposed Rules would: (i) require additional specific disclosure requirements regarding ESG strategies in fund prospectuses, annual reports, and Form ADV, including qualitative and/or quantitative disclosures; (ii) implement a layered, tabular disclosure approach for ESG funds (as described below); and (iii) generally require certain environmentally focused funds to disclose the greenhouse gas (“GHG”) emissions associated with their portfolio investments. The substance of the proposed disclosures varies based on whether a fund or adviser implements integration, ESG-focused, or impact strategies (as discussed in more detail below).

The Proposed Rules represents a significant shift into requiring copious detail about a particular type of strategy – ESG. While the focus on one specific strategy is notably unusual, the focus does not come as a surprise given past SEC staff

<sup>1</sup> The provisions of the Proposed Rules applicable to funds specifically would not apply to private funds. (See Proposing Release at 8).

<sup>2</sup> See SEC Rule Proposal, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, available [here](#).

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publications and speeches given by current SEC commissioners.<sup>3</sup> Certain requirements in the Proposed Rules may be challenging for funds to implement (e.g., GHG emissions metrics) and likely would require significant modification of funds' and advisers' disclosure documents and related compliance policies and procedures.

In proposing the new ESG disclosures, the Commission noted in the proposing release ("Proposing Release") that funds and advisers already are required to disclose material information regarding their objectives, strategies, risks, and governance; however, the Commission stated its belief that investors face a lack of consistent, comparable, and reliable information among investment products and advisers that claim to consider one or more ESG factors. Specifically, the Commission noted that this variation in disclosures, combined with the lack of a more specific disclosure framework, increases the risk of funds and advisers marketing or labeling themselves as "ESG," "green," or "sustainable" in an effort to attract investors or clients, when the ESG-related features of their investment strategies may be limited. This practice is known as "greenwashing." The Commission also noted that the proposed disclosures would help delineate the nuances and different strategy approaches employed by funds and advisers.<sup>4</sup>

### Overview of the Proposed Rules

The following is a summary of the proposed changes:

- *Fund Amendments*: The Proposed Rules would identify three types of "ESG" strategies and funds – "integration," "ESG-focused," and "impact" (as described below). These funds would be required to include certain ESG-related disclosures in their respective registration statements, depending on which ESG category they fall into.
- *Annual Report Disclosures*: The Proposed Rules would require disclosures to be included in certain funds' shareholder reports. Specifically, Impact Funds (as defined below) would be required to disclose their progress on achieving their intended ESG impacts, and ESG-Focused Funds (as defined below) would be required to disclose certain proxy voting and engagement information if the funds disclose that they consider proxy voting and

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<sup>3</sup> The Proposed Rules continue the SEC's focus on ESG disclosures following one Risk Alert issued in 2021 by the Division of Examinations, a 2021 investor bulletin, the creation of the ESG Task Force in 2021, and the directive to review climate-related disclosure in public company filings. See Division of Examinations Risk Alert, The Division of Examinations' Review of ESG Investing, available [here](#) ("Review of ESG Investing"); SEC Investor Bulletin, Environmental, Social and Governance (ESG) Funds – Investor Bulletin, available [here](#); SEC Press Release, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, available [here](#); Statement of Acting Chair Allison Herren Lee, Statement on the Review of Climate-Related Disclosure, available [here](#); and Statement of Acting Chair Allison Herren Lee, Public Input Welcome on Climate Change Disclosures, available [here](#).

<sup>4</sup> Commissioner Hester M. Peirce, Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies (May 25, 2022), dissented [here](#). Commissioner Peirce stated that there is a "legitimate concern about the practice of greenwashing by investment advisers and investment companies[,] . . . [but] we already have a solution: when we see advisers that do not accurately characterize their ESG practices, we can enforce the laws and rules that already apply." (citing SEC Press Release, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022), available [here](#)).

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engagement in their investment decisions. Additionally, ESG-Focused Funds would be required to disclose certain GHG emissions metrics.

- *Form N-CEN Amendments:* The Proposed Rules would require ESG-Focused Funds to disclose certain environmental metrics.
- *Form ADV Amendments:* The Proposed Rules would amend Form ADV Parts 1A and 2A to require certain information to be included based on the adviser's ESG investment strategy.

### The Proposed Rules and Form Amendments for Funds

The Proposed Rules would require additional specific disclosure requirements regarding ESG strategies to investors in fund registration statements and the management discussion of fund performance in fund annual reports (or in the management discussion and analysis in Form 10-Ks filed by BDCs). More specifically, the Proposed Rules would require minimum disclosure requirements for any fund that markets itself as an ESG-Focused Fund (inclusive of Impact Funds) (as defined below), and would require streamlined disclosure for Integration Funds (as defined below) that consider ESG factors as one of many factors in investment selections.

The Proposed Rules would require a fund engaging in ESG investing to provide additional information about the fund's implementation of ESG factors in the fund's principal investment strategies using a layered approach. The amount of disclosure required depends on whether the fund is classified as an Integration Fund, an ESG-Focused Fund, or an Impact Fund, as defined below:

Integration Fund	A [f]und 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. <sup>5</sup>
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<sup>5</sup> See, e.g., Proposed Amendment Item 4(a)(2)(i)(A) of Form N-1A.

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ESG-Focused Fund	A Fund that focuses on one or more ESG factors by using them as a significant or main consideration: (i) in selecting investments; or (ii) in its engagement strategy with the companies in which it invests. An ESG-Focused Fund includes: (i) any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors; and (ii) any fund whose advertisements, as defined pursuant to Rule 482 under the Securities Act of 1933, <sup>6</sup> or sales literature, as defined pursuant to Rule 34b-1 under the Investment Company Act of 1940 (the "Investment Company Act"), <sup>7</sup> 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. <sup>8</sup>
Impact Fund	An ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts. <sup>9</sup>

### Proposed Prospectus ESG Disclosure<sup>10</sup>

The Proposed Rules would amend certain disclosures required by Form N-1A and Form N-2. The level of disclosure in a fund's prospectus that would be required by the Proposed Rules would depend on how integral ESG is to the fund's investment strategy. Integration Funds would provide more limited disclosures, whereas ESG-Focused Funds and Impact Funds would be required to provide more detailed information in a tabular format.

#### *A. Integration Funds*

The Proposed Rules would require an Integration Fund to summarize in a few sentences how the fund incorporates ESG factors into its investment selection process, including what ESG factors the fund considers. Open-end funds would provide this information in the summary section of the fund's prospectus, while closed-end funds would disclose the

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<sup>6</sup> 17 CFR 230.482.

<sup>7</sup> 17 CFR 270.34b-1.

<sup>8</sup> See, e.g., Proposed Amendment Item 4(a)(2)(i)(B) of Form N-1A.

<sup>9</sup> See, e.g., Proposed Amendment Item 4(a)(2)(i)(C) of Form N-1A.

<sup>10</sup> All proposed ESG-related registration statement and annual report disclosures should be filed with the Commission in Inline XBRL. The Proposed Rules would amend Rule 405 of Regulation S-T to reference the ESG-specific form provisions.

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information as part of the prospectus's general description of the fund. The Proposing Release noted that this disclosure is not and should not be extensive, to avoid misleading investors into thinking that ESG factors have a larger role in the investment selection process than they actually do.<sup>11</sup> In addition to this concise description, an Integration Fund would need to provide additional information regarding how it incorporates ESG factors into its investment selection process in an open-end fund's statutory prospectus or later in a closed-end fund's prospectus.

Additionally, if an Integration Fund considers the GHG emissions of portfolio holdings as one ESG factor in the fund's investment selection process, that fund would be required to describe how it considers the GHG emissions of its portfolio holdings. This disclosure must include a description of the methodology that the fund uses as part of its consideration of portfolio company GHG emissions. For example, the Proposing Release stated that an Integration Fund may disclose that it considers the GHG emissions of portfolio companies within certain "high emitting" market sectors, *i.e.*, the energy sector. In this example, the Fund would be required to describe the methodology it used to determine which sectors are "high emitting," and the sources of the GHG emissions data the fund relied on.<sup>12</sup>

### *B. ESG-Focused Funds*

ESG-Focused Funds (including Impact Funds) would be required to provide information about their consideration of ESG factors in a tabular format—an ESG Strategy Overview table—in the fund's prospectus. An open-end fund would be required to provide the disclosure at the beginning of its "risk/return summary," the section of the summary prospectus that summarizes key information about the fund's investments, risk and performance, while a closed-end fund would provide the table at the beginning of the discussion of the fund's organization and operation. The table would include the following:

- Row 1 – Overview of the Fund's [ESG] strategy: the fund would be required to provide a concise description in a few sentences of the factor or factors that are the focus of the fund's strategy and to include a list of common ESG strategies in a "check-the-box" style, indicating all that apply (*e.g.*, tracks an index, applies an inclusionary screen);<sup>13</sup>
- Row 2 – How the Fund incorporates [ESG] factors in its investment decisions: the fund would be required to summarize how the fund incorporates ESG factors into its process for evaluating, selecting, or excluding

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<sup>11</sup> See also SEC Proposed Rule, Changes to Prevent Misleading or Deceptive Fund Names (May 25, 2022), available [here](#). This proposal would deem an Integration Fund's name to be deceptive or misleading if the name includes terms indicating that the fund's investment decisions incorporate one or more ESG factors.

<sup>12</sup> See Proposing Release at 28.

<sup>13</sup> Specifically, the options available in the "check-the-box" list include: (i) tracks an index; (ii) applies an exclusionary screen; (iii) applies an inclusionary screen; (iv) seeks to achieve a specific impact; (v) proxy voting; (vi) engagement with issuers; and (vii) other. (See Proposing Release at 36.)

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investments, as well as disaggregated information with respect to each of the common ESG strategies applicable to the fund as identified by the “check-the-box” disclosure; and

- Row 3 – How the Fund votes proxies and/or engages with companies about [ESG] issues: if a fund selects “voting proxies” under the “check-the-box” list under the row “How the Fund incorporates [ESG] factors in its investment decisions,”<sup>14</sup> the fund would be required to explain in the third row how the fund engages with portfolio companies on ESG issues.<sup>15</sup>

With respect to Row 2 (ESG Factors), if the fund applies an inclusionary or exclusionary screen to select or exclude investments, the summary would be required to briefly explain the factors the screen applies, as well as the percentage of the portfolio (in terms of net asset value) to which the screen applies. If the screen applies to less than 100%, excluding cash and cash equivalents held for cash management, the fund would explain why the screen applies to less than 100% of the portfolio.<sup>16</sup> If the fund uses an internal methodology, a third-party data provider, or a combination of both in evaluating, selecting, or excluding investments, the disclosure would describe how the fund uses the methodology, third-party data provider, or combination of both, as applicable.<sup>17</sup> If the fund tracks an index, the summary would identify the index and briefly describe the index and how it utilizes ESG factors in determining its constituents.<sup>18</sup>

The Proposed Rule also would require an ESG-Focused Fund to provide an overview of any third-party ESG frameworks<sup>19</sup> that the fund follows as part of its investment process, with a more detailed explanation of how the framework applies to the fund later in the prospectus. Item 9 of Form N-1A, or Item 8 of Form N-2, as applicable, would be

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<sup>14</sup> A fund would check-this-box if engagement with issuers, either by voting proxies or otherwise, is a “significant” means of implementing its ESG strategy. (See Proposing Release at 61.)

<sup>15</sup> This information could include an overview of the fund’s voting of proxies and meetings with management. A fund that does not check the box would still be required to include this item and would disclose that neither proxy voting nor engagement with issuers is a significant part of its investment strategy. Additionally, disclosures regarding engagement meetings are for ESG-Focused Funds for which such engagement is a significant means of implementing its strategy. (See Proposing Release at 61.)

<sup>16</sup> A more detailed description would be required later in the prospectus, which discusses the factors applied by any inclusionary or exclusionary screen, including any quantitative thresholds or qualitative factors used to determine a company’s industry classification or whether a company is engaged in a particular activity. (See Proposing Release at 45.)

<sup>17</sup> The summary in the table would be complemented by a more detailed description later in the prospectus, where the fund would provide, if applicable, additional information of any internal methodology used and how that methodology incorporates ESG factors. If the fund used a third-party data provider, the fund would provide a more detailed description of the scoring or ratings system used by the third-party data provider. For both, the disclosure would be required to include how the fund evaluates the quality of the data from such provider. (See Proposing Release at 47.)

<sup>18</sup> The summary in the table would be complemented by a more detailed description later in the prospectus, specifically providing the index’s methodology, including any criteria or methodologies for selecting or excluding components of the index that are based on ESG factors. (See Proposing Release at 48.)

<sup>19</sup> The Proposing Release refers to frameworks such as the United Nations Sustainable Development Goals or the United Nations Principles for Responsible Investing. (See Proposing Release at 48-49.)

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amended to require a more detailed ESG Strategy Overview Table, and Row 2 would require additional information on how the fund incorporates ESG factors into its investment process, including:

- The index methodology for any index the fund tracks, including any criteria or methodologies for selecting or excluding components of the index that are based on ESG factors.
- Any internal methodology used and how that methodology incorporates ESG factors.
- The scoring or ratings system of any third-party data provider, such as a scoring or ratings provider, used by the fund or other third-party provider of ESG-related data about companies, including how the fund evaluates the quality of such data.
- The factors applied by any inclusionary or exclusionary screen, including any quantitative thresholds or qualitative factors used to determine a company's industry classification or whether a company is engaged in a particular activity.
- A description of any third-party ESG frameworks that the fund follows as part of its investment process and how the framework applies to the fund.
- With regard to engagement, whether by voting proxies or otherwise, a description of specific objectives of such engagement, including the fund's time horizon for progressing on such objectives and any key performance indicators that the fund uses to analyze or measure the effectiveness of such engagement.

With respect to Row 3 (Engagement), the overview of how the fund engages with portfolio companies on ESG issues would be required to identify whether the fund has specific or supplemental proxy voting policies and procedures that include one or more ESG considerations for companies in its investment portfolio, and if so, the fund must state which ESG considerations those policies and procedures address. Additionally, if an ESG-Focused Fund seeks to engage with issuers on ESG matters other than through voting proxies, such as through meetings with or advocacy to management, the fund would be required to disclose in this row an overview of the objectives it seeks to achieve with its engagement strategy. Alternatively, a fund would disclose if it does not engage or expect to engage with issuers on ESG issues.

### *C. Impact Funds*

In addition to the disclosure requirements described above for ESG-Focused Funds, Impact Funds would be required to provide an overview of the impact(s) the fund is seeking to achieve and how the fund is seeking to achieve them in the row "How [the Fund] incorporates [ESG] factors in its investment decisions" of the ESG Strategy Overview table. The overview must include: (i) how the fund measures progress toward the specific impact, including the key performance

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indicators the fund analyzes; (ii) the time horizon the fund uses to analyze progress; and (iii) the relationship between the impact the fund is seeking to achieve and financial return(s).<sup>20</sup>

The Proposed Rules also would require Impact Funds to disclose in their investment objectives the ESG impact(s) that the funds seek to generate with their investments.

### *D. Unit Investment Trusts*

The Proposed Rules would amend Form N-8B-2 and Form S-6 to require Unit Investment Trusts (“UITs”) with portfolio securities selected based on one or more ESG factors to provide investors with clear information about how portfolios are selected based on ESG factors. If one or more ESG factors are used to select the portfolio securities, a UIT would be required to describe briefly how such factors are incorporated into the investment selection process, including which ESG factors are considered.

### Fund Annual Report ESG Disclosure

In addition to the proposed amendments to Forms N-1A and N-2, the Proposed Rules would amend Form N-CSR to provide additional ESG-related information in annual shareholder reports.<sup>21</sup> The Proposed Rules would require funds to discuss the following:

- Impact Funds: the fund’s progress on achieving its impact in both qualitative and quantitative terms during the reporting period and key factors that materially affected the fund’s ability to achieve the impact(s) it seeks;
- ESG-Focused Funds: funds for which proxy voting is a significant means of implementing their ESG strategy would be required to disclose how the fund voted proxies relating to portfolio securities on ESG issues during the reporting period; and<sup>22</sup>
- ESG-Focused Funds: funds for which engagement with issuers on ESG issues through means other than proxy voting is a significant means of implementing their ESG strategy would be required to disclose certain information about their engagement practices, including the number or percentage of issuers with which the fund held ESG engagement meetings during the reporting period related to one or more ESG issues and total number of ESG

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<sup>20</sup> More detailed disclosure would be provided later in the prospectus to complement the summary overview in the ESG Strategy Overview table.

<sup>21</sup> For registered management investment companies, the proposed disclosure would be included in the management discussion of fund performance section of the fund’s annual report. For BDCs, the proposed disclosure would be included in the management discussion and analysis in the fund’s annual report on Form 10-K. See proposed amendments to Item 27(b)(7) of Form N-1A and Item 24 of Form N-2.

<sup>22</sup> The fund also would refer to its full voting record filed on Form N-PX by providing a cross reference or hyperlink to the fund’s most recent complete proxy voting record filed on Form N-PX. See Proposing Release at 339.

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engagement meetings. ESG-Focused Funds for which proxy voting is a significant means of implementing their ESG strategy would be required to disclose the percentage of ESG-related voting matters during the reporting period for which the fund voted in furtherance of the initiative. The fund may limit the disclosure to voting matters involving ESG factors that the fund incorporates into investment decisions.

Additionally, the Proposed Rules would require an ESG-Focused Fund that considers environmental factors to disclose the carbon footprint<sup>23</sup> and the weighted average carbon intensity (“WACI”)<sup>24</sup> of the fund’s portfolio in Form N-CEN, which is an annual report for registered investment companies (except face-amount certificate companies). This proposed requirement would apply to ESG-Focused Funds that indicate that they consider environmental factors in response to Item C.3(j)(ii) on Form N-CEN, but *do not* affirmatively state that they *do not* consider issuers’ GHG emissions as part of their investment strategy in the “ESG Strategy Overview” table in the fund’s prospectus (“environmentally focused fund”). However, a fund would not be required to disclose its GHG emissions metrics if it affirmatively states in the “ESG Strategy Overview” table in the fund’s prospectus that it does not consider issuers’ GHG emissions as part of its investment strategy.<sup>25</sup> The fund would disclose its carbon footprint calculation and WACI following a prescribed calculation methodology.<sup>26</sup>

Some of the key metrics of the disclosure calculation methodology are as follows:

Scope 1 Emissions	Emissions that are directly attributable to operations that are owned or controlled by the portfolio company
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<sup>23</sup> Carbon footprint is an economic measure of the amount of absolute GHG emissions that a fund portfolio finances, through both equity ownership and debt investments, normalized by the size of the fund. See Proposing Release at 95 for additional explanation of the calculation of a fund’s carbon footprint.

<sup>24</sup> WACI is the fund’s exposure to carbon-intensive companies, expressed in tons of CO<sub>2</sub>e per million dollars of the portfolio company’s total revenue. A fund’s WACI measures a Fund’s exposure to carbon-intensive companies. See Proposing Release at 96 for additional explanation of the calculation of a fund’s WACI.

<sup>25</sup> This requirement also would apply to BDCs that are environmentally focused funds.

<sup>26</sup> For both the carbon footprint and WACI measures, the Proposed Rules would not permit a fund to reduce the GHG emissions associated with a portfolio company as a result of the company’s use of purchased or generated carbon offsets. Similarly, if a fund engages in a short sale of a security, the fund would not be permitted to subtract the GHG emissions associated with the security from the GHG emissions of the fund’s portfolio that are used to calculate the fund’s WACI or carbon footprint. (See Proposing Release at 99-104).

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Scope 2 Emissions	Emissions that are indirectly attributable to the portfolio company, resulting from the production of electricity, steam, heat or cooling that has been purchased or acquired by operations that are owned or controlled by the portfolio company
Scope 3 Emissions	All other indirect emissions not included in Scope 2 Emissions, which typically result from the activities of third parties in a portfolio company's value chain

- *Publicly Available Reporting:* a fund would determine the GHG emissions associated with each portfolio company it is invested in that generates GHG emissions using the portfolio company's publicly available regulatory reports. However, if a portfolio company does not disclose its emissions in public regulatory reports, the fund must look to other sources of publicly available information from the portfolio company to ascertain GHG emissions information. Scope 1 and Scope 2 emissions data would be required to be disclosed and a fund must do so in the aforementioned manner; however, a fund would not be required to disclose Scope 3 emissions data if the portfolio company does not publicly report that metric.<sup>27</sup>
- *Investments in other Funds:* if a fund is invested in an underlying fund that is an environmentally focused fund required to report its carbon footprint and WACI, the investing fund may rely on the underlying funds' calculation. If the underlying fund is not required to disclose this information, the investing fund may look through its investment to the underlying fund's (including an underlying private fund's) holdings and calculate the GHG emissions.
- *Good-Faith Estimates:* if a fund cannot identify publicly available Scope 1 and Scope 2 emissions information, the fund would be required to use a good-faith estimate of those emissions. If the fund uses good-faith estimates, it must disclose the percentage of the GHG emissions calculated using a good-faith estimation process and briefly explain the calculation method and data sources used. A fund is not required to make good-faith estimates regarding Scope 3 emissions of a portfolio company.<sup>28</sup>

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<sup>27</sup> See Proposing Release at 108.

<sup>28</sup> See Proposing Release at 104.

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### Regulatory Reporting on Form N-CEN

Form N-CEN for registered funds would be amended to collect information about funds' uses of ESG factors, including their uses of ESG providers that provide data to evaluate ESG factors (including issuer-specific ratings or scores).

Form N-CEN also would be amended to “collect census-type information regarding [ESG] funds and the ESG-related service providers they use in structured data language”<sup>29</sup> by adding Item C.3(j) for all three categories of funds, which asks questions tailored to the funds' strategies and processes. A fund that indicates that it incorporates ESG factors would be required to report, among other things:

- the type of ESG strategy it employs (*i.e.*, integration, focused, or impact) as those strategies are defined in proposed Item 4(a)(2)(i) of Form N-1A and proposed Item 8.2.e of Form N-2, as applicable;
- the ESG factor(s) it considers (*i.e.*, E, S, and/or G); and
- the method it uses to implement its ESG strategy (*i.e.*, tracking an index, applying an inclusionary and/or exclusionary screen, proxy voting, engaging with issuers, and/or other).

In responding to proposed Item C.3(j) of Form N-CEN, an Impact Fund would be required to report that it is both an ESG-Focused Fund and an Impact Fund. The proposed amendments also would collect information regarding whether a fund considers ESG-related information or scores provided by ESG providers in implementing its investment strategy. If so, the fund would be required to provide the legal name and legal entity identifier, if any, or provide and describe any other identifying number of each such ESG provider. A fund also would be required to report whether the ESG provider is an affiliated person of the fund. The proposed amendments to Form N-CEN also would require a fund to report whether the fund follows any third-party ESG frameworks.<sup>30</sup> If so, the fund would be required to provide the full name of such frameworks.

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<sup>29</sup> See Proposing Release at 149.

<sup>30</sup> Examples of third-party ESG frameworks include the United Nations Principles for Responsible Investment, the Forum for Sustainable and Responsible Investment, and Ceres. See <https://www.unpri.org/about-us/about-the-pri>.

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### **Form ADV Amendments**

#### Regulatory Reporting on Form ADV Part 1A

The Proposed Rules would amend Form ADV Part 1A for registered advisers and exempt reporting advisers, which the Commission noted would provide additional information about the advisory services provided to separately managed account clients and reported private funds.

##### *A. Item 5. Separately Managed Account (“SMA”) Clients*

The Proposed Rules would include amendments to Item 5.K, specifically applicable to registered advisers or advisers required to be registered with the Commission. Currently, Item 5.K requires advisers to provide information about their advisory businesses with respect to SMA clients. The amendments would require registered advisers to disclose whether they consider ESG factors as part of one or more significant strategies in the advisory services they provide to their SMA clients, including in their selection of other investment advisers and/or as part of their advisory services when requested by SMA clients. If so, the adviser would indicate whether it employs an integration or ESG-focused approach, and if ESG-focused, whether it employs an ESG-impact approach.<sup>31</sup> These advisers also would report whether they incorporate one or more of “E,” “S,” and/or “G” into their strategies. Advisers to private funds would include similar information regarding their private funds reported on Form ADV.

The Proposed Rules would amend Item 5.M and would require advisers to report whether they follow any third-party ESG frameworks in connection with their advisory services. If so, the adviser would list the name of that framework(s).

##### *B. Schedule D, Section 7.B.(1). Private Fund Reporting*

The Proposed Rules also would amend Section 7.B.(1), applicable to both registered advisers and exempt reporting advisers, to collect information from private fund advisers about their uses of ESG factors in managing each reported private fund. Specifically, private fund advisers would answer “yes” or “no” to whether the adviser considers any ESG factors as part of one or more significant investment strategies or methods of analysis in the advisory services they provide to each private fund. Depending on this answer, the adviser would have to answer a series of “yes-or-no” questions about the identified ESG factors.

##### *C. Item 6 and Item 7. Related Persons*

The Proposed Rules would include amendments to Item 6 and Item 7, and would require registered advisers and exempt reporting advisers to disclose whether they conduct other business activities as ESG providers or have related persons

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<sup>31</sup> If the adviser offers all three, it would choose all three.

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that are ESG providers, and complete the corresponding Sections 6.A and 7.A of Schedule D. For example, Section 7.A would require the adviser to include the related person's SEC File Number and additional information about the adviser's control relationship with the related person, for each that is an ESG provider or offers ESG services. Examples of a related person ESG provider include ESG index providers and ESG scoring providers.

### Form ADV Part 2A Disclosure Amendments

The Proposing Release noted that, given the rising significance investors place on the consideration of ESG factors when making investment decisions, it is important for registered investment advisers that consider ESG factors as part of their advisory businesses to include specific disclosure in their Form ADV Part 2A (the "Brochure").

#### *A. Item 8: Methods of Analysis, Investment Strategies and Risk of Loss*

Item 8 of the Brochure requires registered advisers to describe the methods of analysis and investment strategies used when formulating investment advice or managing assets, and to provide a detailed explanation of any material, significant, or unusual risks presented by each of the advisers' significant investment strategies or methods of analysis. The proposed amendments would add a new sub-Item 8.D, which would require a registered adviser, for each significant investment strategy or method of analysis it uses for which it considers any ESG factors, to provide a description of the ESG factor or factors it considers and how it incorporates these factors when advising clients with respect to investments, including in the selection or recommendation of other investment advisers, and whether and how it incorporates E, S, or G factors, or a combination of ESG factors.<sup>32</sup>

This explanation in Item 8.D would include whether and how a registered adviser employs an integration strategy (discussed above) or:

- considers one or more ESG factors alongside other, non-ESG factors in its investment advice, but such ESG factors are factors in advising its clients with respect to investments, such that ESG factors may not be determinative in providing advice with respect to any particular investment ("integration"); or
- focuses on one or more ESG factors that are a significant or main consideration with respect to client investments or in its engagement strategy with portfolio companies (ESG-"focused").

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<sup>32</sup> "Integration," "ESG-focused," and "impact" are defined similarly for both advisers and funds; with one notable difference. The definition of "ESG-Focused Funds" for funds explicitly includes any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors or whose advertising materials 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. With respect to advisers, the determination of whether an adviser is "ESG-focused" does not specifically incorporate advisers with an ESG-related name.

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## SEC Proposes ESG Rules and Amendments for Investment Advisers and Investment Companies

For any ESG impact strategy or methodology (as discussed above), a registered adviser would provide an overview of the impact(s) it is seeking to achieve and how it is seeking to achieve the impact(s) (including how it measures progress toward the stated impact, disclosing the key performance indicators the adviser analyzes, the time horizon it uses to analyze progress, and the relationship between the impact it is seeking to achieve and financial return(s)).

If the adviser uses criteria or a methodology for evaluating, selecting, or excluding investments in its significant investment strategy or method of analysis based on the consideration of ESG factors, it would describe that criterion and/or methodology and how the adviser uses it for each applicable significant investment strategy or method of analysis. This would include, but is not limited to, a description of whether (and how) an adviser uses any of the following:

- 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;
- 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/or
- an index, including the name of the index and a description of the index and how the index utilizes ESG factors in determining its constituents.<sup>33</sup>

### *B. Item 10: Other Financial Industry Activities and Affiliations*

Registered advisers are currently required to disclose information about their other financial industry activities and affiliations in Item 10 of the Brochure. The Proposed Rules would amend the Brochure to include Item 10.C, which would require a registered adviser to describe any relationship or arrangement that is material to the adviser's advisory business or to its clients, or that the adviser or any of its management persons have with any related person that is an ESG consultant or other ESG service provider, for example, ESG index providers and ESG scoring providers.

### *C. Item 17: Voting Client Securities*

Item 17 of the Brochure requires registered advisers that have, or will accept, the authority to vote client securities to briefly describe their voting policies and procedures. The Proposed Rules would amend Item 17.A of the Brochure to require a registered adviser that has specific voting policies or procedures that include one or more ESG considerations when voting client securities to include in its Brochure a description of which ESG factors it considers and how it considers

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<sup>33</sup> The Commission noted that clients who seek advisory services tailored to their ESG investing goals would refer to advisers' disclosures under Item 4 to assess whether and how an adviser tailors its advisory services to the individual needs of the clients, and whether clients may impose restrictions on investing in certain securities or types of securities. (See Proposing Release at 130.)

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## SEC Proposes ESG Rules and Amendments for Investment Advisers and Investment Companies

them. If a registered adviser has different voting policies and procedures for strategies that address ESG-related matters, or for different clients or different ESG-related strategies, the adviser generally should describe those differences.

### *D. Wrap Fee Program Brochure*<sup>34</sup>

Advisers sponsoring wrap fee programs that consider ESG factors in their wrap fee programs would be required to describe in Item 4 of the specialized brochure that must be delivered to their wrap fee clients (“wrap fee program brochure”) what ESG factors they consider, and how they incorporate the factors under each program.

In addition to Item 4, the Proposed Rules would amend Item 6 of the wrap fee program brochure disclosures, requiring advisers that consider ESG factors when selecting, reviewing, or recommending portfolio managers within the wrap fee programs they sponsor, to describe the ESG factors they consider and how they consider them. The description of ESG factors generally should include the types of ESG information the adviser considers and must include how the adviser considers the ESG factors. The summary of how the adviser considers ESG factors would be required to contain:

- a description of any criteria or methodology the adviser uses to assess portfolio managers’ applications of the relevant ESG factors into their portfolio management;<sup>35</sup>
- an explanation of whether the adviser reviews, or whether a third party reviews, portfolio managers’ applications of the relevant ESG factors;<sup>36</sup> and
- an explanation, if applicable, that neither the adviser nor a third party assesses portfolio managers’ applications of the relevant ESG factors into their portfolio management, and/or that the portfolio managers’ applications of the relevant ESG factors may not be calculated, compiled, assessed, or presented on a uniform and consistent basis.<sup>37</sup>

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<sup>34</sup> In addition to the information covered in this section, the Proposed Rules would further amend Item 6.C to require any adviser that acts (itself or through its supervised persons) as a portfolio manager for a wrap fee program described in its wrap fee brochure (a “sponsor-manager”) to respond to proposed Item 8.D of the Brochure, discussed above. If the adviser is a sponsor-manager that considers ESG factors for a significant strategy of its wrap fee program, the disclosure required by proposed Item 8.D of the Form ADV brochure should also be included in amended Item 6.C of the Form ADV wrap fee program brochure.

<sup>35</sup> The Proposing Release noted that this would include any industry or other standards for presenting the achievement of ESG impacts and/or third-party ESG frameworks, and any internal criteria or methodology. (See Proposing Release at 143).

<sup>36</sup> The Proposed Rules would require advisers to describe the nature of the review and the name of any third party conducting the review.

<sup>37</sup> The Proposing Release noted that the adviser also would be required to state and explain, if applicable, why any ESG factors it considers in evaluating portfolio managers may not be calculated, compiled, assessed, or presented on a uniform and consistent basis. (See Proposing Release at 145).

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## SEC Proposes ESG Rules and Amendments for Investment Advisers and Investment Companies

### **Compliance Policies and Procedures and Marketing**

The Proposing Release cited to the issues noted in the April 2021 ESG Risk Alert in reaffirming advisers' and funds' existing obligations under Rule 206(4)-7 under the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 38a-1 under the Investment Company Act, respectively, when advisers and funds incorporate ESG factors.<sup>38</sup> Specifically, the Proposing Release noted Advisers' and funds' compliance policies and procedures should:

- address the accuracy of ESG disclosures made to clients, investors and regulators;
- address portfolio management processes such that portfolios are managed consistently with the ESG-related investment objectives disclosed by the adviser and/or fund;
- be reasonably designed to ensure the adviser manages the portfolios consistently with how its integration strategy was described to investors; and
- include controls that help to ensure client portfolios are managed in accordance with a fund's disclosed global ESG framework.

The Proposing Release also noted that Rule 206(4)-8 under the Advisers Act prohibits advisers to funds from making false or misleading statements to existing or prospective investors, and therefore generally it would be materially misleading for an adviser to overstate in an advertisement the extent to which it utilizes or considers ESG factors in managing client portfolios.

### **Compliance Dates**

The compliance date of any adoption of the Proposed Rules for the following items would be one year following the effective date, which would be 60 days after the date of publication in the Federal Register:

- the proposed disclosure requirements in prospectuses on Forms N-1A and N-2;
- the proposed disclosure requirements for UITs on Form N-8B-2;
- the proposed regulatory reporting on Form N-CEN; and
- the proposed disclosure requirements and regulatory reporting on Form ADV Parts 1 and 2.

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<sup>38</sup> See Review of ESG Investing, *supra* note 3.

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## SEC Proposes ESG Rules and Amendments for Investment Advisers and Investment Companies

The compliance date of any adoption of the proposed disclosures in the report to shareholders and filed on Form N-CSR would be 18 months following the effective date, which would be 60 days after the date of publication in the Federal Register.

Comments on the Proposed Rules are due to the Commission on or before August 16, 2022.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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