REGISTERED FUNDS AND THE NEW ESG RULE PROPOSALS: EVERYTHING YOU WANTED TO KNOW (BUT WERE AFRAID TO ASK)

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U.S. Asset Management and Investment Funds Alert

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UPDATE: Since this alert was published, the proposals have been printed in the Federal Register, and the comment period will close on 16 August 2022.

EXECUTIVE SUMMARY

On 25 May 2022, the Securities and Exchange Commission (SEC) proposed a series of amendments (the Proposed Amendments) to rules and reporting forms, which purport to provide investors with additional information about registered funds that incorporate environmental, social, and governance (ESG) factors into their investment selection processes. If adopted as proposed, the amendments, which the SEC issued in two separate proposing releases (available here and here), would affect investment companies registered under the Investment Company Act of 1940, as amended (the 1940 Act) in the following ways:

- Modify prospectus and shareholder report disclosure requirements that apply to all investment companies and business development companies (BDCs) registered under the 1940 Act to elicit additional information regarding funds' ESG investment approaches.
- Amend Rule 35d-1 under the 1940 Act (the Names Rule) expanding the scope of names covered by that rule, including names that indicate ESG-related investment strategies, such as “sustainable” or “green.”

This alert focuses on the impact of the proposals on registered funds as they relate to ESG matters. Set forth below is a summary of the relevant changes in the Proposed Amendments as well as highlights of key areas that registered fund complexes and registered fund industry participants should consider when preparing comments in response to the Proposed Amendments. We note the proposals also affect investment advisers in key ways, which are summarized here.

The comment period for the Proposed Amendments is 60 days after their publication in the *Federal Register*.[1] If adopted as proposed, compliance with the Proposed Amendments will be required following a one-year transition period.

PROPOSED ESG-RELATED AMENDMENTS TO REPORTING FORMS

The proposed ESG-related disclosure and reporting requirements for registered funds focus on prospectuses, annual shareholder reports, and Form N-CEN. As the SEC noted in its proposing release, the absence of a

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common disclosure framework for ESG products has made it challenging for investors to compare funds with different ESG strategies and evaluate whether funds support their ESG-related claims with “concrete and specific measures” to address ESG goals.

New ESG Taxonomy

The extent of a fund's disclosure obligations will depend on whether it constitutes an *Integration Fund*, an *ESG-Focused Fund*, or an *Impact Fund* under the proposed rules:

- *Integration Funds* are funds that consider one or more ESG factors alongside other, non-ESG factors in their investment decision making-process, but where such ESG factors are not dispositive in the funds' investment decisions. For such funds, ESG factors would generally not be given greater weight or consideration than other non-ESG factors in the investment selection process.
- *ESG-Focused Funds* are funds that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies. ESG-Focused Funds include, for example, funds that apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement with issuers, and funds that track an ESG-focused index. This category also includes any fund that markets itself as having an ESG focus.
- *Impact Funds* are a subset of ESG-Focused Funds that seek to achieve one or more specific ESG impacts (e.g., advancing the availability of clean water or sustainable management of timberland).

In setting out this framework for categorizing funds by their level of ESG investments, the SEC asked for feedback on whether this approach was appropriate or whether the SEC should undertake to define “ESG” or similar terms or otherwise issue guidance as to what constitutes ESG.

Prospectus Disclosures

Under the Proposed Amendments, a fund engaged in ESG investing would be required to disclose certain additional information about the fund's implementation of ESG factors in its principal investment strategies through a layered disclosure framework. As proposed, open-end funds would provide a concise description of this information in the fund's summary prospectus and a more detailed description in the fund's statutory prospectus.

For closed-end funds, disclosure of summary information would be provided as part of the prospectus's general description of the fund, with the more detailed disclosure presented later in the prospectus.

Integration Fund Disclosure

Integration Funds would be required to explain how they incorporate ESG factors into their investment selection processes and how such ESG factors are considered alongside other factors. In addition to this general requirement, an Integration Fund that considers greenhouse gas (GHG) emissions would also be required to disclose additional information about how the fund considers GHG emissions, including the methodology and data sources that fund may use as part of its consideration of GHG emissions.

ESG-Focused Fund Disclosure

ESG-Focused Funds would be required to provide more detailed disclosure than Integration Funds, including a standardized “ESG Strategy Overview Table” in the fund's prospectus. Part of the table would consist of a “check-box” format for funds to indicate which common ESG strategies the fund employs (e.g., tracks an index, applies a

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screen, seeks to achieve a specific impact, proxy voting, engagement, other), while the rest would require brief narrative descriptions of the ESG factor or factors that are the focus of the fund's strategy, how the fund incorporates these ESG factors into its investment decisions, and how the fund votes proxies or otherwise engages with portfolio companies on ESG issues. These disclosures would be complemented by more detailed descriptions later in the prospectus that would address, among other things, any internal methodology or third-party data provider (if applicable) used in selecting investments, identification of indices the fund tracks (if applicable), and the participation of the fund and (as relevant) the fund's adviser in any third-party ESG frameworks (e.g., United Nations (UN) Principles for Responsible Investment, UN Sustainable Development Goals).

Impact Fund Disclosure

In addition to fulfilling the standard ESG-Focused Fund disclosure requirements, Impact Funds would be required to disclose in their investment objectives the ESG impact the fund seeks to generate with its investments and describe (i) how it measures its progress toward the stated impact, (ii) the time horizon used to measure that progress, and (iii) the relationship between the impact the fund is seeking to achieve and the fund's financial returns.

Annual Shareholder Report Disclosures

In addition to the proposed prospectus disclosure requirements, the SEC proposed amendments that would require funds to include ESG-related information in annual shareholder reports. For registered investment companies, the proposed disclosure would be included in the management's discussion of fund performance (MDFP) section and, for BDCs, in the management discussion and analysis (MD&A) section. These disclosures would include:

- For Impact Funds, a summary of progress towards achieving stated ESG impacts.
- For ESG-Focused Funds that use proxy voting as a significant means of implementing and ESG strategy, information regarding how the fund voted proxies on particular ESG-related voting matters.
- For ESG Focused Funds that use ESG engagement as a significant means of implementing an ESG strategy, information regarding the funds' participation in ESG engagement meetings, including the ESG issues discussed.[2]
- For certain ESG-Focused Funds that consider environmental factors, GHG emission metrics.

Importantly, all ESG-Focused Funds would be required to disclose the carbon footprint and the weighted average carbon intensity in their annual shareholder reports unless the fund affirmatively states that it does not consider issuers' GHG emissions as part of its investment strategy in the ESG Strategy Overview Table in the fund's prospectus (discussed above). Consequently, funds would need to pay particular attention to ensuring consistency between statements regarding GHG emissions made in fund prospectuses and annual shareholder reports. These requirements would dovetail with requirements in similar rules that the SEC proposed in March 2022 that, if adopted as proposed, would require public companies to disclose certain ESG-related information, including GHG emission metrics.

Reporting on Form N-CEN

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As part of the Proposed Amendments, the SEC also proposed revisions to Form N-CEN that would collect census-type information regarding funds and the ESG-related service providers they use. The updates to Form N-CEN would include additional reporting related to:

- The type of ESG strategy a fund employs (i.e., integration, focused, or impact).
- The ESG factor(s) a fund considers.
- The methods a fund uses to implement its ESG strategy (i.e., tracking an index, applying an inclusionary or exclusionary screen, proxy voting, engaging with issues, and others).
- Whether a fund considers ESG-related information or scores provided by ESG providers in implementing its investment strategy.
- Whether the fund follows any third-party ESG frameworks.
- For ESG funds that track an index, the name and legal entity identifier, if any, of the index the funds track.

XBRL Tagging

If the Proposed Amendments are adopted, they will also require that any ESG-related disclosure information in fund registration statements and annual shareholder reports be tagged using the Inline eXtensible Business Reporting Language, which is a structured and machine-readable data language.

EXPANSION OF THE NAMES RULE

If adopted as proposed, the amendments would significantly expand the scope of terms that the SEC considers materially deceptive and misleading in a registered investment company's name.

Currently, the Names Rule requires a fund with a name that suggests investments in certain types of investments, industries, countries, or geographic regions to invest at least 80% of their net assets, plus the amount of any borrowings for investment purposes (an 80% Policy), in holdings aligned with their names. Historically, the SEC has not applied the Names Rule to names that correspond to a particular investment focus or strategy, as strategies had frequently been considered a subjective aspect of a fund's investment policies.

In a key departure from historic practices, the proposal would broaden the scope of the Names Rule to cover fund names that describe investment strategies as well as investment types or industries. Although the expanded Names Rule would apply to many types of investment strategies, this alert focuses solely on its effect on ESG strategies.

This expansion of the Names Rule would have several effects on registered funds that employ ESG strategies:

Expansion of 80% Policy Requirement

Funds that have ESG-related terms in their names would need to adopt investment policies to ensure that 80% of the value of their assets is invested in ESG-related or sustainable investments, or otherwise change their names. Notably, the Proposed Amendments would prohibit Integration Funds (as defined above) from using ESG-related terms in their names. In addition, under the Proposed Amendments, a fund cannot include ESG-related terms in its name if ESG factors are not the determinative consideration in investment decisions.

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- The Proposed Amendments also codify the SEC position from the original Names Rule adopting release in 2001 that technical compliance with the Names Rule is not a safe harbor, and a fund name may be materially deceptive or misleading even where the fund complies with its 80% Policy. As such, the use of "ESG" or similar terminology in the name of an Integration Fund likely would be treated as misleading and in violation of the Names Rule. Further, the proposing release for the Proposed Amendments explains that a fund's name could be materially deceptive or misleading if the fund makes a substantial investment that is antithetical to the fund's investment focus or invests in a way such that the source of a substantial portion of the fund's risk or returns is different from that which an investor reasonably would expect based on the fund's name, regardless of the fund's compliance with the requirements of the Names Rule. Accordingly, the 20% basket that has traditionally been used by funds as a catch-all or as an opportunistic bucket may have limitations if the Proposed Amendments are adopted.

Departures from 80% Policy

The current Names Rule only applies "under normal circumstances" and at the time of investment. However, the Proposed Amendments specify particular circumstances in which a fund may depart from its 80% Policy, including specific time frames for coming back into compliance (generally, as soon as reasonably practicable but in any event within 30 consecutive days, subject to certain exceptions). Unlike the current "time of investment" standard, funds would need to continuously monitor whether their ESG-related investments continue to qualify as such and thus continue to qualify for the fund's 80% Policy.

Additional Prospectus Disclosure Obligations

In addition to including the disclosures outlined above in their prospectuses, the proposed amendments to the Names Rule would require a fund with an 80% Policy to include disclosure in its prospectus that defines the terms in its name that are related to the fund's investment focus or strategies, including any specific criteria the fund uses to select the investments the term describes. Further, where a fund's name suggests an investment focus in multiple types of investments or investment strategies, the fund's 80% Policy must address all elements in the name. In particular, the Proposed Amendments would require that funds that include "ESG" in their names must adopt 80% Policies to individually address ESG investments (rather than a single element of the "ESG" term).

- Consistent with the current Names Rule, a fund must define a term used in its name reasonably. However, under the proposed amendment to the Names Rule, a fund using a name that suggests an investment focus, including a focus on ESG-related investments, would be required to use a term consistent with the term's "plain English" meaning or established industry use. Fund issuers would be prohibited from using fund-naming terminology that differs from the plain English meaning or industry-established use in an effort to more closely align fund-naming terminology with investor expectations.

New Recordkeeping and Reporting Responsibilities

If the Proposed Amendments are adopted, funds that are subject to the amended Names Rule would be required to maintain certain records documenting their compliance with the rule, such as recording which investments are counted toward the fund's 80% Policy, dates of such departures from the 80% Policy, and any related shareholder communications. In addition, funds would be required to report on Form N-PORT whether each portfolio investment was included in the 80% basket at the end of the period. Further, all funds will be affected by the

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amended Names Rule, as funds that do not adopt an 80% Policy would be required to maintain a written record of their analysis that such an 80% Policy is not required under the Names Rule in light of the fund's name.

For more information about these and other proposed changes to the Names Rule outside of the ESG context, please read our recent client alert on the SEC's proposal.

KEY TAKEAWAYS AND REQUESTS FOR COMMENTS

The comment period for the Proposed Amendments is 60 days after their publication in the Federal Register. The ESG proposals, if adopted as proposed, will impose a prescriptive regime that will impose compliance costs that could affect a fund complex's appetite to pursue ESG investments.

With respect to the ESG disclosure proposals, the following key areas are likely to affect registered fund complexes and industry participants, and they are ripe for comments:

- The proposed new ESG taxonomy and categorization of funds creates a prescriptive regime that may not align with the way funds manage their ESG investment programs.
- The new ESG disclosure requirements are in parts overly broad in scope and require disclosures that will be costly to document and may not provide a commensurate benefit to investors from an investment standpoint.
- Funds may not be able to appropriately measure, assess, and document the various ESG metrics, including those with respect to proxy voting, engagement, and GHG emissions, which would be required under the proposal.

With respect to the proposed Names Rule amendments, the following key areas are likely to affect registered fund complexes and industry participants, and they are ripe for comments:

- The Names Rule has been expanded to capture ESG-related strategies (rather than investment types), which will require fund complexes to undertake costly reviews and determine whether portfolio holdings and strategies will need to be changed to conform to fund names or (more likely) whether fund names should be changed to better align with existing portfolio holdings and strategies.
- The proposals create a departure from a “time of investment” 80% Policy to one where funds are required to continually monitor that a particular investment makes sense in the context of ESG-related investments.
- Given the proposed compliance period and the interplay between the proposed ESG disclosure requirements and the Names Rule requirements, funds may not have sufficient time to review and determine how to sufficiently define how they have structured their 80% Policies and make all relevant disclosures.

The SEC requested comments on a number of different topics, but ultimately how closely the final rules resemble the proposal will be affected by the level of industry engagement with, and feedback to, the Proposed Amendments.[3]

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FOOTNOTES

[1] As of the date of this alert, the Proposed Amendments have not been published in the *Federal Register*.

[2] The SEC has suggested that ESG Focused Funds may need to adopt new policies and procedures to ensure that this information is recorded at ESG engagement meetings.

[3] See below for a sample of the SEC requests for comment included in the Proposed Amendments, which focus on the key areas identified above.

ESG Taxonomy

1. Whether the SEC should seek to define "ESG" or any of its subparts and include a nonexhaustive list of examples of ESG factors in the various regulatory reporting forms.
2. Whether the definition of "Integration Fund" is appropriate and clear and whether there are funds that do not currently consider themselves to integrate ESG factors but would fall under this definition and be required to provide disclosures.
3. Whether ESG-Focused Funds should be defined as proposed as funds that focus on one or more ESG factors by using them as a significant or main considerations in selecting their investments or their engagement strategy with issuers of their investments.

ESG Prospectus Disclosures

4. Whether the disclosure requirements should apply equally to registered open-end funds, registered closed-end funds, and BDCs.
5. Whether there are, or should be, additional distinctions that the proposed disclosure rules make besides the proposed distinctions between Integration Funds and ESG-Focused Funds for the level of detail required in prospectus disclosures.
6. Whether the "ESG" in the ESG Strategy Overview Table name should be replaced with another term or phrase that a fund believes more accurately describes the ESG factors that the fund considers.
7. Whether there are alternatives to the prospectus ESG Strategy Overview table's layered approach that would be more helpful to investors.
8. Whether the SEC should prescribe how extensive an inclusionary or exclusionary screen must be in order for a fund applying the screen to be an ESG-Focused Fund and, relatedly, whether funds should be required to describe any exceptions to their screening mechanisms.

ESG Annual Report Disclosures

9. Whether environmentally focused funds should be required to disclose their GHG emissions, whether alternative metrics are more appropriate, and whether this information is useful to investors.
10. Whether funds should be required to provide impact, engagement, and GHG emissions disclosure in their annual reports in the MDFP or MD&A sections, as applicable, or whether these disclosures should instead appear in another regulatory document.
11. Whether the required prospectus or annual shareholder report disclosures should be revised or included

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in different parts of each filing.

Names Rule Amendments

12. Whether the Names Rule should be expanded, as proposed, to apply to names that suggest an investment focus in investments or issues that have particular characteristics, including ESG-related investments.
13. Whether investors rely on ESG-related terms in a fund's name as indications of the kinds of companies in which the fund invests or does not invest.
14. Whether funds currently “drift” away from the investment focus suggested by their name and how effective would the proposed rule be at addressing materially deceptive or misleading names over time.
15. Whether funds will be able to reasonably determine what investments qualify as ESG-related for their 80% baskets under the proposed rule.
16. Whether the Names Rule should include a specific provision requiring funds with ESG (or similar terminology) in their names only to attribute a particular type of investment towards their 80% basket.
17. Whether there are any circumstances in which a fund's name could be misleading or deceptive, even when it complies with the 80% Policy requirement, and whether the SEC should codify in the rule, as proposed, the position that the Names Rule's 80% investment policy requirement is not intended to create a safe harbor for fund names.
18. Whether the SEC should consider a fund name as materially deceptive or misleading when an Integration Fund uses ESG-related terms in its name.
19. Whether a fund should be able to use an ESG term in its name as long as the fund also identifies itself in its name as an Integration Fund (e.g., “XYZ ESG Integration Fund”).
20. Whether the SEC should further limit the extent to which funds may use specific ESG-related terms in their names, for example, permitting the use of certain terms only if a fund has a certain investment focus.

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