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Kirkland Alert

SEC Proposes Pair of Long-Awaited ESG Rules; Non-ESG Funds Swept Up as Well

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On May 25, 2022, in a long-awaited move, the U.S. Securities and Exchange Commission ("SEC") issued a pair of rule proposals related to the use of environmental, social and governance ("ESG") investment practices by open-end and closed-end registered investment companies, as well as by business development companies ("BDCs," and collectively, "funds"). The SEC's stated goals with these proposals are to increase transparency and confidence in funds that consider ESG factors as part of their investment process, given the recent and ongoing dramatic growth in investor interest in ESG investing. The SEC believes that investors looking to participate in ESG investing currently face a lack of consistent, comparable and reliable information among funds that claim to consider one or more ESG factors.

The first proposal seeks to create a robust disclosure and reporting framework for funds regarding their ESG investment practices. To effectuate this goal, the proposal would make a number of amendments to the registration and reporting forms utilized by funds in their securities offerings and ongoing periodic reporting. While the SEC does not generally prescribe specific disclosures for particular investment strategies, the SEC believes that ESG strategies and disclosures differ materially in certain respects that necessitate specific requirements and mandatory content standards to assist investors in making more informed investment decisions.

The second proposal would amend Rule 35d-1 (the so-called "Names Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act"), to, among other things, add new requirements for funds that consider ESG factors in connection with their investment practices. The SEC believes that the Names Rule, which has not been amended since its adoption over 20 years ago, has not kept pace with industry developments and product evolution. Additionally, the SEC emphasized that competitive pressures may incentivize asset managers to include words in a fund's name as a way to attract investor assets — for example, terms related to ESG.

Further, the SEC expressed concern that the current Names Rule may permit funds to depart, over time, from the investment focus suggested by their name. Importantly, the proposed amendments to the Names Rule also would have significant implications for non-ESG funds, especially for those funds that may invest in more illiquid assets (including funds of private funds), and would mark a significant change, as the rule does not currently apply to commonly used fund names that focus on investment strategies instead of particular investments, such as "growth" or "income" funds.

Each proposal was approved by the SEC in a 3-1 vote along party lines, with Commissioner Peirce dissenting. The proposals will remain open for public comment for **60 days** after their publication in the Federal Register.

Proposed Enhanced ESG Disclosures for Funds

The SEC's proposed amendments would require funds to provide additional information regarding their ESG investment practices in their registration statements and annual reports. In the same release, the SEC also proposed similar disclosure requirements for registered investment advisers and exempt reporting advisers, which we cover in a separate *Kirkland AIM*.

Proposed Disclosure and Reporting Amendments

The SEC's proposal would require funds that utilize ESG factors as part of their investment strategies to include additional disclosures in their registration statements and annual reports (i.e., in MDFPs and MD&As). Consistent with the SEC's recent approach to disclosure enhancements, the proposal would utilize a layered approach — for example, open-end funds would be required to include key information in the summary section of their prospectuses, with all funds providing more detailed information elsewhere in their prospectuses.

The proposal distinguishes among funds based on the extent to which they consider ESG factors in their investment processes. Funds that utilize ESG factors to a greater extent would be required to include more detailed disclosures regarding their use of ESG factors than funds that only consider ESG factors in combination with other non-ESG factors. In this regard, the proposal refers to three categories of ESG funds:

- *Integration funds.* Funds that consider ESG factors in making their investment decisions, but give them no greater weight than non-ESG factors. An integration

fund would be required to describe, in a few sentences in its prospectus, how ESG factors are incorporated into its investment processes.

- *ESG-focused funds.* Funds for which ESG factors are a significant or main consideration in selecting investments or in their engagement strategies with portfolio companies. An ESG-focused fund would be required to provide detailed ESG disclosures, including the following standardized ESG strategy overview table in its prospectus:

<table>
<tr><td rowspan="2">Overview of the Fund's [ESG] strategy</td><td></td></tr>
<tr><td>The Fund engages in the following to implement its [ESG] Strategy:

□ Tracks an index
□ Applies an inclusionary screen
□ Applies an exclusionary screen
□ Seeks to achieve a specific impact
□ Proxy voting
□ Engagement with issuers
□ Other</td></tr>
<tr><td>How the Fund incorporates [ESG] factors in its investment decisions</td><td></td></tr>
<tr><td>How the Fund votes proxies and/or engages with companies about [ESG] issues</td><td></td></tr>
</table>

- *Impact funds*. Impact funds, which seek to achieve a particular ESG objective, would be required to disclose in their annual reports their progress in achieving their objective(s), both in quantitative and qualitative terms, as well as the key factors that materially affected their ability to achieve their objective(s). The SEC proposes to define impact funds as a subset of ESG-focused funds, and, therefore, impact funds also would be required to include in their prospectuses the disclosures noted above for ESG-focused funds.

Greenhouse Gas Reporting

The SEC's proposal also would create new disclosure standards for Greenhouse Gas ("GHG") reporting for funds that consider environmental factors. The proposal would require all ESG-focused funds that consider environmental factors (as indicated in their Form N-CEN filings) to disclose additional information regarding the GHG emissions associated with their portfolio company investments, unless they affirmatively disclose in the ESG strategy overview table that they do not consider GHG emissions as part of their investment strategy. The SEC believes that this information will provide investors with consistent, comparable and reliable data to review funds that market themselves as focusing on climate factors in their investment process.

Significantly, the proposal would require these funds to disclose in their annual reports their portfolio's (1) carbon footprint and (2) weighted average carbon intensity. The carbon footprint and weighted average carbon intensity calculations would be based on portfolio companies' Scope 1 and 2 emissions, and funds would not be allowed to reduce the GHG emissions associated with a portfolio company based on the company's use of purchased or generated carbon offsets.[1] In addition, these funds would be required to separately disclose by industry sector, in their annual reports, the Scope 3 emissions of their portfolio companies to the extent such data is reported by their portfolio companies.

In an effort to promote reporting consistency among funds, the SEC's proposal provides instructions for performing the GHG calculations, which are generally consistent with the GHG Protocol and Partnership for Carbon Accounting Financials (“PCAF”) standards.[2] The proposed rulemaking also provides guidance on the information sources funds should rely on for GHG emissions and valuation information. If GHG emissions information is not available for certain portfolio companies, the proposal directs funds to make a good faith estimate of those companies' Scope 1 and 2 emissions. The proposal does not prescribe any particular methodology for the estimation, but does require funds to disclose details about the estimation procedure

it uses, as well as the percentage of the aggregate portfolio GHG emissions calculated with that procedure.

Integration funds that consider GHG emissions would be subject to a lesser requirement to disclose in their prospectuses how they consider GHG emissions as part of their overall investment process, including the methodologies and data sources the fund utilizes. For example, an integration fund that considers GHG emissions might disclose that it considers such emissions only with respect to potential investments in certain "high emitting" market sectors, such as energy. This information would be found later in a fund's prospectus (i.e., not in the summary section for open-end funds).

Voting and Reporting Requirements

The SEC's proposal would require funds that use either proxy voting or engagement with issuers as a significant means of implementing their ESG strategies to provide additional information in their annual reports about the following matters:

- *Proxy voting*. Funds would be required to disclose how they voted proxies relating to portfolio securities on ESG issues during the reporting period.
- *"ESG engagement meetings."* The proposal would define an "ESG engagement meeting" to mean a substantive discussion with a company's management advocating for one or more specific ESG goals, provided that any progress that is made toward meeting such goal is measurable. Funds would be required to disclose the number or percentage of companies with which they held ESG engagement meetings and the total number of ESG engagement meetings, as well as the progress of such engagement on any key performance indicators.

In an effort to provide clarity and transparency, the proposal encourages funds to memorialize the discussion of ESG issues, including the creation and preservation of meeting agendas and contemporaneous notes of engagements relating to ESG issues, in their compliance policies and procedures to maximize the accuracy of reporting on the number of engagements.

Additional Disclosure Requirements

The proposal includes amendments to Form N-CEN that are designed to collect additional census-type information about funds' use of ESG factors, including their

use of ESG service providers. The proposed amendments would collect information on the ESG strategy a fund employs (i.e., integration, focused or impact), the ESG factors it considers, the method it uses to implement its ESG strategy, as well as whether the fund considers ESG-related information or scores provided by a service provider.

To further increase investors' access and ability to locate relevant information, the proposal requires that all ESG-related disclosures would be required to be in a machine-readable Inline XBRL format.

Transition and Compliance Matters

The SEC has proposed a one-year compliance period, from the effective date of any final rulemaking, with respect to compliance with (i) the prospectus disclosure requirements and (ii) regulatory reporting on Form N-CEN. The SEC has proposed a longer, 18-month compliance deadline, for annual report disclosure obligations.
The SEC also highlights in the proposal its views that a fund's compliance policies and procedures should address (i) the accuracy of ESG-disclosures made to investors as well as (ii) portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the fund.

Proposed Amendments to the "Names Rule"

In a more sweeping rulemaking, the SEC proposes to amend the Names Rule with the stated intent to ensure that a fund's name accurately reflects its investments and related risks, and to provide clarity and transparency to investors on the nature of their investments. Although the SEC has cautioned that investors should not rely on a fund's name as the sole source of information about a fund, a fund's name is a key piece of information for investors, as well as an important marketing tool, and can have a significant impact on investment decisions.

Originally adopted in 2001, the Names Rule currently requires a fund with a name that suggests a focus in a specific type of investment, industry (or group of industries), or geography to adopt an investment policy requiring investment of at least 80% of the value of its assets in the suggested focus areas (the "80% Requirement"). As a precursor to the proposal, the SEC published a Request for Comment on Fund Names in March 2020, which sought public comment on the framework for addressing fund names, particularly in light of market and other developments (e.g., increased use of

derivatives and similar financial instruments, growth in ESG and similar products, electronic delivery of fund information to investors).

Proposed Amendments

Modernization of the 80% Requirement. The SEC and its staff have historically taken the position that fund names that incorporate terms that describe a fund's investment “strategy,” but not a particular investment “focus,” are not subject to the 80% Requirement. In a significant departure from that position, the proposal would expand the 80% Requirement to apply not only to fund names that suggest investment in certain types of assets, but also to names such as "growth" or "value" that suggest the fund's investment strategy as well as risks associated with that strategy. This proposal also would pick up fund names that include "global" or "international" as well as "income," all of which were previously outside of the 80% Requirement.

In addition, the proposal seeks to bring naming standards in line with market practices by requiring funds investing in various types of derivatives to use a derivative instrument's notional amount, rather than its market value, for the purpose of determining compliance with the 80% Requirement.[3] This valuation process would not affect a fund's valuation practices under Rule 2a-5. Though the use of notional value is intended to increase transparency, in practice, it could have beneficial or detrimental effects, as it could facilitate compliance by certain funds (e.g., those with economic exposure to investments suggested by the fund's name) but also make compliance more difficult for others (e.g., those with economic exposure to investments other than those suggested by the fund's name).

The proposal also seeks to provide consistency and transparency to investors by expanding the Names Rule to apply to fund names indicating that the fund's investment decisions incorporate one or more ESG factors.[4] The use of ESG or similar terminology in a fund's name has become increasingly common, and such practice would violate the proposed amendments to the Names Rule if the identified ESG factors do not play a central role in the fund's strategy. If an ESG term is included in a fund's name, the fund must be an ESG-focused fund (i.e., ESG factors must play a central role in the fund's investment strategy). ESG integration funds would be prohibited from using ESG terminology in their name.

The proposal also includes a provision to the Names Rule providing that a fund's name may be materially deceptive or misleading under Section 35(d) even if the fund adopts an 80% Requirement and otherwise complies with the requirement to adopt and

implement such a policy (i.e., compliance with the Names Rule would not provide a safe harbor for compliance with Section 35(d) of the Investment Company Act). As a related matter, the proposal also seeks to solidify previously-enacted obligations of funds to have policies and procedures under Rule 38a-1 that are designed to prevent violations of Section 35(d), even if a fund is not required to comply with the 80% Requirement under the proposal.

Changes over Time and Temporary Departures from the 80% Requirement. Pursuant to the current Names Rule, a fund is required to invest in accordance with its 80% Requirement "under normal circumstances" (which is not defined by the rule), and compliance with the 80% Requirement is tested at the time of an investment by the fund. To further increase continuity in standards around funds' naming conventions, the proposal would eliminate the "under normal circumstances" concept and, instead, establish a limited time frame and specific circumstances in which a fund would be permitted to deviate from its 80% Requirement. Temporary departures would be permitted only: (i) as a result of market fluctuations (or similar events) unrelated to the purchase or sale of an investment by a fund; (ii) to address unusually large cash inflows into, or redemptions out of, a fund; (iii) to take certain defensive positions as a result of adverse market, economic, political or other conditions; and (iv) portfolio repositioning in connection with fund launches, reorganizations (as defined in Section 2(a)(33) of the Investment Company Act) or changes to the 80% Requirement. A fund generally would need to come back into compliance with the 80% Requirement within 30 days, except it would have 60 days to reposition its portfolio following notice to investors of a change to its 80% Requirement or 180 days in connection with its initial launch.[5] In all instances, a fund would have to come back into compliance as soon as reasonably practicable.

Unlisted Closed-End Funds and BDCs. The proposal would require any closed-end fund or BDC whose shares are not listed on a national securities exchange and that has an 80% Requirement to make such policy a fundamental investment policy that cannot be changed without approval of a majority of the fund's outstanding voting securities. The SEC cited the limited liquidity of investors in these funds as the impetus for the proposed change — that is, it would provide investors an opportunity to vote on a change in the fund's investment policy as those investors cannot "vote with their feet" by redeeming their fund shares at net asset value (for mutual funds) or selling their shares in the secondary market (for listed funds) at a current market price.

Modernization of the Notice Requirement. The proposal would retain the current Names Rule requirement that investors receive notice of a change to a fund's 80% Requirement (unless a shareholder vote is required) as well as a change to the fund's

name that accompanies the change to the 80% Requirement. The proposal would update this requirement to permit funds to use electronic delivery methods to provide such notice.

Additional Elements of the Proposed Amendments. The proposal would amend prospectus disclosure requirements under fund registration forms (e.g., Forms N-1A and N-2) to require a fund to define the terms used in its name, including the criteria the fund uses to select the investments that the terms describe (which must be tagged using Inline XBRL). The proposal would require any terms used in a fund's name that suggest an investment focus, or that the fund is a tax-exempt fund, to be consistent with those terms' plain English meaning or established industry use and would add new recordkeeping and reporting requirements (on Form N-PORT). However, money market funds and BDCs would not be subject to the Form N-PORT reporting requirements.

Transition and Compliance Matters

The SEC has proposed a one-year compliance period, from the effective date of any final rulemaking, for the proposed amendments to the Names Rule. The SEC staff also is reviewing no-action letters and other statements with respect to the Names Rule to determine if such letters or statements, in whole or in part, should be withdrawn in connection with any final rulemaking.

Takeaways

It is no surprise that the SEC has proposed rulemakings to address funds' use of ESG factors in their investment practices and names. Several Commissioners have spoken publicly of the need to impose consistent standards to assist investors in making their investment decisions, and also to prevent funds from exaggerating the extent to which they consider ESG factors.[6] This continues, however, to be a controversial topic, and Commissioner Peirce, along with certain members of Congress, have expressed their opposition to additional ESG disclosures, with Commissioner Peirce arguing that the SEC already has a sufficient solution to address so-called greenwashing, namely, enforcement of existing laws and rules.[7]

Given the current composition of the SEC, it appears likely that these proposals ultimately will be adopted (albeit perhaps in a modified form). Therefore, to the extent funds that consider ESG factors have not done so already, they should begin to

consider the practical operational implications of these proposed disclosure requirements, including the following:

- *Evaluation of Fund Names.* Funds should assess whether it is advisable to remove certain words from their names to simplify compliance with the Names Rule. For over 20 years, funds have relied on the SEC's position, as supplemented by its staff, that intentionally excluded types of investment strategies, as contrasted to actual investments, from the 80% Requirement. Recent comments from the SEC staff during the disclosure review process have suggested that the SEC has been looking to broaden the application of the Names Rule, and this proposed rulemaking is consistent with those comments. Funds that use words like "growth" or "value", as well as "income" or even "global" or "international," should start to consider their ability to adopt and comply with an 80% Requirement. Although it affects a smaller universe of funds, closed-end funds and BDCs that invest in illiquid securities (especially funds that invest in underlying private funds) face an additional complication, as such funds (in particular funds of private funds, as the underlying funds are not subject to Rule 35d-1) may not be in a position to rebalance their portfolios in the timeframe mandated by the proposed rule amendments. As a result, such funds may need to consider name changes that, ironically, may provide investors with reduced information about the funds' investments and investment strategies.
- *Development and Refinement of ESG Disclosure Procedures (and Strategies)*. Apart from fund names, all funds that consider ESG factors should consider how they would be classified under the proposals and how they would implement the required ESG disclosures into their registration statements and annual reports. Funds that are also subject to ESG regulation in other jurisdictions, such as the European Union's Sustainable Finance Disclosure Regulation ("SFDR") should consider evaluating all existing and potential regulatory requirements at the same time, to help inform the development of comprehensive compliance procedures as well as consistent disclosures to all investors and regulators.[8] Funds that do not currently have processes in place to comply with the more significant disclosure requirements applicable to ESG-focused funds should weigh the costs associated with developing and maintaining those procedures against the benefits of that classification.
- *Ensuring Investment Practices Are Consistent with Stated Disclosures*. The SEC's proposal — and Commissioner Peirce's statement against it — note the SEC's existing authority to take enforcement action when funds are managed inconsistent with their stated investment objectives. In light of continued SEC scrutiny around ESG investing, funds may wish to consider carefully reviewing their ESG investment practices to ensure they are consistent with disclosures to investors, including with

respect to application of particular ESG frameworks, screens, or engagement practices.

In considering the above, funds that would be subject to the proposed rulemakings may also wish to consider any cost, feasibility, or other concerns — or key aspects of the proposals that they wish to see retained — that may warrant participation in the public comment process, either on their own or as part of an industry group.

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1. A fund would be allowed to separately disclose information about offsets. Also, funds would not be allowed to subtract GHG emissions associated with short positions.↩

2. The SEC's proposed climate disclosure requirements for public companies, which we discuss in a March 24 *Alert*, also bases its emissions disclosure requirement on the GHG Protocol and references PCAF as a methodology to calculate "financed emissions."↩

3. The notional value test, which would require a fund to convert interest rate derivatives to their 10-year bond equivalent and delta adjust the notional amounts of options contracts, includes certain adjustments, including the deduction of cash and cash equivalents from the fund's assets up to the notional amounts of the fund's derivatives instruments.↩

4. The proposing release does not define ESG factors but cites the following examples of ESG terminology: "socially responsible investing," "sustainable," "green," "ethical," "impact," or "good governance" to the extent they describe environmental, social and/or governance factors that may be considered when making an investment decision. See p. 19 of the Names Rule proposal.↩

5. The proposal does not specify a time frame regarding departures from the 80% Requirement as a result of reorganizations.↩

6. *Comm'r Allison Herren Lee*, Shelter from the Storm: Helping Investors Navigate Climate Change Risk (Mar. 21, 2022); *Comm'r Caroline A. Crenshaw*, Virtual Remarks at the Center for American Progress and Sierra Club: Down the Rabbit Hole of Climate Pledges (Dec. 14, 2021); and *Comm'r Allison Herren Lee,* A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC (Mar. 15, 2021).↩

7. Commissioner Pierce cited as an example the SEC's recent enforcement action against BNY Mellon Investment Adviser for misstatements and omissions concerning ESG considerations.↩

8. Many of the requirements of the SEC's proposals echo the European Securities and Markets Authority's recent Supervisory Briefing on Sustainability Risks and Disclosures in the Area of Investment Management, which notes,

for example, that “[f]unds’ names should not be misleading, as the disclosure of sustainability characteristics should be commensurate with the effective application of those characteristics to the fund.”↩

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Practices

- ESG & Impact
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Suggested Reading

- 16 November 2022 - 17 November 2022 Sponsored Event PEI Responsible Investment Forum Europe
- 08 November 2022 - 10 November 2022 Sponsored Event PERE America Summit 2022
- 25 July 2022 - 26 July 2022 Sponsored Event Pension Bridge Private Equity Exclusive

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