

June 6, 2022

SEC Proposes Enhanced ESG Disclosure Requirements for Investment Advisers and Investment Companies

Proposal Would Apply to Investment Advisers, Registered Investment Companies and Business Development Companies That Consider ESG Factors

SUMMARY

On May 25, 2022, the Securities and Exchange Commission (the “SEC”) voted 3 to 1 (Commissioner Peirce dissenting)¹ to propose enhanced disclosure requirements regarding the environmental, social and governance (“ESG”) practices of registered investment advisers, certain advisers that are exempt from registration, registered investment companies and business development companies.² The proposal states that the proposed rule and form amendments are “designed to create a consistent, comparable, and decision-useful regulatory framework . . . to inform and protect investors.”³ While the proposal’s prescriptive approach of mandating specific disclosures for funds and advisers for a particular investment strategy diverges from the SEC’s historical principles and materiality-based reporting framework, the approach is consistent with the SEC’s recent proposal on climate-related disclosures for public companies.⁴

The proposed amendments follow a number of public statements by SEC Chair Gensler and other commissioners, as well as actions by the SEC staff, evidencing an increasing focus on disclosures of advisers and funds that implement an investment strategy that incorporates ESG criteria.⁵ The proposed amendments were issued concurrently with proposed amendments to Rule 35d-1 under the Investment Company Act, the “Names Rule,” which, if adopted, would apply broadly to ESG funds and, among other things, prohibit the use of ESG terminology in names of so-called “ESG integration” funds that consider ESG factors alongside other, non-ESG factors in investment decisions but are generally no more significant than the other factors in the investment selection process.⁶

SULLIVAN & CROMWELL LLP

If adopted as proposed, the amendments would meaningfully increase the ESG-related disclosure obligations of funds and investment advisers. Among other things, the proposed amendments would:

- Define three types of ESG funds—“Integration Funds,” “ESG-Focused Funds” and “Impact Funds”—to which the proposed amendments would apply;
- Require additional specific disclosures regarding ESG strategies in fund prospectuses, annual reports and adviser brochures, which for funds would vary depending on how central ESG factors are to a fund’s strategy;
- Implement a layered, tabular disclosure approach for ESG-Focused Funds;
- Require funds that use proxy voting or engagement with issuers as a significant means of implementing their ESG strategy to provide information about their proxy voting or ESG engagements, as applicable;
- Require Impact Funds to provide information regarding the fund’s progress on achieving its specific impact(s) and the key factors that materially affected the fund’s ability to achieve the specific impact(s); and
- Require ESG-Focused Funds that consider environmental factors as part of their investment strategies to disclose the Scope 1 and Scope 2 greenhouse gas (“GHG”) emissions associated with their portfolio investments, normalized by net asset value and by portfolio revenue, and Scope 3 emissions to the extent reported by their portfolio companies.

Funds and advisers would generally be required to comply with the proposed amendments one year following the effective date of their adoption, and funds would be obliged to include the proposed disclosures in annual reports to shareholders on Form N-CSR 18 months following the effective date of adoption.

The SEC is seeking comment on the proposal, including responses to 198 specific questions included in the Release. Returning to the SEC’s traditional comment period for rule proposals, comments are due 60 days after the Release is published in the Federal Register.⁷

BACKGROUND

The Release states that investor interest in ESG strategies has rapidly increased in recent years, with significant inflows of capital to ESG-related services and investment products.⁸ Although the actual size and scope of ESG-related products and services offered vary significantly depending on the focus of the analysis, the growth is significant, with one study reporting that “since 1995, the ‘U.S. sustainable investment universe’ has increased more than 25 times from \$639 billion to \$17.1 trillion.”⁹ In light of the growing investor interest and varying practices of funds and advisers in ESG investing, the SEC expressed concern that “the lack of specific disclosure requirements tailored to ESG investing creates the risk that funds and advisers marketing such strategies may exaggerate their ESG practices or the extent to which their investment products or services take into account ESG factors,”¹⁰ a practice commonly known as “greenwashing.”

SULLIVAN & CROMWELL LLP

The topic of greenwashing has become a priority for the SEC.¹¹ In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement aimed at “[developing] initiatives to proactively identify ESG-related misconduct.”¹² In the following month, the SEC’s Division of Examinations issued a Risk Alert to highlight “observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing,”¹³ which noted that the SEC staff had observed, among other things, inconsistencies between disclosures about ESG approaches and actual portfolio management practices, inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices, and inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm’s practices.¹⁴ More recently, the SEC’s Division of Examinations announced ESG investing as one of its 2022 examination priorities, stating that the examinations will typically focus on the accuracy of funds’ ESG-related disclosures, implementation of policies and procedures designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures, and alignment of proxy voting policies and procedures with ESG-related disclosures and mandates.¹⁵ One of the articulated purposes of the proposed amendments is to “provide consistent standards for ESG disclosures, allowing investors to make more informed decisions as they compare various ESG investments.”¹⁶

At the open meeting regarding the proposed amendments, Commissioner Peirce voted against the proposal, stating that the proposal “avoids explicitly defining E, S, and G, yet implicitly uses disclosure requirements to induce substantive changes in funds’ and advisers’ ESG practices” rather than requiring simple disclosures on how the fund defines ESG and how products or services align with such definition.¹⁷

The proposed amendments come on the heels of the SEC’s expansive proposed rules regarding climate-related disclosure for U.S. public companies and foreign private issuers, which were issued in March 2022. For more information on that set of proposed rules, which would require public companies to disclose among other things, detailed information about GHG emissions, climate transition plans, climate targets, risks and financial impacts, please refer to our publication [here](#).¹⁸

OVERVIEW OF THE PROPOSED AMENDMENTS

Acknowledging that funds vary in the extent to which ESG factors are considered in a fund’s investment strategy, the proposed amendments would categorize funds that consider ESG factors into the following three categories:

- **“Integration Fund”** would be defined as a fund that considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.¹⁹
- **“ESG-Focused Fund”** would be defined as a fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its

SULLIVAN & CROMWELL LLP

engagement strategy with the companies in which it invests. The proposed definition also explicitly 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 or sales literature indicates that the fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. The Release cites funds that track an ESG-focused index, funds that apply a screen to include or exclude investments in particular industries based on ESG factors or funds with a policy to vote its proxies and engage with the management of its portfolio companies to encourage ESG practices as examples of funds that would be included under this proposed definition.²⁰

- **“Impact Fund”** would be a subset of ESG-Focused Funds – those that seek to achieve a specific ESG impact or impacts.²¹

The proposed amendments, if adopted as proposed, would implement a “layered” disclosure framework, under which the amount of required ESG-related disclosure in a fund's prospectus and ongoing reporting would depend on how central ESG factors are to the fund's strategy.²² Integration Funds would provide comparatively limited disclosures and ESG-Focused Funds would be required to provide more detailed information in a tabular format. Impact Funds would be required to provide the disclosures proposed for ESG-Focused Funds, as well as additional disclosures, including an overview of the impacts the funds seek to achieve and how the funds are seeking to achieve such impacts. Notably, the proposed amendments do not define “ESG” or similar terms but instead require funds to disclose how they incorporate ESG factors into their investment strategies and selection processes.

FUND PROSPECTUS DISCLOSURES

1. Integration Funds

The proposed amendments 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, in addition to the information that funds already are required to provide in their prospectuses about their investments, risks and performance.²³ Open-end funds would provide this information in the summary section of the fund's prospectus, while closed-end funds would disclose the information as part of the prospectus's general description of the fund.²⁴ The proposed amendments include a further specific requirement for Integration Funds that consider GHG emissions to provide detailed information in an open-fund's statutory prospectus or later in a closed-end fund's prospectus regarding how the fund considers GHG emissions of its portfolio holdings, as well as the methodology that the fund uses as part of its consideration of portfolio company GHG emissions.²⁵

2. ESG-Focused Funds

In an effort to facilitate investor comparison of different funds' areas of focus,²⁶ the proposed amendments would require an ESG-Focused Fund (including an Impact Fund) to provide prescribed information about its consideration of ESG factors in a specified tabular format—an ESG Strategy Overview table²⁷—in the

SULLIVAN & CROMWELL LLP

fund's prospectus. The disclosure required by each row in the proposed ESG Strategy Overview table would be as follows:

- **Overview of the Fund's ESG strategy:** This row would require a concise description of the factors that are the focus of the fund's strategy. Further, funds would be required to "check the box" for all listed strategies that apply, including (1) tracks an index; (2) applies an inclusionary screen; (3) applies an exclusionary screen; (4) seeks to achieve a specific impact; (5) proxy voting; (6) engagement with issuers; and (7) other (where none of the common ESG strategies apply).²⁸
- **How the Fund incorporates ESG factors in its investment decisions:** This row would require a summary of how the fund incorporates ESG factors into its process for evaluating, selecting or excluding investments. Funds would be required to provide specific information with respect to each of the common ESG strategies applicable to the fund as identified by the "check the box" disclosure in the overview row as well as an overview of any third-party ESG frameworks that the fund follows as part of its investment process.
- **How the Fund votes proxies and/or engages with companies about ESG issues:** This row would require funds for which engagement with issuers, either by voting proxies or otherwise, is a significant means of implementing their ESG strategy (and accordingly check either the proxy voting or engagement box in the first row of the table) to provide a brief narrative overview of how the fund engages with portfolio companies on ESG issues.²⁹ The narrative should (1) 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, state which ESG considerations those policies and procedures address, and (2) 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, feature an overview of the objectives it seeks to achieve with its engagement strategy.³⁰

3. Impact Funds

In addition to the disclosures required for an ESG-Focused Fund in the ESG Strategy Overview table, an Impact Fund would be required to provide further information in the row "How the Fund incorporates ESG factors in its investment decisions," including (1) an overview of the impact(s) the fund is seeking to achieve; (2) how it will achieve the impact(s); (3) how the fund measures progress toward the specific impact the fund seeks to achieve, including the key performance indicators the fund analyzes; (4) the time horizon the fund uses to analyze progress; and (5) the relationship between the impact the fund is seeking to achieve and financial return(s).³¹

FUND ANNUAL REPORT DISCLOSURES

The proposed amendments would require certain ESG-Focused Funds to provide additional ESG-related information in their annual reports. For registered management investment companies, the proposed disclosure would be included in the management's discussion of fund performance ("MDFP") section of the fund's annual shareholder report. For business development companies ("BDCs"), the proposed disclosure would be included in the management's discussion and analysis ("MD&A") in the fund's annual report on Form 10-K.

1. ESG Impact Fund Disclosure

The proposed amendments would require an Impact Fund to summarize both the fund's progress on achieving its specific impact(s) in both qualitative and quantitative terms during the reporting period and the key factors that materially affected the fund's ability to achieve the specific impact(s).³²

2. ESG Proxy Voting Disclosure

An ESG-Focused Fund for which proxy voting is a significant means of implementing its 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 specific ESG-related initiative at issue. A fund would be permitted to limit disclosure to voting matters involving ESG factors that the fund incorporates into its investment decisions. Additionally, a fund would be required to refer investors to the fund's full voting record filed on Form N-PX by providing a cross-reference to the fund's most recent complete proxy voting record filed on Form N-PX, which would direct investors to the fund's existing granular report that provides its full proxy voting record.³³ The SEC is seeking specific comment on whether funds should be required to provide a narrative explanation of how they cast their proxy votes on ESG matters, either instead of or in addition to the proposed quantitative voting statistics.³⁴ Commenters may also wish to comment on any complexities, ambiguities or burdens with regards to determining whether proxy voting is a "significant means" of implementing its ESG strategy, whether a voting matter involves ESG factors, and how to calculate the percentage of fund votes in furtherance of an ESG voting matter.

3. ESG Engagement Disclosure

The proposed amendments would require ESG-Focused Funds for which engagement with issuers through means other than proxy voting is a significant means of implementing their ESG strategy to disclose progress on any key performance indicators of such engagement. The proposed amendments would also require disclosure of 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 the total number of ESG engagement meetings. As used in the foregoing, the proposed amendments define "ESG engagement meeting" to mean "a substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given time period, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal," which is "intended to identify substantive interactions on ESG issues" and "distinguish an 'ESG engagement meeting' for this purpose from other meetings or interactions for which advocacy on ESG issues is not a focus, or from aspects of a fund's ESG engagement strategy that are not directed to a particular company."³⁵

The Release notes that funds have previously claimed that much of their influence is asserted in private communications outside of formal shareholder votes. The SEC believes that this requirement would both reduce the potential for exaggerated claims of engagement and allow investors to understand better

SULLIVAN & CROMWELL LLP

whether these funds are accomplishing their objectives. The Release notes that funds should generally consider including in their compliance policies and procedures a requirement that employees memorialize the discussions of ESG issues in order to ensure accurate reporting of the true number of ESG engagement meetings.³⁶

4. GHG Emissions Metrics Disclosure

The proposed amendments would require that an ESG-Focused Fund that considers environmental factors as part of its investment strategy disclose the carbon footprint³⁷ and the weighted average carbon intensity (“WACI”)³⁸ of the fund’s portfolio based on the Scope 1³⁹ and Scope 2⁴⁰ GHG emissions of the fund’s portfolio companies. The Release notes that the proposed carbon footprint and WACI metrics are generally aligned with the recommendations from the Task Force on Climate-Related Financial Disclosures and Partnership for Carbon Accounting Financials frameworks and based on emissions data consistent with those defined by the GHG Protocol⁴¹ framework. This proposed requirement would apply to all ESG-Focused Funds that indicate that they consider environmental factors in response to Item C.3(j)(ii) on Form N-CEN, 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 (“Environmentally Focused Fund”).⁴² These proposed requirements would also apply to a BDC that is an Environmentally Focused Fund.⁴³

Scope of Portfolio GHG Emissions Reporting

The proposed amendments provide specific instructions for calculating a fund’s carbon footprint and WACI.⁴⁴ GHG emissions are to be determined at the portfolio company level, and a fund would be required to take into account GHG emissions associated with its investments in other funds or private funds.⁴⁵

Under the proposed amendments, a fund would be required to disclose GHG metrics data in its annual report along with a brief summary of the sources of the data and the amount of estimated GHG emissions used, while providing more detailed information regarding the fund’s process and methodology for calculating and estimating GHG metrics on Form N-CSR (as applicable).

For both carbon footprint and WACI measures, the proposed amendments do 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.⁴⁶ Similarly, if a fund engages in a short sale of a security, the proposed requirements do not permit the fund 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.⁴⁷

GHG Emissions Data Collection and Estimation

The SEC is proposing a “data hierarchy” for sources that funds would be required to use in obtaining portfolio company GHG emissions data. If a portfolio company discloses its Scope 1 and 2 emissions in a

SULLIVAN & CROMWELL LLP

regulatory report, a fund would be required to use that data when calculating its carbon footprint and WACI. If a portfolio company does not file such regulatory reports, or such reports do not contain the GHG information necessary for the fund's purpose, the fund would be required to use GHG data that is otherwise publicly provided by the portfolio company, such as the company's sustainability report. In certain circumstances where, after a reasonable search a fund cannot identify GHG emissions for a certain portfolio company, the proposed amendments would require the fund to use a "good faith estimate" of a portfolio company's GHG emissions.⁴⁸ The SEC believes that "requiring a fund to make a good faith estimate—rather than excluding non-reporting portfolio companies altogether—would allow the fund to ascribe GHG emissions information to each of its portfolio holdings and therefore provide portfolio-wide measures of the fund's carbon footprint and carbon intensity."⁴⁹ However, the SEC recognizes "the methodologies and assumptions underlying different good faith estimates of a company's GHG emissions data may impact the consistency of the data across different portfolio holdings of one fund as well as the comparability of funds with the same or similar portfolio holdings."⁵⁰

Scope 3 Emissions

While the proposed amendments generally only require disclosure of Scope 1 and Scope 2 emissions, an Environmentally Focused Fund would also be required to disclose the Scope 3⁵¹ emissions of its portfolio companies to the extent that Scope 3 emissions data is reported by such companies.⁵² Scope 3 emissions would be disclosed separately for each industry sector in which the fund invests, and would be calculated using the same carbon footprint methodology used for Scope 1 and Scope 2 emissions.⁵³ Funds would not be required to estimate the Scope 3 emissions of their portfolio companies under the proposal.

The Release states the SEC's belief that disclosures on GHG emissions would benefit investors that have made net zero or similar commitments. This issue is front of mind for many asset managers; in 2020, an international group of asset managers launched the Net Zero Asset Managers Initiative (now representing 236 signatories with over \$57 trillion in assets under management), each committing to support the goal of net zero GHG emissions by 2050 or sooner.⁵⁴

UNIT INVESTMENT TRUSTS

Under the proposed amendments, any Unit Investment Trust ("UIT") with portfolio securities selected based on one or more ESG factors would be required to explain how those factors were used to select the portfolio securities. The SEC notes that the proposed amendments are designed to reflect the unmanaged nature of UITs and thus, are less detailed than the disclosure required for other types of funds.⁵⁵

INVESTMENT ADVISER BROCHURE REQUIREMENTS

The SEC proposes to amend Form ADV Part 2A to require information about registered advisers' ESG practices. While the proposed amendments to the brochure requirements share several elements with the

proposed amendments for fund prospectuses and reporting, the proposed amendments to Form ADV reflect that an adviser's brochure typically reflects the entire business of the adviser (rather than a single portfolio strategy as a fund prospectus would) and that key aspects of the advisory relationship, including certain relationships with related persons, are disclosed.⁵⁶

1. Methods of Analysis, Investment Strategies and Risk of Loss

The SEC proposes to add a new sub-item to Item 8.D to Form ADV Part 2A which would require an adviser to provide a description of the ESG factors it considers for each significant investment strategy or method of analysis ("significant strategies") for which the adviser considers any ESG factors. The proposed disclosure would include an explanation of whether and how the adviser employs integration and/or ESG-focused strategies, and if ESG-focused, whether and how the adviser also employs ESG impact strategies. Further, if an adviser uses, for any significant strategy, criteria or a methodology to evaluate, select or exclude investments based on the consideration of ESG factors, the proposed amendments would require the adviser to describe those criteria and/or methodologies and how it uses them.

Similar to the proposed disclosure for funds, the proposed sub-Item 8.D would require advisers to provide a non-exclusive list of criteria and methodology for advisers to address as applicable, including an adviser's use of (1) 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; (2) 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 (3) an index, including the name and a description of the index and how the index utilizes ESG factors in determining its constituents.⁵⁷

2. Other Financial Industry Activities and Affiliations

The SEC proposes to amend Item 10.C of Form ADV Part 2A to require an adviser to describe any relationship or arrangement that is material to the adviser's advisory business or to its clients, and that the adviser or any of its management persons has with any related person that is an ESG consultant or other ESG service provider (e.g., ESG index providers and ESG-scoring providers).⁵⁸

3. Voting Client Securities

The proposed amendments would amend Item 17.A of Form ADV Part 2A to require advisers that have specific voting policies or procedures that include one or more ESG considerations when voting client securities to include in their brochures a description of which ESG factors they consider and how they consider them.⁵⁹ The Release notes that an adviser generally should include whether the adviser allows clients to direct their votes on ESG-related voting matters.⁶⁰

SULLIVAN & CROMWELL LLP

4. Wrap Fee Brochure

The proposed amendments would amend Item 4 of Form ADV Part 2A to specify that advisers that consider ESG factors in their wrap fee programs must provide a description of what ESG factors they consider, and how they incorporate the factors under each program. Further, the proposal would amend Item 6 of Form ADV Part 2A to require 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 how advisers that sponsor wrap fee programs consider the relevant ESG factors must comply with three disclosure requirements under the proposed rule.

- First, the proposed amendments would require the adviser to describe any criteria or methodology it uses to assess portfolio managers' applications of the relevant ESG factors into their portfolio management, including any industry or other standard for presenting the achievement of ESG impacts and/or third-party ESG frameworks, as well as any internal criteria or methodologies.
- Second, the adviser would be required to provide an explanation of whether it reviews, or whether a third party reviews, portfolio managers' applications of the relevant ESG factors described elsewhere. If so, the proposed amendments would further require the adviser to describe the nature of the review and name any third party conducting the review.
- Lastly, the proposed amendments would require that the adviser explain, if applicable, that neither the adviser nor the third party assesses portfolio managers' applications of the relevant ESG factors in 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.⁶¹

REGULATORY REPORTING ON FORM N-CEN AND ADV PART 1A

The SEC proposes to amend Forms N-CEN and ADV Part 1A for registered funds and advisers, respectively, to collect census-type information about funds' and advisers' use of ESG factors using the structured XML-based data languages in which those forms are currently submitted.

1. Form N-CEN

The proposed amendments would add Item C.3(j) to Form N-CEN to ask questions tailored to ESG funds' strategies and processes. A fund that indicates that it incorporates ESG factors would then be required to report, among other things (i) the type of ESG strategy it employs (*i.e.*, integration, focused, or impact); (ii) the ESG factor(s) it considers (*i.e.*, E, S, and/or G); and (iii) 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). The proposed amendments would also require a fund that considers ESG-related information or scores provided by ESG providers in implementing its investment strategy to provide the legal name and legal entity identifier ("LEI") of such ESG provider or provide and describe the other identifying number of each such ESG provider. The proposed amendments would also require a fund to report whether it follows any third-party ESG frameworks and if so, to provide the full name of such

frameworks. Lastly, the proposed amendments would require each index fund to report the name and LEI, if any, or provide and describe the other identifying number of the index the fund tracks.

2. Form ADV Part 1A Reporting

The SEC proposes to amend Form ADV Part 1A to expand the information collected about an adviser's uses of ESG factors in its advisory services provided to separately managed client accounts and reported private funds. The proposed additions to separately managed account reporting would apply only to investment advisers registered or required to be registered with the SEC, and the proposed additions to private fund reporting and other business activities would apply to both registered advisers and exempt reporting advisers, including venture capital fund advisers, as discussed below.

- **ESG Data for Separately Managed Account Clients and Private Funds:** The proposed amendments would require an adviser to disclose whether it considers ESG factors as part of one or more significant strategies in the advisory services it provides to its separately managed account ("SMA") clients, including in its selection of other investment advisers and/or as part of their advisory services when requested by SMA clients. Similarly, if an adviser considers any ESG factors as part of one or more significant investment strategies or methods of analysis in the advisory services it provides to a reported private fund, the adviser would report whether it employs in its management of that private fund an ESG integration approach, ESG-focused approach, or ESG impact approach.⁶²
- **Third-Party ESG Frameworks:** The proposed amendments would require advisers to report whether they follow any third-party ESG frameworks in connection with their advisory services, and if so, the name of the framework.
- **Additional Information about Other Business Activities and Financial Industry Affiliations:** The proposed amendments would require advisers to disclose whether they conduct other business activities as ESG providers or have related persons that are ESG providers. For each related person ESG provider, the adviser would be required to provide additional information as applicable, such as the related person's SEC File Number and the adviser's control relationship with the related person.

COMPLIANCE POLICIES AND PROCEDURES AND MARKETING

In light of the comprehensive nature of the proposed amendments, the Release states that the SEC "believe[s] it would be appropriate and beneficial to reaffirm existing obligations under the compliance rules when advisers and funds incorporate ESG factors."⁶³ The Release specifically notes that advisers' and funds' compliance policies and procedures should address the accuracy of ESG disclosures made to clients, investors and regulators as well as portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives and strategies disclosed by the adviser and/or fund.

COMPLIANCE DATES

If the proposed amendments are adopted, funds and advisers would generally be required to comply with any amendments one year following the effective date of adoption, which would be 60 days after publication

SULLIVAN & CROMWELL LLP

in the Federal Register, and funds would be obliged to include the proposed disclosures in the annual report to shareholders on Form N-CSR 18 months following the effective date of adoption.

* * *

ENDNOTES

- 1 The Commission is currently comprised of only four commissioners following the recent departure of Commissioner Roisman, which was announced in December 2021. See Statement of Commissioner Elad L. Roisman (Dec. 20, 2021), *available at* <https://www.sec.gov/news/statement/roisman-20211220>.
- 2 Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, SEC Release No. IA-6034, at 10 (May 25, 2022) (the “Release”); *see also* Fact Sheet: ESG Disclosures for Investment Advisers and Investment Companies (May 26, 2022), *available at* <https://www.sec.gov/files/ia-6034-fact-sheet.pdf> (“Fact Sheet”).
- 3 Release at 1; *see also* Fact Sheet.
- 4 The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Release Nos. 33-11042, 34-94478 (Mar. 21, 2022) 87 FR 21334 (Apr. 11, 2022), *available at* <https://www.sec.gov/rules/proposed/2022/33-11042.pdf>.
- 5 See Chair Gary Gensler, Prepared Remarks Before the Asset Management Advisory Committee (July 7, 2021), *available at* <https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07>. *See also* Chair Gary Gensler, Prepared Remarks Before the Principles for Responsible Investment “Climate and Global Financial Markets” Webinar (July 28, 2021), *available at* <https://www.sec.gov/news/speech/gensler-pri-2021-07-28>.
- 6 Sullivan & Cromwell, SEC Proposes Amendments to Fund “Names Rule” (June 3, 2022), *available at* [sc-publication-SEC-proposes-amendments-to-expand-fund-names-rule.pdf](https://www.sullcrom.com/sc-publication-SEC-proposes-amendments-to-expand-fund-names-rule.pdf) ([sullcrom.com](https://www.sullcrom.com)).
- 7 The SEC had imposed shorter comment deadlines on several recent rulemaking proposals under Chair Gensler. *See, e.g.*, The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Release Nos. 33-11042 34-94478 (Mar. 21, 2022), *available at* <https://www.sec.gov/rules/proposed/2022/33-11042.pdf>; and Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, SEC Release No. IA-5955 (Feb. 9, 2022), *available at* <https://www.sec.gov/rules/proposed/2022/ia-5955.pdf>. The original deadline for comments on these proposals was 30 days after publication of the proposal in the Federal Register, or 60 days after publication on the SEC website, whichever was later. The SEC subsequently extended the comment period of the climate-related disclosures proposal and reopened comments on the private fund advisers proposal and another proposal that also had a shorter comment period. SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS (May 9, 2022), *available at* <https://www.sec.gov/news/press-release/2022-82>.
- 8 Release at 2.
- 9 *Id.* at 12.
- 10 *Id.* at 8.
- 11 Other jurisdictions have also taken action to regulate ESG-related disclosures and practices for financial products and financial advisers. For example, in July 2021, the UK Financial Conduct Authority (FCA) published its expectations for the design, delivery and disclosure for ESG-focused investment funds. *See* Financial Conduct Authority, Authorized ESG & Sustainable Investment Funds: Improving Quality and Clarity (Jul. 19, 2021), *available at* <https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf>. And in December 2021, the FCA mandated entity- and product/portfolio-level disclosures aligned with the Task Force on Climate-Related Financial Disclosures framework (including GHG emissions) for FCA-regulated asset managers, life insurers and pension providers (regardless of whether environmental criteria are considered for the relevant product). *See*

ENDNOTES (CONTINUED)

- Financial Conduct Authority, Enhancing Climate-Related Disclosures by Asset Managers, Life Insurers and FCA-regulated Pension Providers (Dec. 2021), *available at* <https://www.fca.org.uk/publication/policy/ps21-24.pdf>. Meanwhile, the EU has been implementing a comprehensive disclosure and sustainability risk management regime for financial products and financial advisers (pursuant to the 2019 Sustainable Finance Disclosure Regulation ((EU) 2019/2088) and related regulations), requiring entity- and product-level disclosures (with some disclosures required even when no ESG investment criteria are used).
- 12 See Press Release, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), *available at* <https://www.sec.gov/news/press-release/2021-42>.
- 13 Division of Examinations Risk Alert, The Division of Examinations' Review of ESG Investing (Apr. 9, 2021) at 2, *available at* <https://www.sec.gov/files/esg-risk-alert.pdf>.
- 14 See *id.* at 4-5.
- 15 See Press Release, SEC Division of Examinations Announces 2022 Examination Priorities (Mar. 30, 2022), *available at* <https://www.sec.gov/news/press-release/2022-57>.
- 16 Fact Sheet at 1.
- 17 Commissioner Hester M. Peirce, Statement by Commissioner Peirce on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies (May 25, 2022), *available at* <https://www.sec.gov/news/statement/peirce-statement-esg-052522> (emphasis omitted).
- 18 See Sullivan & Cromwell, SEC Proposes Expansive Climate-Related Disclosure Rules (Mar. 28, 2022), *available at* <https://www.sullcrom.com/files/upload/sc-publication-sec-proposes-expansive-climate-related-disclosure-rules.pdf>.
- 19 Release at 26.
- 20 *Id.* at 33-34.
- 21 *Id.* at 35.
- 22 *Id.* at 23.
- 23 *Id.* at 25-26.
- 24 *Id.* at 26.
- 25 *Id.* at 27-28.
- 26 *Id.* at 41.
- 27 See *id.* at 36 for the ESG Strategy Overview table.
- 28 *Id.* at 41.
- 29 *Id.* at 61.
- 30 *Id.* at 62-63
- 31 *Id.* at 56.
- 32 Release at 74.
- 33 Additional amendments to Form N-PX have been proposed by the Commission that would, among other things, require filers to identify from a standardized list of categories the subject matter of each proxy voting item that they report. *Id.* at 77-78, 78 n.111.
- 34 *Id.* at 79.
- 35 *Id.* at 81.

ENDNOTES (CONTINUED)

³⁶ *Id.* at 82.

³⁷ In the Release, the SEC outlines the calculation that a fund would need to use to determine its carbon footprint. The first step involves calculating the portfolio's enterprise value by adding each portfolio company's equity value to its total debt. Next, the fund would calculate the carbon emissions associated with each portfolio holding by dividing the current value of the fund's investment in the portfolio company by the portfolio company's enterprise value. That value would then be multiplied by the portfolio company's Scope 1 and Scope 2 GHG emissions. To arrive at the fund's carbon footprint, the fund would take the sum of the carbon emissions associated with each portfolio holding and divide the resulting amount by the current net asset value of the portfolio. For further details on the calculation, *see id.* at 95.

³⁸ The SEC also specifies a proposed calculation to determine WACI values in the Release. WACI essentially measures a fund's exposure to carbon-intensive companies. Thus, calculations involve first determining the portfolio weight of each portfolio holding by dividing the value of the fund's investment in the portfolio company by the current net asset value of the fund. Next, the fund would derive the carbon emissions of each portfolio company by dividing the portfolio company's Scope 1 and Scope 2 GHG emissions by the portfolio company's total revenue (in millions of dollars). These emissions would then be attributed to the fund in proportion to the weight of the investment in the fund's portfolio. This calculation must be made individually for each portfolio company in the fund's portfolio. Taking the sum of these individual values yields the fund's WACI. For further details on the calculation, *see id.* at 96-97.

³⁹ Under the GHG Protocol, Scope 1 emissions are "direct GHG emissions that occur from sources owned or controlled by the company, such as emissions from company-owned or controlled machinery or vehicles." *Id.* at 91. The SEC proposes using the following definition for Scope 1 emissions of a portfolio company: "the direct GHG emissions from operations that are owned or controlled by a portfolio company." *Id.* at 99, n.155.

⁴⁰ Under the GHG Protocol, Scope 2 emissions are "those indirect emissions primarily resulting from the generation of electricity purchased and consumed by the company." *Id.* at 91. The SEC proposes defining Scope 2 emissions of a portfolio company as "indirect GHG emissions from the generation of purchased or acquired electricity, steam, heat, or cooling that is consumed by operations owned or controlled by a portfolio company." *Id.* at 99, n.155.

⁴¹ The Greenhouse Gas Protocol, A Corporate Accounting and Reporting Standard, Revised Edition, *available at* <https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf>; Release at 88.

⁴² Release at 88.

⁴³ *Id.* at 89. The Release notes that the emissions disclosure for BDCs would complement the disclosures that would be mandated by another recent proposed rule, which would require BDCs to provide climate-related information in their annual reports on Form 10-K. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Release Nos. 33-11042, 34-94478 (Mar. 21, 2022) 87 FR 21334 (Apr. 11, 2022), *available at* <https://www.sec.gov/rules/proposed/2022/33-11042.pdf>.

⁴⁴ *See supra* notes 37-38.

⁴⁵ The Release defines "portfolio company" as: (a) an issuer that is engaged in or operates a business or activity that generates GHG emissions; or (b) an investment company, or an entity that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act (a "private fund"), that invests in issuers described in clause (a), except for an investment in reliance on 17 CFR 12d1-1 ("rule 12d1-1") under the Investment Company Act (*i.e.*, investments in money market funds). Fund investments that are not portfolio companies include cash, foreign currencies (or derivatives thereof) and interest rate swaps and would therefore be excluded from the GHG metrics calculations. Release at 100-101.

ENDNOTES (CONTINUED)

46 *Id.* at 98.

47 *Id.* at 98-99.

48 *Id.* at 104.

49 *Id.* at 104-105.

50 *Id.* at 106.

51 Under the GHG Protocol, Scope 3 emissions include “all other indirect emissions not accounted for in Scope 2 emissions.” The SEC states that these emissions are “a consequence of the company’s activities but are generated from sources that are neither owned nor controlled by the company.” *Id.* at 91. The SEC proposes to define Scope 3 emissions as “all indirect GHG emissions not otherwise included in a portfolio company’s Scope 2 emissions, which occur in the upstream and downstream activities of a portfolio company’s value chain.” *Id.* at 99, n.155.

52 *Id.* at 108.

53 *Id.* at 108.

54 See Net Zero Asset Managers Initiative Progress Report (Nov. 1, 2021), *available at* <https://www.netzeroassetmanagers.org>. A similar Net-Zero Asset Owner Alliance also exists. See UN-Convened Net-Zero Asset Owner Alliance, *available at* <https://www.unepfi.org/net-zero-alliance/>.

55 *Id.* at 68. The SEC notes that it designed the proposed amendment to provide UIT investors with the ability to understand the role ESG factors played in the portfolio selection process, and emphasized that it is not proposing to differentiate disclosure based on whether a UIT’s selection process was an integration model or an “ESG-focused” model as the portfolio of a UIT is fixed.

56 *Id.* at 127-38.

57 *Id.* at 129-132.

58 *Id.* at 133.

59 *Id.* at 134.

60 *Id.* at 134 n.200.

61 *Id.* at 141-45.

62 *Id.* at 155-57.

63 *Id.* at 165.

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.