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IN FOCUS

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Environmental, Social and Governance Funds: SEC-Proposed Disclosure Reform

On May 25, 2022, citing concerns over lack of consistent, comparable, and reliable investor disclosures regarding environmental, social, and governance (ESG) fund and ESG investment adviser strategies, the Securities and Exchange Commission (SEC) voted 3-1 to issue amendments to regulations implementing the Investment Advisers Act of 1940 (P.L. 76-768) and the Investment Company Act of 1940 (P.L. 76-768) aimed at addressing such perceived inadequacies. The proposal is broadly portrayed as seeking to address "greenwashing"—when a fund overstates the ESG attributes of its investments. This In Focus provides background on the issues prompting the rulemaking, a description of the new rules, and positions of proponents and opponents of the rules.

Background

ESG funds are portfolios of equities and/or bonds, typically in the form of mutual funds, for which ESG considerations have been integrated into the investment process. For example, the fund may invest only in companies with low carbon emissions or that promise to pay workers a living wage. Investor interest in such funds has grown significantly in recent years. According to one industry estimate, domestic ESG funds had $357 billion in assets under management at the end of 2021, more than four times the amount of three years earlier.

The SEC regulates funds and investment advisers primarily through its Division of Investment Management and the Division of Enforcement. The agency does not have rules that specifically govern the use of ESG principles or their disclosures that are relevant to specific factors such as climate change, for example. Applying instead are general rules requiring public disclosure of factors that affect financial returns and are considered "material" for investors.

According to an SEC 2021 statement: "The ways that different funds and advisers define ESG can vary widely. Similarly, there are significant differences in the data, criteria, and strategies used as part of ESG strategies [that] make it harder for investors who seek to understand which investments or investment policies are associated with a particular ESG strategy. In the absence of informative disclosures, a fund's or adviser's disclosure could exaggerate its actual consideration of ESG factors."

The May 2022 fund disclosure reform proposal covered below is one part of a series of related recent SEC developments. In April 2020, the SEC's Division of Examinations warned that its review of ESG funds had found a number of misleading statements regarding ESG investing processes and adherence to global ESG frameworks, among other issues. In March 2021, the agency announced the creation of an ESG Task Force within the Division of Enforcement to analyze disclosure and compliance issues relating to ESG strategies. In May 2022, the SEC also charged and settled with BNY Mellon Investment Adviser over alleged misstatements and omissions concerning various ESG considerations regarding mutual funds that it managed. The case was the aforementioned ESG Task Force's first enforcement action. The same month, the SEC voted in favor of a proposal to modernize its fund naming convention under the Investment Company Act, including ESG-focused funds.

May 2022 ESG Fund and Investment Adviser Disclosure Proposals

The May 2022 proposal would mandate various disclosures for open-end mutual funds, closed-end mutual funds, business development companies (closed-end funds that invest in small, medium-sized, and distressed firms), and investment advisers to institutional and retail investors who strategically incorporate ESG considerations into their investment selection processes. The proposals do not define *ESG* or related terms but, instead, would direct funds and investment advisors who incorporate one or more ESG factors to disclose how (1) ESG factors play a role in their portfolio investment selection procedures and (2) ESG factors are integrated into their investment strategies.

Funds Under the Proposal

As part of this, the proposal identifies several types of ESG funds that dictate various ESG disclosure obligations.

Integration funds would incorporate a combination of ESG factors and non-ESG factors in their investment strategies, and the weight they give to ESG factors would not exceed that for non-ESG factors. The funds would be required to disclose how ESG factors help steer their investment processes. Funds that consider greenhouse gas (GHG) emissions in their strategies would have to provide detailed information on how they consider such emissions of their portfolio companies and the methodologies they use as part of those emissions considerations.

ESG-focused funds (ESG-FFs) would be significantly focused on ESG factors and would be required to submit various new ESG-related disclosures, including a tabular ESG strategy overview that would include whether they track a particular securities index, pursue a particular ESG impact, or apply inclusionary or exclusionary ESG screens. ESG-FFs that use proxy voting or engagement with issuers to implement their ESG strategies would be required to disclose how they voted their proxies and engaged their underlying portfolio securities firms on ESG-related matters. In addition, ESG-FFs with an environmental investment focus would be required to disclose information on the GHG emissions linked to their investments, including Scope 1, 2, and 3 emissions; the carbon footprint; and the weighted average carbon intensity. Scope 1 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; Scope 2 are indirect emissions that result primarily from the generation of electricity purchased and consumed by the company; and Scope 3 are all other indirect emissions not accounted for in Scope 2. The proposal noted that not all portfolio companies that environmentally focused ESG-FFs are invested in publicly provide the necessary GHG emission data. In this case, funds would be required to provide "good faith estimates" of Scope 1 and Scope 2 portfolio company emissions.

Impact funds would be a subset of ESG-FFs that pursue a specific ESG impact (such as underwriting the construction of affordable housing or helping to make clean water more available). In addition to the aforementioned ESG-FF disclosures, Impact funds would be required to disclose how they qualitatively and quantitatively measure progress toward their impact goals and to describe the status of their progress toward the goals.

Investment Advisers under the Proposal

Under the proposals, investment advisers who strategically incorporate ESG factors and advise institutional and retail investors would be required to disclose in their brochures (known as Form ADV Part 2) whether and how they employ Integration-based strategies and/or ESG-focused strategies. If the strategies are identified as ESG-focused, advisers would have to disclose whether and how they also employ ESG impact strategies. If an adviser considers different ESG factors for distinct strategies, separate disclosures would be required for each unique strategy. Advisers would also have to disclose the criteria or methodology used to evaluate, select, or screen out investments in their consideration of ESG factors. Also, if an adviser has specific proxy voting policies involving at least one ESG factor when he or she votes a client's securities, a description in the brochure of which ESG factors are being considered and how they are being considered would be required. Advisers would also have to describe material relationships that they have with related persons who act as ESG consultants or service providers.

Some Supportive Perspectives

The proposal has been generally embraced by financial reform advocates, including the Americans for Financial Reform, and environmental and sustainable investing groups such as the Sierra Club, Ceres, and US SIF.

Proponents cite a number of arguments. On the issue of the SEC's authority to promulgate them (which opponents have raised), they argue that Congress gave the SEC authority to mandate disclosures aimed at protecting investors or to serve the overall public interest via the Securities and Exchange Act of 1934 (P.L. 73-291). An additional argument derives from the notion that a number of conventional funds claim to use ESG information in their investment processes but are hard pressed to explain the nature of its use as investment criteria or the frequency of that use. To address this, the proposal is said to provide a mechanism for such funds to clarify those issues. Another argument is that the proposed emissions reporting by Integration funds will especially benefit investors, including those with various environmental commitments. Another argument is that the emissions reporting will provide investors in environmentally focused funds with a comprehensive view of emissions associated with a fund's financed GHG footprint. An attendant defense is that the emissions reporting will provide quantitative metrics related to climate for investors focused on climate risk while also providing verifiable data from which to evaluate environmental claims, which should help counter exaggerated fund "greenwashed" environmental claims. In support of the enhanced investment adviser brochure is the notion that it will help investors to better understand advisers' approaches to investing and comparing the scope of their emerging investment approaches, including the use of inclusionary and exclusionary screens and their engagement with issuers to achieve their ESG objectives.

Some Critical Perspectives

The proposals have garnered criticism from various business advocacy groups, including the U.S. Chamber of Commerce, the National Federation of Independent Businesses, the Investment Advisers Association, and a major fund trade group, the Investment Company Institute.

A central argument is that the current SEC rules are effective as is, sufficiently requiring fund disclosure of investment objectives, principal investment strategies, and principal investment risks. A corollary assertion is that the volume of prescriptive and standardized disclosure required by the proposal would not give investors useful information for decisionmaking. An additional issue is that the proposal's more prescriptive character could expose funds to various liability risks. Another concern is that the "Integration fund" category would confusingly capture other fund types, including non-ESG-focused ones. A related assertion is that the proposed definition of *ESG-focused funds* would include a fund's engagement with its portfolio companies in areas such as board composition, which could apply to various non-ESG funds as well.

Related CRS Products

CRS In Focus IF11716, *Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues*, by Raj Gnanarajah and Gary Shorter.

CRS In Focus IF12108, *Overview of the SEC Climate Risk Disclosure Proposed Rule*, by Gary Shorter and Rena S. Miller.

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