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Client Alert

SEC Proposes Rules Governing ESG Investment Disclosures

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Investment companies and advisers would be subject to more stringent standards regarding how investment funds are named; and heightened disclosure requirements regarding Environmental, Social, and Governance (ESG) factors, under two proposals the Securities and Exchange Commission (SEC) issued on May 25, 2022. For example, the SEC proposes to amend the "Names Rule," first implemented in 2001, to require that any fund using terminology such as "growth," "value," or "ESG" in its name must invest at least 80% of its assets in investments matching the name. The SEC also proposes to amend regulations under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 to require investment advisers to disclose information such as the carbon footprint of a fund that advertises that such information is part of the fund's strategy. This proposal comes just two months after the SEC proposed sweeping disclosure rules related to climate-related risks, as described in a prior alert.

The Naming and ESG proposals should come as no surprise to those who have been following the SEC in the past year. In February 2021, the SEC's Office of Investor Education and Advocacy issued an investor bulletin identifying factors to consider when evaluating whether to invest in an ESG fund, and making clear that ESG factors might affect performance. In July 2021, Chair Gensler memorably likened investment names to nutrition labels, explaining that it is much more difficult to determine whether a "green" or "sustainable" investment lives up to its name than whether milk marketed as "fat-free" actually contains any fat.

Also in July 2021, the SEC Asset Management Advisory Committee issued "Recommendations for ESG," and included among those recommendations that the SEC "suggest best practices to enhance ESG investment product disclosure, including … [a] clear description of each product's strategy and investment priorities, as well as description of non-financial objectives such as environmental impact or adherence to religious requirements." The committee also suggested that the SEC adopt terminology to classify investment strategies, to align with the E.U. Sustainable Finance Disclosure Regulation (SFDR), which entered into force in March 2021. ESG performance benchmarking was also identified as a tool that could provide investors with important information.

Names Rule:

In the webcast prior to the vote on these proposals, the SEC Commissioners and staff discussed the importance of fund names to investors, and how funds should not be allowed to mask the composition of the fund by using a name that really only conveys the fund's strategy. The SEC highlighted in particular funds with names including the terms "growth," "value," and "ESG" as being particularly problematic.

Consistent with those concerns, the proposed amendment to the Names Rule would, among other elements, do the following:

- Deem a fund name as materially deceptive and misleading unless it "has adopted a policy to invest … at least 80% of the value of its assets in investments in accordance with the investment focus that the fund's name suggests" (which represents an expansion of the existing 80% rule);
- Prohibit "Integration Funds" (e.g., funds that consider multiple factors, including but not limited to one or more ESG factors) from using a name incorporating ESG-related terminology; and
- Require that a fund prospectus includes definitions of the terms used in the fund's name.

Disclosures Rule:

On the disclosures rule, SEC staff and the Commissioners discussed during the open meeting how ESG can encompass a broad set of factors, and how, as a result, there is a risk that a fund may not align with investor expectations without sufficient information provided about the fund. As such, the proposal is intended to provide objective, uniform requirements to serve as guardrails and provide context for investors. The proposal includes, among other elements, the following:

- Any fund that markets itself as an ESG-Focused Fund would have minimum disclosure requirements in its prospectus, annual reports, and advisor brochures. Any Integration Funds—i.e. a fund that considers ESG factors as one of many factors in its investment decisions—would have streamlined disclosure requirements.
- Funds must tag their ESG disclosures using the "Inline eXtensible Business Reporting Landing," which the SEC says will provide machine readable data that will allow investors to more easily evaluate and compare ESG funds.
- Funds that claim an ESG impact would be required to summarize, in their annual reports, their qualitative and quantitative progress towards achieving those impacts.
- For ESG-Focused Funds that consider environmental factors, they would need to provide additional disclosures about their carbon footprint and greenhouse gas ("GHG") emissions, unless the funds disclose that they do not consider GHG emissions as part of their ESG strategy.

Both proposals passed 3-1, with those Commissioners in favor emphasizing that the Names Rule builds on 20 years of experience following its promulgation, and that enhanced disclosure requirements are intended to provide the investing public with the information the Commission perceives it to be demanding. As with the March climate-related disclosures proposal, Commissioner Peirce opposed both proposals, with the thrust of her comments being that the proposals are too prescriptive and unnecessary in light of existing enforcement tools.

This proposal also comes at a time when the SEC has stepped up its enforcement efforts in areas that it deems related to ESG, including filing a complaint against mining company Vale S.A. alleging false statements to investors regarding the safety and stability of its tailings dams, which we discuss in a prior alert; as well as a recent $1.5M fine levied against BNY Mellon Investment Adviser, Inc. following a finding that it had not conducted ESG quality reviews in instances where it implied that it had. Indeed, the latter matter provides an example of what the SEC is targeting with these new proposals.

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All Commissioners invited the public to comment on these proposals; comments are due 60 days after publication in the Federal Register. In the meantime, the SEC's enforcement efforts are not likely to abate, and are important to watch alongside these rulemaking proposals as another indicator of how the Commission continues its focus on disclosures and claims regarding all things ESG.

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