SEC Proposes ESG Reporting and Disclosure Requirements for Private Fund Advisers

A Practical Guidance® Article by
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This article discusses rule and form amendments proposed by the U.S. Securities and Exchange Commission (SEC) in a release issued May 25, 2022, to require registered and exempt investment advisers, registered investment companies, and business development companies to provide additional information regarding their environmental, social, and governance (ESG) investment practices.

For additional information on ESG matters related to private funds and advisers, see SEC Proposes Expanded ESG Disclosures for Certain Investment Companies and Investment Advisers: Client Alert Digest, ESG Goes Mainstream: How "Return First" PE Funds Can Factor ESG Considerations into Their Investment and Portfolio Management Strategies, and SEC Risk Alert Provides Insight into Examinations Related to ESG Investing.

Context for the Proposed Rules

On May 25, the SEC issued proposed rules under the Investment Advisers Act of 1940 ("Advisers Act") for advisers to private funds that consider environmental, social or governance factors ("ESG") as part of one or more significant investment strategies. The proposed rules would require advisers employing ESG strategies to report additional information about those strategies to the SEC and provide additional, more detailed disclosure to clients. See Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Advisers Act Rel. No. 6034 (proposed May 25, 2022).

The proposed rules are part of an effort by the SEC to address the growth in ESG-focused investing and concerns that claims made by advisers about their ESG practices do not meet investor expectations (for example, as with the names selected for registered investment companies or business development companies, that convey an investment company's commitment to ESG principles and priorities. Investment Company Names, Investment Company Act Rel. No. 34593 (proposed May 25, 2022)) The SEC's consideration of the rule proposals came only days after the SEC settled its first ESG-related enforcement action against an adviser to mutual funds, alleging that the adviser misled investors into believing that all of the funds were being managed in accordance with certain ESG principles

(BNY Mellon Investment Adviser, Inc., Advisers Act Rel. No. 6032 (May 23, 2022)). The SEC has previously brought similar enforcement actions that predate adoption of the term ESG, alleging failure to manage a fund consistent with disclosures made to investors. See e.g., Pax World Management Corp., Advisers Act Rel. No. 2761 (July 30, 2008). The proposal marks a continuation of the SEC's focus on ESG practices among investment advisers, beginning in 2019 with a series of ESG-focused examinations (ESG Funds Draw SEC Scrutiny, The Wall Street Journal (Dec. 16, 2019)) followed by a 2021 Division of Examinations Risk Alert on this topic (The Division of Examinations' Review of ESG Investing, Risk Alert, SEC Division of Examinations (Apr. 9, 2021)).

The SEC does not currently require detailed disclosures by an adviser about ESG or any other investment strategy employed by it. The proposing release explained that the SEC believes that ESG-focused investors may need more specific disclosure because they face special risks of being misled by advisers about their ESG policies.

The proposed rules would have the greatest impact on registered investment companies, i.e., mutual funds, ETFs, closed-end funds and BDCs. They would have a lesser but still significant effect on advisers to private funds, particularly those registered with the SEC.

Comments are due 60 days after the proposing release is published in the Federal Register. We note that the comment period is twice as long as some recent comment periods for SEC rule proposals, which the SEC extended and re-opened after numerous industry complaints.

Scope of the Proposed Rules

The proposed rules would apply to all advisers registered with the SEC under the Advisers Act and exempt reporting advisers that "consider" ESG factors as part of one or more "significant" investment strategies provided to clients. Many, if not all, advisers consider some aspects of ESG in selecting investments within an investment strategy primarily focused on achieving positive returns for clients. As a practical matter, an adviser's use of ESG factors in formulating investment advice would likely be considered "significant" under the proposed rules where the adviser discloses or promotes its use of ESG strategies to clients and prospective investors. Advisers that do not disclose or promote ESG strategies would likely be unaffected by the rule proposals.

Environmental, Social or Governance Factors

The proposed rules are designed to address current market confusion about what exactly are ESG investment strategies. Whether they would accomplish that objective was the subject of debate at the open Commission meeting, at which Commissioner Hester Peirce expressed skepticism given that the proposed rules would not define "E," "S" or "G." See Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies, Commissioner Hester M. Pierce (May 25, 2022).

Environmental matters (the "E") are generally understood to involve the extent to which a company safeguards the environment, and its policies to address such matters as climate change, waste, pollution, and resource depletion. Social matters (the "S") are generally understood to refer to how a company deals with its employees, suppliers and customers, and the communities in which it operates. Governance (the "G") is generally understood to deal with a company's leadership, executive pay, internal controls, and shareholder rights.

Market participants take different positions based on subjective judgments as to whether a particular industry, practice or policy is favorable from an ESG perspective, as well as the relative importance of one or more of the ESG factors. Moreover, ESG investing is known by different terms, including "socially-responsible investing," "sustainable investing" and "green investing," each of which may be understood somewhat differently by market participants. In addition, there are many organizations currently providing competing guidelines, screens or methodologies to investors that are seeking to bring ESG factors to bear in their investment activities, including a growing number of private funds.

The SEC acknowledges that there are many approaches to ESG investing and seeks to organize the universe of ESG strategies not by their substance but by the nature of the adviser's commitment to incorporating ESG into its investment strategy. The SEC would thus require advisers to group the ESG strategies they employ into three buckets and, in the case of registered advisers, describe the strategies to their clients.

"ESG Integration" strategies consider one or more of the ESG factors, but ESG is not dispositive to an investment decision. These strategies incorporate ESG considerations into the investment process alongside traditional factors and analysis that make up the investment strategy.

"ESG Focused" strategies, according to the SEC, use one or more factors "as a significant or main consideration in either selecting investments or in engaging with portfolio companies." This might include an adviser that selected companies for investments because of their favorable ESG characteristics, as well as a company that did not have

favorable ESG characteristics, but the adviser planned to engage with the company (through proxy voting or direct engagement) to enhance its ESG characteristics.

"ESG Impact" strategies are those that have "a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits." The SEC treats ESG Impact strategies as a subset of ESG-Focused strategies.

Reporting to the SEC—Part 1A of Form ADV

The SEC proposed to amend Part 1A of Form ADV to obtain a "census" of advisers that use ESG factors, including their use of ESG consultants. The new reporting requirements would identify SEC advisers employing ESG strategies, allowing SEC examiners to identify candidates for future examinations to help safeguard against "greenwashing" (i.e., overstating or otherwise misrepresenting the ESG factors incorporated into portfolio selection). The SEC notes that, because Form ADV is public, the new information will also permit the public to better identify advisers providing various levels of ESG strategies.

Items 5 (separately managed accounts) and Item 7 (private funds) would be amended to require an adviser to report (on corresponding sections of Schedule D) whether it considers ESG factors as part of one or more strategies and, if so, whether that strategy is "ESG Integration," "ESG Focused" or "ESG Impact." An adviser that considers ESG factors must report which factor(s) it considers (i.e., "E," "S," and/or "G"). If the adviser follows one or more third-party frameworks in connection with its ESG strategies, Item 5.M. would require it to identify the framework(s).

Items 6 (description of business) and 7 (financial industry affiliations) would be expanded to require that advisers report whether they themselves act as an ESG consultant or service provider or have a related person that is an ESG consultant or service provider. This information is designed to help the SEC and clients identify potential conflicts when an adviser uses a related person who is an ESG service provider.

The proposed ESG reporting would apply to both registered and exempt reporting advisers. The amendments to Item 5 of Form ADV apply only to registered advisers in as much as exempt reporting advisers are not required to complete Item 5. Reporting would not be required for clients that are investment companies, for which the SEC proposed separate reporting requirements.

Client Brochure—Part 2A of Form ADV

Item 8 of Part 2 of Form ADV currently requires registered advisers to disclose the methods of analysis and strategies the adviser uses in formulating advice provided to clients. For each "significant method of analysis or investment strategy" used, the adviser must disclose the material risks of that strategy. Currently, the risks of a strategy must be disclosed in detail only if the strategy involves "significant" or unusual risks. A strategy is "significant" for purpose of Item 8 if "more than a small portion of the adviser's clients' assets are advised using the method or strategy." Amendments to Form ADV, Advisers Act Rel. No. 3060 (Aug. 12, 2010) (amending Form ADV to add the current narrative brochure requirements) at n.74.

The SEC proposes to amend Item 8 to add several new items. Item 8.D. would require an adviser to disclose ESG factors, if any, it considers for each significant investment strategy and how the adviser incorporates the factors (and which factors (i.e., E, S and/or G) it incorporates) when advising its clients. Thus, an adviser that employed an ESG strategy for selecting or excluding certain securities would need to disclose the criterion or methodology it employs, including any internal or third-party framework, screen or index.

The proposed form language would appear to require disclosure of ESG factors considered in any significant investment strategy employed by the adviser, regardless of whether the ESG factors are a significant element of a significant strategy. For example, an adviser to a private equity fund, in evaluating the acquisition of a prospective portfolio company, might take into account the proposed post-acquisition governance structure of the company as one of many factors considered, but with company valuation and operations being much more significant elements of the adviser's overall evaluation. This would seem to be a drafting error that we expect to be pointed out by commenters.

Item 10 (other industry activities and affiliations) would be amended to require advisers to disclose material relationships they or their control persons have with ESG consultants and service providers. Finally, Item 17 (proxy voting) would be amended to require advisers with specific voting policies that include ESG considerations to disclose them and how they consider them, including whether the adviser may employ different strategies to vote proxies for different clients.

Private Funds

Only a portion of the amendments proposed by the SEC would directly affect advisers to private funds. Exempt reporting advisers are not required to prepare or deliver a brochure and, thus, would not be directly affected by the proposed Part 2 brochure amendments, nor are they required to complete Item 5 of Part 1A.

Form ADV does not directly speak to disclosures made to investors in private funds. It is not unreasonable, however, to anticipate that whatever ESG disclosure requirements the SEC ultimately adopts, private fund advisers will feel a need to include the disclosures in fund offering documents, both to address regulatory concerns and investor expectations.

More directly, the SEC's focus on ESG strategies by advisers would likely have a significant spill-over effect that private fund advisers could not afford to ignore under existing law. The SEC's release proposing the new ESG rules emphasized that existing legal obligations, including the anti-fraud provisions of the Advisers Act, apply to all advisers, including advisers to private funds. To the extent that private fund advisers make representations or provide other assurances to investors or prospective investors about a fund's ESG strategies, it is expected that they would be exposed to the same liabilities as the mutual fund adviser that was the subject of the foregoing settled enforcement action.

And we note that the SEC is watching. The Division of Examinations included both private funds and ESG investing at the top of its list of significant focus areas for 2022. 2022 Examination Priorities, SEC Division of Examinations (Mar. 30, 2022). Specifically, it cautioned that the Division would be examining advisers to determine whether they (i) were accurately disclosing their ESG investing approaches and had adopted policies and procedures designed to prevent violations of the Advisers Act in light of the ESG-related disclosures; (ii) were voting client securities in accordance with their proxy voting policies; or (iii) were overstating or otherwise misrepresenting the ESG factors incorporated into portfolio selection (i.e., "greenwashing"). For at least the next year, advisers to private funds with ESG strategies can expect SEC examiners conducting an examination to drill into how those strategies are being implemented and the compliance policies around that implementation.

In light of these developments, private fund advisers should review their strategies, marketing materials and client/investor disclosures to determine whether they are fully consistent with the ESG strategies that they employ. In addition, they should be prepared to demonstrate (i.e., document) compliance around these issues to SEC examiners. For example, SEC examiners often request copies of Investment Committee memos or other records evidencing the implementation of any ESG screening criteria described in the adviser's marketing materials. Although they are yet to be adopted, the proposed rules provide insights into the SEC's view of the application of existing legal obligations of fund managers who employ ESG strategies.

Final Thoughts

The rule would better operate to achieve the SEC's goals if ESG reporting and disclosure was triggered when an adviser holds itself out as employing an ESG strategy rather than the "significance" of the strategy. Elements of ESG investing are found in many if not most investment strategies, and it will be difficult to ascertain their "significance" with respect to a particular portfolio. But the greenwashing about which the SEC is concerned is all about use of a misleading marketing strategy, and the significance of the strategy to its clients may be presumed if the adviser is holding itself out as employing an ESG strategy.

Law360 News

- SEC Proposals Target 'Greenwashing' By Advisers, Funds

Related Content

Practice Notes

- Environmental, Social, and Governance (ESG) Resource Kit
- ESG Spotlight: Breaking Down the ESG Risk Alert and What to Expect from Enforcement
- Private Equity Fund Launch Considerations

Articles

- ESG Goes Mainstream: How "Return First" PE Funds Can Factor ESG Considerations into Their Investment and Portfolio Management Strategies
- ESG and Investment Managers: SEC Recommendations
- SEC Risk Alert Provides Insight into Examinations Related to ESG Investing
- Expected ESG and Climate Regulation Impacting Private Equity under the Biden Administration

Templates

- Due Diligence Questionnaire 2.0 and Diversity Metrics Template (ILPA Model Form)

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Robert Plaze advises investment advisers, investment companies, hedge funds, private equity funds and their service providers on regulatory and compliance issues under the federal securities laws. Following nearly 30 years in the SEC's Division of Investment Management, most recently as Deputy Director, Bob is a partner in Proskauer's Registered Funds Group.

At the SEC, Bob was responsible for policy development and management of the key regulatory initiatives affecting investment companies and investment advisers, including rules governing fund and adviser compliance programs, money market funds, fund corporate governance, personal trading, custody and brokerage practices, prohibitions on "pay to play" practices, and protection of investor privacy. After the passage of the Dodd-Frank Act, Bob was responsible for rulemaking requiring advisers to private funds to register with the SEC, providing new exemptions from registration and requiring reporting by certain exempt advisers.

Bob's comprehensive outline of the SEC's regulation of investment advisers is relied on by lawyers and compliance professionals throughout the industry.

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Robert Sutton is a partner of the Private Funds Group and a member of the Corporate Department. He is a seasoned practitioner with over 20 years of experience counseling managers and advisers of private funds on regulatory matters, as well as regulatory issues related to the formation and operation of private equity, credit, real estate, infrastructure, hedge and other private funds.

Rob has a deep knowledge of the market practice of asset managers and in particular, as it relates to Advisers Act-related issues. From some of the largest and most sophisticated firms in the global asset management industry to start-ups and mid-sized firms, Rob's experience includes a wide spectrum of funds and asset classes across their life cycles. Rob regularly advises on matters in connection with: U.S. investment adviser registration and regulation; Advisers Act and other U.S. securities law issues relating to the formation, marketing and offering of private funds; Identifying and managing conflicts of interest, and addressing related Advisers Act risks, SEC examinations, and exam readiness preparation; Design and implementation of investment adviser compliance policies and procedures; U.S. regulatory issues relating to purchases and sales of investment advisory businesses (minority stake and control stake transactions, buy-side and sell-side representations); Advisers Act and other U.S. regulatory issues relating to private fund restructurings and recapitalizations, strip sales, continuation fund formations and similar transactions; Advisers Act issues relating to the formation of SPACs by investment advisers; and, Investment Company Act status analyses of private fund structures, investment transaction structures and other non-registered investment company structures.

Rob has been recognized by his clients and peers for his extraordinary work, gaining various accolades including mentions in preeminent directories such as *The Legal 500*. He is also very active within the private funds industry, contributing to numerous publications and collaborating on several speaking engagements.

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Mark Audet is an associate in the Corporate Department and a member of the Private Funds Group.

Mark focuses his practice on counseling investment advisers on regulatory and compliance issues under the federal securities laws. Previously, Mark was a securities compliance examiner in the U.S. Securities and Exchange Commission's Division of Examinations (formerly the Office of Compliance Inspections and Examinations), where he conducted regulatory examinations of registered investment advisers to hedge funds, private equity funds, credit funds, mutual funds, BDCs, and other asset classes.

Before joining Proskauer, Mark was Chief Compliance Officer and Counsel at Matrix Capital Management, a long/short hedge fund based outside of Boston.