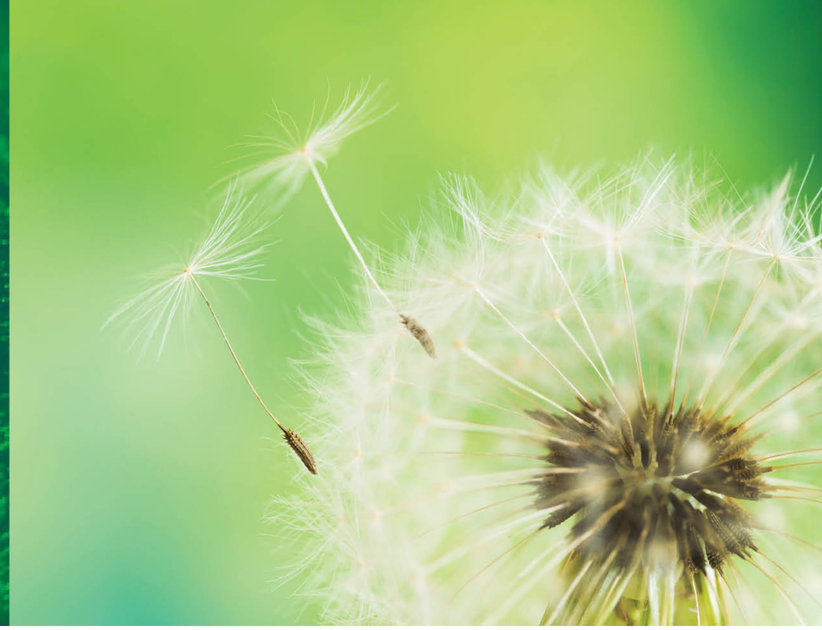
KPMG

SEC on ESG

Focus on investment management

May 26, 2022



SEC proposals target funds and investment advisers with the Names Rule plus ESG disclosures.

Applicability

Certain funds governed by the Investment Company Act (registered investment companies, business development companies, unit investment trusts) and certain advisers governed by the Advisers Act.

SEC Release Nos. IC-34593, Investment Company Names; IA-6034, IC-34594, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices

Fast facts, impacts, actions

The proposed rules are intended to provide consistent standards for Environmental, Social & Governance (ESG) disclosures, and to provide investors with more certainty about the nature of a fund. The following is an overview of the key points.

Funds	Integration fund	ESG-focused fund	Impact fund (subset)
Classification based on relevance of ESG to investment decisions	ESG factors integrated alongside non-ESG factors	ESG factors are a significant consideration	+ Seeks to achieve a particular ESG impact
Proposed ESG strategy disclosures	How ESG is incorporated into investment process	Detailed disclosures, including standardized overview table	+ How progress is measured
Greenhouse gas (GHG) emissions	How GHG emissions are considered, if applicable	Carbon intensity and footprint (Scopes 1 and 2), if environmental factors are considered in investment strategy; Scope 3 in some circumstances	
Names Rule	Likely will not qualify to use 'ESG' in the name of the fund	≥ 80% of asset value would need to be invested consistent with what the fund's name suggests (e.g. social impact, green); derivatives measured at notional amount	

Advisers	Similar disclosures with respect to consideration of ESG factors in significant investment strategies or methods of analysis; would apply to both exempt reporting advisers and registered investment advisers

Comments are due within 60 days of publication in the Federal Register, which could be as soon as the end of July.

Background

Investor interest in 'impact investing' and other ESG-focused fund strategies has grown significantly in recent years. While the SEC's current disclosure requirements include specific information about investment strategies used and other key attributes, a range of other matters that is considered in making investment decisions is not always disclosed.

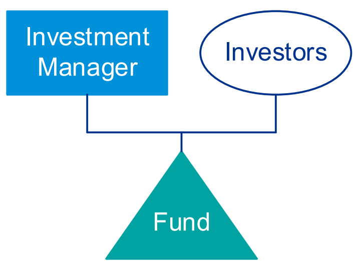
Strategies used by fund advisers to select investments may include qualitative and quantitative factors in making portfolio allocation decisions. ESG strategies are implemented in many different ways and – without clear disclosure of the strategy and activities of a fund adviser – the extent to which a fund adviser incorporates ESG into its selection of underlying investments may be disconnected from investor expectations.

With the growth of funds that use ESG terminology in their names and strategies, concerns about potential 'greenwashing' have increased. SEC Chair Gary Gensler noted, "when an investor reads current disclosures…it can be very difficult to understand what some funds mean when they say they're an ESG fund. There also is a risk that funds and investment advisers mislead investors by overstating their ESG focus." These proposals are intended to prevent this practice in how funds are named, and help prevent fund advisers from overemphasizing their ESG practices or the extent to which their investment products or services take into account ESG factors.

Applicability of proposals

The ESG Enhanced Disclosure Rule and the Names Rule will impact different reports by various stakeholders. The basic fund structure illustrated below outlines the typical reports by stakeholders and how they would be impacted by these proposals.

Typical reports (Invest Mgr)		Typical reports (Fund)		
Form ADV	ESG	Prospectus	NR	ESG
		Annual report	NR	ESG
		Monthly portfolio investment report	NR	



NR: Proposed Names Rule would apply

ESG: Proposed ESG Enhanced Disclosure Rule would apply

The Names Rule proposal

A prominent piece of information investors see about a fund is its name. While investors should look closely at a fund's complete disclosures in the prospectus before making investing decisions, a fund's name can be an important tool that investors use to filter through fund options. The competitive landscape to attract investors, together with an increasing demand for investment options that advance certain ESG initiatives, may create incentives to develop funds focused on those strategies and to include ESG terminology in fund names.

The Names Rule has existed for over two decades with the objective of ensuring that a fund's investment actions and strategies are consistent with investors' expectations based on all available information, including a fund's name. The proposed amendments seek to further advance the purpose of the Names Rule to provide better investor clarity into a fund's investment strategy.

The following table describes the key proposed amendments to the Names Rule.

Modernize the 80% investment policy requirement	— Expand the scope to apply to any fund names that include terms suggesting the fund focuses on investments that have, or whose issuers have, particular characteristics – e.g. ESG, sustainable, green, value, growth.

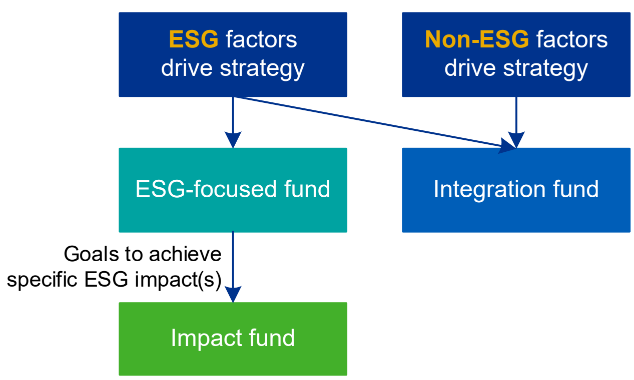
	— Require a fund to use a derivative instrument’s notional amount, rather than its market value, for purposes of determining the fund’s compliance with the 80% investment policy requirement.
Clarify materially deceptive and misleading use of ESG terminology in certain fund names	— Prohibit an integration fund from using terms in the fund’s name suggesting that its investment decisions incorporate one or more ESG factors when the fund considers ESG factors alongside, but not more significantly than, non-ESG factors. — Require additional disclosures in fund prospectuses to define terms used in a fund’s name.
Other non-ESG amendments	— Specify circumstances when a fund may depart from its 80% investment policy for a limited time. — Prohibit a closed-end fund or business development company that is not listed on a national exchange from changing its 80% investment policy without shareholder approval. — Amend Form N-PORT to require disclosure of which investments align with the fund’s 80% investment policy and other Names Rule compliance information. — Modernize the notice requirement to expressly address the use of electronic delivery methods for providing information to shareholders.

The ESG Enhanced Disclosure Rule proposal

A key objective of the proposal is to establish standardized disclosures that explain how the defined ESG strategy and goals described in a fund’s reporting are deployed. The proposed amendments impact the prospectus, annual reports and regulatory reporting.

Funds in scope of the proposal

The proposal identifies three types of ESG funds, with the aim of scaling disclosures depending on the significance of ESG factors to a fund’s strategy.



- An ‘integration fund’ considers one or more ESG factors in its investment decisions, but they are no more significant than other factors in selecting investments.
- For an ‘ESG-focused fund’, ESG factors are a significant or main consideration in (1) selecting investments or (2) engaging with the companies in which it invests. If a fund has an ‘ESG’ name or advertising that indicates an ESG focus, it is an ESG-focused fund.
- An ‘impact fund’ is a type of ESG-focused fund that seeks to achieve a particular ESG impact.

Proposed fund disclosures: prospectus

Integration funds

In the prospectus, an integration fund would only be required to disclose how it incorporates ESG factors into its investment selection process, including which ESG factors it considers. A supplemental description later in the prospectus would provide further information about the extent of integration of ESG factors into its investment strategy. If an integration fund considers GHG emissions in its investment selection process, it would disclose its methodology and sources used for emissions data.

ESG-focused and impact funds

ESG-focused funds, including impact funds, would include an ESG strategy overview in a prescribed table. Other disclosures would appear in different places in the prospectus depending on whether a fund is open- or closed-ended. The following table summarizes some of the proposed disclosures.

<table>
<tr><th></th><th>ESG strategy overview table</th><th>Other disclosures</th></tr>
<tr><td>Overview of fund's ESG strategy</td><td>— Brief description of strategic focus.
— Check box indication of applicable ESG strategies – e.g. whether the fund tracks an index, applies inclusionary or exclusionary screens, seeks to achieve a specific impact (impact investing), exercises proxy voting as an investor, engages with issuers.</td><td>None</td></tr>
<tr><td>How the fund incorporates ESG factors into its investment decisions</td><td>Summary information disaggregated by each ESG strategy, including:
— How ESG factors are used in evaluating, selecting or excluding investments.
— How a fund uses an internal methodology and/or third-party data provider for evaluating, selecting or excluding investments.
— Brief description of the index a fund tracks, if applicable, and how it used ESG factors in determining its constituents.
— Overview of any third-party ESG frameworks the fund follows as part of its investment process and how they align with the fund's investment objective.
— If environmental factors are considered, but issuers' GHG emissions are not, an affirmative statement that the fund does not consider the GHG emissions of the portfolio companies in which it invests.
— Investment objective (impact) the fund seeks to generate with its investments.[1]
— Overview of impact(s) the fund is seeking to achieve and how progress is measured, the time horizon to analyze progress, and the relationship of impact to financial return.[1]</td><td>— Inclusionary or exclusionary screens used to determine a company's industry classification or whether a company is engaged in a particular activity.
— More detailed description of internal methodology and how ESG factors are incorporated.
— More detailed description of scoring or ratings systems used by third-party data providers, if applicable.
— More detailed description of index's methodology and criteria used by the index that are based on ESG factors.
— Description of how the goal/objective of the third-party ESG framework is used to determine if a portfolio company contributes to that goal.</td></tr>
<tr><td>How the fund votes proxies and/or engages with companies on ESG issues</td><td>— How the fund engages or expects to engage with issuers on ESG issues.
— Whether the fund has specific or supplemental policies and procedures that include one or more ESG considerations in voting proxies.</td><td>Specific information on the objectives it seeks to achieve with its engagement strategy, including the fund's time horizon for making progress and any key performance indicators used to analyze engagement effectiveness.</td></tr>
<tr><td colspan="3">Note 1: This disclosure is required only for an impact fund.</td></tr>
</table>

Unit investment trusts

A unit investment trust that uses ESG factors to select its portfolio investments would be required to explain how each of those factors was used in its investment selection process.

Proposed fund disclosures: annual report

ESG-focused funds (including impact funds) would provide the following ESG-related disclosures in their annual reports, if indicated as significant to investment strategy:

- how the fund voted proxies related to portfolio securities on ESG issues during the reporting period; and
- certain information about engagement practices – such as the number or percentage of issuers with whom the fund held ESG engagement meetings and progress on key performance indicators of engagement.

Impact funds would disclose further information, within either management's discussion of fund performance or MD&A (as applicable), including:

- progress on achieving the fund's specific impact(s) in both qualitative and quantitative terms; and
- key factors that materially affected the fund's ability to achieve the impact(s).

GHG emissions

An ESG-focused fund that considers environmental factors in its investment strategy – unless such a fund affirmatively states in its prospectus that it does not consider the GHG emissions of the portfolio companies in which it invests – would disclose the following metrics for the aggregated GHG emissions of the portfolio:

- weighted-average carbon intensity (using Scopes 1 and 2 emissions);
- carbon footprint (using Scopes 1 and 2 emissions); and
- to the extent data is reported publicly, the carbon footprint of Scope 3 emissions of portfolio companies by industry sector invested.

The carbon footprint and weighted-average carbon intensity metrics are generally aligned with the recommendations of the Task Force for Climate-related Financial Disclosures and Partnership for Carbon Accounting Financials, and based on emissions data consistent with those defined by the GHG Protocol.

The emissions metrics would be supplemented with information about the source of the portfolio companies' emissions data, whether included in a regulatory report or a 'good faith estimate'.

Annually, Form N-CSR would provide more granular information about a fund's process for calculating and estimating its portfolios' GHG emissions, including assumptions and methodologies.

Proposed fund inline XBRL reporting

The proposed prospectus and annual report disclosures would be provided in Inline XBRL format. Submission in this format is intended to make disclosures and reports more available and accessible to investors, market participants and others.

Proposed regulatory reporting amendments

In addition to what is proposed to be included within a fund's prospectus and annual reports, the SEC has also proposed amendments to Form N-CEN that are designed to collect information regarding these funds and the ESG-related service providers they use. A fund that indicates that it incorporates ESG factors would be required to report, among other things, the type of ESG strategy it employs, the ESG factors it considers and the method it uses to implement its ESG strategy. A fund would also have to disclose whether it considers ESG-related information, or scores provided by ESG providers in implementing its investment strategy, and whether it follows any third-party ESG frameworks.

The SEC has proposed amendments to Form ADV, which are designed to collect information about an adviser's use of ESG factors in its advisory business with respect to its separately managed account (SMA) and private fund clients. The intention is to help (prospective) clients better evaluate firms offering advisory services that consider ESG factors. The proposals would require information collection from not only registered investment advisers but also exempt reporting advisers. Information would be collected through standardized questions added to Form ADV, including:

- whether ESG factors are considered, and whether they are a main consideration;
- whether the adviser follows an integration, ESG-focused or ESG impact approach;
- which of the E, S and/or G factors are considered; and
- whether any third-party ESG frameworks are followed.

Transition

The effective date of the amendments to the Names Rule and the ESG Enhanced Disclosure Rule will remain open until the SEC adopts the final rules. The Names Rule proposal envisages a one-year transition to provide time for funds to prepare for compliance. A similar transition period is proposed for the ESG Enhanced Disclosure Rule, except for those disclosures made in the annual report to shareholders and Form N-CSR, which would be required 18 months from the effective date.

Next steps

The comment period may close as early as the end of July, and many funds and their advisers would be impacted by the proposed rules.

- Identify how these proposed rules may impact you.
- If you are subject to the European Union's Sustainable Finance Disclosure Regulation (SFDR), understand any key differences that could impact your compliance with these proposed disclosures versus the SFDR.
- Evaluate what it would take to operationally comply with the proposal if it becomes final.
- Consider commenting on the proposals.

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KPMG Financial Reporting View

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