

## SEC Proposes New ESG Disclosure Requirements Affecting Investment Advisers

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### Key Takeaways:

- On May 25, 2022, the SEC released a proposed rule containing new environmental, social and governance compliance requirements, including amendments to the Form ADV, for advisers that use ESG considerations as part of their investment process.
- The proposed rule, if enacted, will affect registered investment advisers, exempt reporting advisers, private funds, registered investment companies and business development companies.
- Advisers employing ESG in their business will need to review client disclosures, as well as internal compliance policies and procedures, in order to comply.

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On May 25, 2022, the U.S. Securities and Exchange Commission (the “SEC”) issued a release containing a proposed rule (the “ESG Proposed Rule”) which, if enacted, would require certain exempt and registered investment advisers, private funds, registered investment companies and business development companies to comply with certain environmental, social and governance (“ESG”) disclosures and would impact their related fund registration statements, the management discussion of fund performance in fund annual reports and adviser brochures.

Although the ESG Proposed Rule covers different types of reporting entities, including registered investment companies and business development companies, this alert focuses on the ESG Proposed Rule specifically as it relates to changes for registered investment advisers (“RIAs”) and exempt reporting advisers managing private funds (“ERAs”) (RIAs and ERAs referred to herein as “Advisers”). If adopted, the ESG Proposed Rule will have a compliance date of one year after the effective date of the rule.

**Rationale behind the ESG Proposed Rule:** In issuing the ESG Proposed Rule, the SEC notes that it is seeking to provide investors with consistent, comparable and reliable information among investment advisers in considering one or more ESG factors to align the anticipated strategy with investor expectations and avoid marketing strategies which may exaggerate the extent to which their investment products or services take into account ESG factors.

### Key Terms

The ESG Proposed Rule divides ESG investment strategies into three categories: “ESG Integration,” “ESG-Focused,” and “ESG Impact” (with an ESG Impact strategy being categorized as a sub-category of an ESG-Focused strategy.) Notwithstanding the foregoing, the ESG Proposed Rule does not include any definition for the term “ESG,” which is left for advisers to describe to clients and prospective clients the factors that they consider and how they incorporate those factors into their investment programs.

- **ESG Integration Strategy:** ESG Integration strategies may consider both ESG factors along with non-ESG factors in their investment selection process. Although one or more ESG factors may be considered, under an ESG Integration strategy, ESG factors generally are not determinative as to whether or not a particular investment will be selected and are generally not weighed more heavily than other non-ESG factors.
- **ESG-Focused Strategy:** ESG Focused strategies place a significant weight on one or more ESG factors in the investment selection process or in engaging with existing portfolio companies. An ESG factor may be the main consideration as to whether or not an

investment is made.

- ▶ For example, ESG-Focused strategies may exclude investments based on certain ESG criteria such as screens for carbon emissions, board diversity, data protection and privacy, or other ESG criteria.
- **ESG Impact Strategy:** An ESG Impact strategy has a stated goal that seeks to achieve a specific and often measurable impact, which generates ESG-related benefits. The SEC considers an ESG Impact strategy as a subset of an ESG-Focused strategy.
  - ▶ An example of a fund which follows an ESG Impact strategy under the ESG Proposed Rule is a fund that invests with the goal of seeking current income while also financing the construction of affordable housing units.

### Proposed Amendments to Form ADV Part 1A Reporting

The ESG Proposed Rule expands the information collected about certain advisory services provided by both RIAs and ERAs. If an Adviser considers ESG factors as part of one or more significant strategies (i.e. an ESG-focused strategy or an ESG impact strategy), the Adviser is required to disclose the following additional items in completing Form ADV Part 1A:

- For RIAs Managing Separately Managed Accounts (“SMA”). The following amendments are proposed to Item 5.K and Schedule D (covering separately managed account clients):
  - ▶ Whether in its SMA strategies the RIA employs an ESG-integration, ESG-focused or ESG impact approach.
  - ▶ Whether in its SMA strategies the RIA incorporates environmental, social and/or governance factors into SMA strategies.
  - ▶ Whether in its SMA strategies the RIA follows ESG frameworks provided by third-parties in providing its advisory services, and if so the RIA will be required to identify the name of the framework.
- For Advisers to Private Funds (both RIAs and ERAs). The following amendments to Item 7.B(1) of Schedule D are proposed:
  - ▶ Whether in its management of private funds, the Adviser employs an ESG-integration, ESG-focused or ESG impact approach.
  - ▶ Whether in its management of private funds, the Adviser incorporates environmental, social and/or governance factors into SMA strategies.
  - ▶ Whether in its management of private funds, the Adviser follows ESG frameworks provided by third-parties in providing its advisory services and if so, the Adviser will be required to identify the name of the framework.
- All Advisers (both RIAs and ERAs). The following amendments to Items 6 and 7, and Schedule D 6.A and 7.A are proposed:
  - ▶ Whether the Adviser conducts other business activities as an ESG provider, or has related persons that are ESG providers. For every related person that is an ESG provider, the Adviser will be required to complete the relevant items in Section 7.A. of Schedule D.

### Proposed Amendments to Form ADV Part 2A Reporting

The ESG Proposed Rule also implements new required disclosures into the Form ADV Part 2A brochure for RIAs that consider ESG factors in their provision of investment advice. The disclosures will vary depending on whether the RIA employs ESG Integration, ESG-Focused or ESG-Impact strategies.

- All RIAs That Consider ESG Factors: A new sub-item 8.D and amendments to Items 10 and 17.A are proposed:
  - ▶ New Sub-Item 8.D
    - Whether and how the RIA considers ESG factors, including a description of the E, S and G factors considered, for any investment strategies offered by the RIA and whether the RIA employs Integration of ESG-Focused (and ESG-Impact) strategies.
    - For Integration strategies, the RIA must disclose how ESG factors are considered alongside non-ESG factors and that the ESG factors may not be determinative to an investment decision.
    - For ESG-Focused strategies, the RIA must disclose whether and how the RIA employs ESG factors and that such factors are the significant or main consideration.
    - For ESG-Impact strategies, the RIA must describe (i) the impact the RIA is seeking to achieve, (ii) how the RIA will

pursue achieving them, and how progress will be measured (including performance indicators and time horizon), and (iii) the relationship between the impact sought and financial returns.

- If an RIA is using ESG criteria in its investment strategies, the RIA must describe the criterion and/or methodology used (and how used) including whether and how any of the following are used: (i) internal methodologies, third-party scoring criterion, ESG frameworks or a combination of these, (ii) inclusionary or exclusionary screens, and (iii) any ESG index (including the name and description of the index).
- ▶ Amended Item 10: The RIA must describe any material relationships or arrangements that it, or its management, has with any related person that is an ESG consultant or other ESG service provider (for example, an ESG index provider or an ESG scoring provider).
- ▶ Amended Item 17.A: RIAs that have proxy voting policies or procedures that include one or more ESG considerations when voting client securities must disclose the ESG factors considered and how they are considered.
- RIAs With Wrap Fee Programs (Form ADV Part 2A, Appendix 1): The following amendments to Items 1, 6 and 6.C of Appendix 1 are proposed:
  - ▶ Amended Item 4: The RIA must disclose the ESG factors considered and how they are incorporated into the wrap fee program.
  - ▶ Amended Item 6: If the RIA considers ESG factors when selecting, reviewing, or recommending portfolio managers, they must describe the ESG factors and how they are considered. The description must include: (i) any criteria or methodology used to assess portfolio managers' applications of the relevant ESG factors into their portfolio management, including any industry or other standards for presenting the achievement of ESG impacts and/or third-party ESG frameworks, and any internal criteria or methodology; (ii) an explanation of whether the RIA reviews, or whether a third-party reviews (including the name of any third party), portfolio managers' applications of the relevant ESG factors described above; and (iii) if applicable, an explanation that neither the RIA nor a third-party assesses portfolio managers' application of the relevant ESG factors into their portfolio management, and/or that the portfolio managers' application of the relevant ESG factors may not be calculated, compiled, assessed, or presented on a uniform and consistent basis.
  - ▶ Amended Item 6.C: For any RIA that acts as a sponsor and portfolio manager for a wrap fee program, this amended item adds the proposed new Item 8.D to Form ADV Part 2A to the list of enumerated sections that the portfolio manager is directed to respond to.

## Compliance Policies and Procedures and Marketing

The ESG Proposed Rule further includes guidance that Advisers should include appropriate ESG specific compliance policies and procedures that take into account the manner in which the Adviser is using ESG factors, and that ensure that ESG disclosures to clients, investors and regulators are accurate. In addition, portfolio management processes should be reviewed to confirm that portfolios are being managed consistently with ESG-related investment objectives being disclosed by the Adviser. Examples:

The SEC includes several illustrative examples of effective ESG-related disclosures, policies, procedures and practices:

- For integration strategies, have policies and procedures reasonably designed to ensure that the Adviser manages the portfolios consistently with how the strategy was described to investors (using ESG factors in the manner disclosed);
- For Advisers that use screens (positive or negative), the Adviser should have controls to maintain, monitor, implement, and update those screens;
- If an Adviser has agreed to implement a client's ESG-related investing guidelines, mandates, or restrictions, the Adviser should have policies and procedures designed to ensure that those guidelines/mandates/restrictions are followed; and
- If an Adviser discloses that ESG-related proxy proposals will be independently evaluated on a case-by-case basis, the Adviser should have policies and procedures for such evaluation, and if they state that clients will have an opportunity to vote separately on ESG-related proposals, the Adviser must ensure that those voting opportunities are being provided to clients.

The ESG Proposed Rule further notes that the anti-fraud and marketing rules of the Investment Advisers Act will prohibit any false or misleading statements to current and prospective clients and investors. This prohibited conduct would include any statement or advertisement that overstates the extent to which an Adviser considers ESG factors in managing client portfolios (i.e., "greenwashing"). [\[1\]](#)

## We're Here to Help

If enacted, the ESG Proposed Rule could lead to increased regulatory interest and scrutiny of disclosures and marketing materials released by Advisers employing ESG factors. Careful planning and consideration may be required in contemplating:

- Where a private fund or Adviser's strategies falls within one or more categories of "ESG Integration," "ESG-Focused" or "ESG Impact."
- Whether certain entity names or logos could lead to greater scrutiny.
- Whether amendments to prospectus, organizational documents and client marketing materials should be made.

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[1] In a separate rule amendment released by the SEC, the SEC introduced proposed changes to Section 35(d) of the Investment Company Act of 1940, which included that the use of ESG-related terms in an Integration strategy would be considered misleading. While the names rule by its terms applies only to registered investment company, Advisers to private funds should consider whether, under general anti-fraud principles, the use of ESG terms in the name of the private fund is appropriate in light of the investment strategy being employed and the composition of the private fund's portfolio.

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