Q&A ON THE PROPOSED ESG REFORMS FOR REGISTERED FUNDS: ADDRESSING THE POTENTIAL CHALLENGES IMPOSED AND COMMENT OPPORTUNITIES

Date: 21 June 2022

U.S Asset Management and Investment Funds Alert

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After much anticipation, the U.S. Securities and Exchange Commission (SEC) proposed significant, and potentially burdensome, disclosure and reporting requirements (the Proposed Amendments) for registered funds that use environmental, social, and governance (ESG) factors in their investment practices. Our Client Alerts issued on 27 May 2022 and 8 June 2022 (Client Alerts) summarize the substance of the Proposed Amendments, including the proposed new taxonomy and disclosure and reporting requirements for registered funds. This Q&A, which is designed to provide responses to topics that may not have been specifically addressed in the Proposed Amendments or the proposing release regarding the Proposed Amendments (Proposing Release)[1], is intended to highlight some of the tremendous challenges that certain funds would face if the Proposed Amendments are adopted without modification. As indicated below, the Proposed Amendments could be particularly problematic for, among other entities, multi-manager funds, funds-of-funds, funds that use derivatives, funds that apply limited inclusionary or exclusionary screens in their investment process, funds with certain names and funds that would be subject to greenhouse gas (GHG) emissions disclosure and reporting requirements.

The comment period, *which ends 16 August 2022*, is quickly approaching. In light of that, and considering the significant impact that the Proposed Amendments could have if adopted, we have also highlighted some topics on which industry participants may wish to comment.[2]

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I. SCOPE OF THE PROPOSED AMENDMENTS

The Proposed Amendments apply to every SEC-registered investment company that incorporates at least one ESG factor into its investment selection process, including mutual funds, exchange-traded funds (ETFs), closed-end funds (including business development companies (BDCs)), and unit investment trusts (UITs). The Proposed Amendments do not impose any specific ESG-related disclosure obligations on private funds.

Question 1: Are registered investment companies that invest in other funds (i.e., funds-of-funds) subject to the Proposed Amendments, even if none of their assets are invested directly in securities issued by operating companies?

Answer 1: Under the Proposed Amendments, registered funds-of-funds would be subject to the same disclosure and reporting requirements, to the extent applicable, as other registered funds. In fact, the Proposing Release makes clear that for purposes of satisfying the proposed GHG emissions disclosure requirements for environmentally-focused funds (discussed later in this Q&A), such a fund-of-funds must consider the GHG emissions associated with its investments in the underlying funds (other than money market funds) that invest in issuers engaged in or operating a business or activity that generates GHG emissions.

Question 2: Are insurance company separate accounts subject to the Proposed Amendments?

Answer 2: No. The Proposed Amendments would not require insurance company separate accounts organized as UITs to provide additional ESG disclosure. However, mutual funds in which insurance company separate accounts invest would be subject to the Proposed Amendments.[3]

II. PROPOSED NEW FUND TAXONOMY: INTEGRATION FUNDS, ESG-FOCUSED FUNDS AND IMPACT FUNDS

The Proposed Amendments would introduce a new fund taxonomy consisting of three categories of funds that incorporate ESG factors into their investment selection process: Integration Funds, ESG-Focused Funds, and Impact Funds (which would be a subset of ESG-Focused Funds). Please refer to the Client Alerts for more information about each category.

Defining “ESG” and “ESG Factors”

Question 3: The proposed new taxonomy refers to “ESG factors” and a fund's use thereof. Do the Proposed Amendments define the term “ESG factors”?

Answer 3: No. The Proposed Amendments do not define "ESG" or similar terms. Likewise, they do not define "Environmental," "Social," or "Governance." However, other guidance indicates that: (1) climate change impacts, GHG emissions, energy efficiency, renewable energy, air, water, pollution, waste management, and biodiversity impacts are examples of "Environmental" factors; (2) labor standards, human rights, and gender and diversity are examples of "Social" factors; and (3) board composition, executive compensation, whistleblower programs, accident and safety management, and bribery and corruption are examples of "Governance" factors. To the extent that a fund considers one or more of these topics when making investment decisions, it would likely be viewed as using ESG factors in its investment selection process.

> Opportunity to Comment: The SEC is seeking comments regarding whether it should seek to define "ESG" or any of its subparts. It is also requesting comments on whether it should provide a non-exhaustive list of examples of ESG factors in the forms, and/or define certain types of factors as "ESG factors" while also allowing funds to add additional factors. In addition, the SEC is seeking comments on whether there are other approaches that it should take to provide guidance regarding what constitutes "ESG." Funds that would benefit from receiving specific definitions or more guidance regarding these terms may wish to consider requesting that information in a comment letter. Alternatively, funds that believe they–and investors–benefit from the absence of prescribed definitions may wish to explain how the lack of SEC-imposed definitions is advantageous to both funds and investors.

Implications for Referring to ESG in Advertising and Sales Literature

Question 4: The proposed definition of "ESG-Focused Fund" refers to the mention of ESG factors in advertisements and sales literature. Can a fund discuss its consideration of ESG factors in advertisements or sales literature without automatically being deemed an ESG-Focused Fund?

Answer 4: A fund would not automatically be deemed an ESG-Focused Fund solely because its advertisements or sales literature mention ESG factors, unless those factors are portrayed as a "significant or main consideration" in the fund's investment or engagement strategy. Accordingly, an Integration Fund would be permitted to discuss––albeit to a limited extent and in accordance with the Proposed Amendments—in its advertisements or sales literature how ESG factors play a role in the fund's investment or engagement strategy.

The SEC did not elaborate in the Proposing Release on what types of statements could be viewed as portraying that ESG factors are a "significant or main consideration" in a fund's investment or engagement strategy. Accordingly, it is not clear to what extent an Integration Fund could discuss ESG factors without causing the fund to be viewed as an ESG-Focused Fund, and SEC staff may develop views in this respect that are not consistent with the current assumptions and expectations of managers.

(For a discussion about how a fund could be deemed an ESG-Focused Fund based on its name, please see Question and Answer 20 below.)

Implications of Using Inclusionary and Exclusionary Screens

Question 5: The proposed definition of "ESG-Focused Fund" does not explicitly include a fund that uses inclusionary or exclusionary screens. Would a fund that, for example, excludes from its portfolio securities issued *by coal mining companies because of such companies' environmental impact be considered an ESG-Focused Fund?*

Answer 5: Even though the definition of "ESG-Focused Fund" set forth in the proposed amendments to Forms N-1A and N-2 does not specifically refer to funds that use ESG-related inclusionary or exclusionary screens in their investment selection process, the SEC makes clear in the Proposing Release that, in its view, such a fund is an example of a fund that uses one or more ESG factors as a "significant or main consideration . . . in selecting investments."[4] The SEC states that funds that "apply a screen to include or exclude investments in particular industries based on ESG factors" would be included in the proposed definition of an ESG-Focused Fund.[5]

Question 6: Would a fund be considered an ESG-Focused Fund if it seeks to avoid investing in companies that its adviser has determined are "significantly involved" in a certain business, such as manufacturing firearms, but does not have a policy against investing in a company that, for example, distributes products sold by firearm manufacturing companies as part of the company's diverse global transportation business? What if the fund applies such an investment practice to only part of its portfolio but invests the rest of its portfolio without any consideration of a company's involvement in firearms manufacturing?

Answer 6: Based on the guidance in the Proposing Release, it seems that such a fund would likely be included in the definition of an "ESG-Focused Fund." The proposed disclosure requirements set forth in the proposed amendments to Forms N-1A and N-2 (i) state that an exclusionary screen is a method of excluding investments based on ESG criteria, and (ii) indicate that an exclusionary screen could include exceptions. A fund that has a policy of trying to avoid investing in companies "significantly involved" in certain businesses based on ESG criteria would likely be viewed as excluding certain investments based on ESG criteria, even if the policy does not prohibit investment in all companies associated with the applicable businesses. (However, neither the proposed rule text nor the discussion in the Proposing Release directly addresses this.) In addition, the proposed disclosure requirements seem to indicate that a fund would still be viewed as using an exclusionary screen even if its exclusionary policy applies to less than 100% (excluding cash and cash equivalents held for cash management purposes) of the portfolio.[6]

> Opportunity to Comment: The SEC is requesting comments on whether it should prescribe how extensive an inclusionary or exclusionary screen must be in order for a fund applying the screen to be considered an ESG-Focused Fund. A fund may wish to provide comments if, for example, it believes that applying a limited exclusionary screen should not itself cause a fund to be considered an ESG-Focused Fund. A fund may also wish to provide comments if it believes the screen must be a material part of the fund's investment strategy in order for the fund to be an ESG-Focused Fund.

Potential Challenges for Multi-Manager Funds

Question 7: The proposed taxonomy raises questions for multi-manager funds where different underlying managers/sub-advisers may utilize different ESG-related strategies. For example, if (i) 70% of a fund's assets are managed by a sub-adviser that considers ESG-related factors in its investment selection process but applies greater weight to economic factors when making investment decisions ("Subadviser A"), and (ii) the remaining 30% of the fund's assets are managed by a subadviser that pursues impact strategies ("Subadviser B"), would the *fund be an Integration Fund (consistent with the approach taken by Subadviser A) or an ESG-Focused Fund (more consistent with the approach taken by Subadviser B)?*

Answer 7: The Proposed Amendments do not specifically address the potential challenges to multi-manager funds of complying with the proposed reforms, and the SEC does not offer guidance to assist such funds in making the determination referenced above. Multi-manager funds that foresee obstacles in complying with the proposed taxonomy should consider informing the SEC of the potential challenges of the Proposed Amendments—and suggesting a potential alternative, if possible—in a comment letter.

Absent any further guidance, and assuming the Proposed Amendments are adopted without modification, a multi-manager fund may wish to consider (i) whether the arrangements with underlying managers permit the multi-manager fund's adviser to make the final determination with respect to the fund's portfolio holdings, in which case the use of ESG factors employed by that adviser could help guide whether the fund is an Integration Fund, ESG-Focused Fund, or Impact Fund; or (ii) the appropriateness of utilizing a single ESG strategy across all sleeves and underlying managers (*e.g.*, applying an integration strategy with respect to the entire portfolio). A fund could also consider seeking exemptive or no-action relief if it determines that such guidance is necessary in light of its investment approach and structure.

If a fund determines to require subadvisers to apply a particular strategy in managing the fund's assets for the purpose of complying with the new taxonomy, the fund will need to consider whether any other investment policies or strategies need to be modified, and whether any changes to existing disclosure or marketing materials will need to be revised to account for such a change.

> Opportunity to Comment: The SEC is seeking comments on whether there should be additional categories of funds other than the three categories set forth in the Proposed Amendments. Funds that utilize a multi-manager structure, or other funds that would face challenges if the categories were adopted as proposed, may wish to comment that an additional category should be created to account for the unique characteristics of such funds, including, with respect to multi-manager funds, the varying approaches of the underlying managers. Alternatively, a fund could comment that, as an alternative to an additional category, the proposed definition of an ESG-Focused Fund should apply only to a fund for which the use of ESG factors, and/or the engagement with issuers, is a material aspect of the fund’s investment strategy (either in terms of percentage of the portfolio affected or otherwise).

III. DISCLOSURE REQUIREMENTS

Under the Proposed Amendments, Integration Funds, ESG-Focused Funds, and Impact Funds would be subject to different prospectus and shareholder report disclosure requirements. In addition, depending on a fund's use of ESG-related considerations, one fund may be subject to different requirements than another fund in the same category. Please refer to the Client Alerts for information about the proposed disclosure requirements.

Special Considerations for Integration Funds

Question 8: In the Proposing Release, the SEC indicates that “extensive information” about Integration Funds' use of ESG factors could cause an investor to mistakenly believe that such factors play a central role in the fund's *strategy. How, then, may an Integration Fund adequately, and without potentially being misleading, describe its incorporation of ESG factors in its investment selection process, when the proposed amendments to Item 4 of Form N-1A and Item 8 of Form N-2 require the fund to summarize its use of ESG factors briefly "in a few sentences"?*

Answer 8: Integration Funds will be required to provide supplemental information about their use of ESG factors in their investment selection process following the initial brief summary. This supplemental information, which would appear in an open-end fund's statutory prospectus or later in a closed-end fund's prospectus, must include, to the extent applicable, information about the GHG emissions of the Integration Fund's portfolio holdings. While the SEC expressed its concern that extensive information about ESG factors could confuse investors about the prominence of such factors in the funds' investment selection process, Integration Funds would not be limited to a few sentences when providing this supplemental information.

> Opportunity to Comment: The SEC is requesting comments on whether Integration Funds should be required to make any ESG-related disclosures. The SEC is also seeking comments on whether it is feasible for Integration Funds to satisfy the proposed disclosure requirements with a brief description, whether a word limit or other method should be adopted to ensure brevity, and whether the proposed disclosure should not be required to be brief.

Limited Use of Inclusionary and Exclusionary Screens

Question 9: Under the Proposed Amendments, would a fund that limits its holdings only by excluding securities issued by companies in one industry based on ESG factors (e.g., a fund that excludes only securities issued by companies engaged solely in the forestry industry) be subject to the same disclosure requirements as a fund that uses ESG factors more substantially, such as a fund that (i) considers multiple ESG factors as significant factors when selecting investments, or (ii) tracks an ESG-focused index?

Answer 9: The Proposing Release seems to indicate that under the Proposed Amendments, a fund that applies an exclusionary screen, even narrowly, based on ESG factors would likely be included in the broad definition of an "ESG-Focused Fund", and therefore would be subject to the proposed disclosure requirements of ESG-Focused Funds. In addition, the fund's summary must briefly explain the factors the screen applies, such as particular industries or business activities it seeks to include or exclude, and any exceptions that apply. In addition, if the screen applies to less than 100% of the fund's portfolio, excluding cash and cash equivalents held for cash management, the fund would be required to (i) state the percentage of the portfolio, in terms of the fund's net asset value (NAV), to which the screen applies, and (ii) explain briefly why the screen does not apply to the entire portfolio.

> Opportunity to Comment: As noted above, the SEC is requesting comments on whether it should prescribe how extensive an inclusionary or exclusionary screen must be in order for a fund applying the screen to be considered an ESG-Focused Fund. It is also seeking comments on whether a fund that applies a screen should be required to disclose the percentage of the portfolio to which the screen is applied. A fund may wish to provide comments if, for example, it believes that the narrow application of an

> exclusionary screen should not itself cause a fund to be considered an ESG-Focused Fund. A fund may also wish to comment that it should not be defined as an "ESG-Focused Fund" if it would be defined as such only because of its use of an exclusionary screen that is not a material part of the fund's investment strategy.

Special Considerations for Impact Funds

Question 10: Under the Proposed Amendments, an Impact Fund would be required to disclose in its investment objective the ESG impact that the fund seeks to generate with its investments. Some funds' investment objectives are fundamental policies that cannot be changed without shareholder approval. In light of this, would an Impact Fund whose investment objective is a fundamental policy need to obtain shareholder approval in order to comply with this new disclosure requirement?

Answer 10: The Proposed Amendments and discussion in the Proposing Release do not provide guidance regarding whether, if the proposed disclosure requirements for Impact Funds are adopted, such funds would be permitted to modify their investment objectives that are fundamental investment policies solely to comply with the disclosure requirements without obtaining shareholder approval.

> Opportunity to Comment: The SEC is requesting comments on whether an Impact Fund should be required to disclose the ESG impact it seeks to achieve in the discussion of the fund's investment objective. An Impact Fund that is concerned about the potential ramifications of the proposed disclosure requirement, such as the potential need to obtain shareholder approval, the potential change to marketing materials or the fund's categorization by third parties (*e.g.*, Lipper category) or otherwise may wish to describe these concerns to the SEC and propose, if applicable, an alternative that may be more appropriate.

Potential Challenges for Multi-Manager Funds and Funds-of-Funds

Question 11: The proposed disclosure requirements could pose challenges for funds-of-funds and multi-manager funds. For example, how could a multi-manager ESG-Focused Fund clearly disclose, in a manner that will not cause investor confusion, the fund's use of third-party ESG frameworks or the use of third-party data providers' rating systems if the fund's various subadvisers utilize different frameworks or ratings systems? Likewise, how would such a fund describe, without causing investor confusion, the specific objectives of any engagement strategy and the analysis used to measure the effectiveness thereof if the various sub-advisers seek different objectives and utilize different analyses to measure achievement?

Using the same examples, would a fund-of-funds have to disclose information about the underlying funds' use of third-party ESG frameworks or third-party data providers' rating systems in order to comply with the proposed disclosure requirements? How could such disclosure be provided with respect to multiple underlying funds without causing investor confusion?

Answer 11: As indicated above, the Proposed Amendments do not specifically provide for multi-manager funds or, other than with respect to the proposed GHG emissions disclosures, funds-of-funds, and do not address the potential challenges imposed on such funds by the proposed new taxonomy and disclosure requirements. Multi-manager funds and funds-of-funds that foresee difficulties in complying with the proposed disclosure requirements may wish to consider describing these challenges—and suggesting a potential alternative, if possible—in a comment letter. They may also wish to convey, to the extent applicable, the difficulty in obtaining the required information from subadvisers or underlying funds, and the risk that such data may not be indicative of the ESG-Focused Fund's overall ESG strategy or otherwise helpful to investors.

Absent additional guidance, and if the Proposed Amendments were adopted without modification, multi-manager funds and funds-of-funds that are ESG-Focused Funds, including Impact Funds, may wish to consider how to structure their disclosures in a manner that complies with the disclosure requirements, but also describes how different subadvisers or underlying funds may differ in their approach and how those differences impact the fund's portfolio. Such funds may also wish to consider whether it would be appropriate to seek exemptive or no-action relief in light of the particular challenges they face with complying with the disclosure requirements.

> Opportunity to Comment: The SEC is seeking comments on whether the proposed disclosure requirements relating to how a fund incorporates ESG factors into its investment process is appropriate and sufficiently clear. Any fund, including a multi-manager fund or fund-of-fund, that believes the proposed disclosure requirements impose particular compliance or other challenges, could respond to this request for comment by explaining how the proposed requirements may not be appropriate or where greater clarity is needed. The SEC is also seeking comments on whether funds should be permitted or required to provide only the information about the fund’s “primary” third-party data provider (i.e., the provider used more than others when making investment decisions), and on whether the proposed third-party data provider disclosure requirements would result in disclosure that would be difficult for retail investors to understand.

Potential Challenges for Environmentally-Focused Funds, Including Funds-of-Funds, and GHG Emissions Data

Question 12: Under the Proposed Amendments, an environmentally-focused fund that considers a variety of ESG-related characteristics of portfolio companies but does not specifically consider such companies' GHG emissions in its investment selection process would have to either (i) affirmatively state that it does not consider that information, or (ii) disclose its portfolio's carbon footprint and weighted average carbon intensity (WACI), which could be difficult for such funds to calculate. This proposed disclosure requirement could create the erroneous implication that a fund is not a “true” environmentally-focused fund. (Similarly, a fund that makes the carbon footprint and WACI disclosures because it considers GHG reduction among several environmental considerations may create the erroneous impression that it is focused on GHG reduction, when its primary focus is on other environmental considerations.) This, in turn, creates the risk that a fund would be disadvantaged in the market, and could confuse investors by conveying a false message. How may an environmentally-focused fund combat this challenge?

Answer 12: Although it seems that the SEC was intending to limit the scope of the GHG emissions disclosure requirement by not imposing it on certain ESG-Focused Funds, requiring environmentally-focused funds that do not consider the GHG emissions of portfolio companies to affirmatively make this statement may impose other challenges. The Proposed Amendments do not prohibit ESG-Focused Funds that do not consider GHG emissions in this manner from describing how such funds otherwise pursue their environmentally-focused strategies. Accordingly, if a fund were required to add the affirmative statement described above, presumably it could also supplement its disclosure to describe how it otherwise pursues its environmentally-focused strategy. Similarly, a fund that makes the carbon footprint and WACI disclosures presumably could supplement that disclosure to describe the other environmental considerations that are more significant to the fund's strategy than GHG emissions.

> Opportunity to Comment: The SEC is seeking comments on whether environmentally-focused funds should be required to disclose their GHG emissions at all, and whether such disclosure would even be helpful to investors. A fund could, for example, explain the challenges of complying with the GHG emissions information disclosure requirements, including the unique challenges to funds that do not consider GHG emissions of portfolio companies, in a comment letter. The SEC is also seeking comments on whether Integration Funds should be required to state that they use GHG metrics in their integration or investment process, and whether Integration Funds that consider environmental factors should be required to disclose their GHG emissions. In addition, the SEC is seeking comments on whether all funds should be required to disclose their GHG emissions. Funds may wish to comment, for example, that such disclosure would provide minimal, if any, benefit to an investor and could potentially cause confusion in light of other disclosures in a fund's prospectus or the type of investors that the fund attracts (e.g.¸ investors seeking exposure to infrastructure companies that seek to employ minorities). Funds may also wish to explain to the SEC the costs associated with complying with the proposed disclosure requirements and, if accurate, the relatively small, if any, benefit anticipated to result from such expenditures.

Question 13: The Proposed Amendments would require an environmentally-focused fund to disclose its portfolio's carbon footprint and WACI in the fund's annual report. Under the proposed calculation methodologies, these measures are derived, in part, using the fund's net assets as of a certain date and its portfolio companies' respective Scope 1 emissions[7] *and Scope 2 GHG emissions*[8] *as of certain dates.*[9] *For this purpose, portfolio companies would also include any underlying funds.*

In light of these requirements, and since GHG emissions data may be reported by portfolio companies as of a date that is different than the date used to calculate the environmentally-focused fund's net assets, how can an environmentally-focused fund reconcile the reporting period differences to avoid presenting skewed information that does not provide an accurate portrayal of the portfolio's carbon footprint or WACI?

Answer 13: The SEC acknowledged in the Proposing Release that, where the carbon footprint and WACI calculations require the value of a fund's holding in a portfolio company or a fund's NAV as of the fund's most recently completed fiscal year, there would likely be discrepancies between the date of the fund's values on the one hand and the dates of the portfolio companies' data on the other. However, the SEC stated its belief that any such "data anomalies" would be justified by the benefits of the proposed approach.

Question 14: How may an environmentally-focused fund comply with the GHG emissions disclosure requirements if one or more of the portfolio companies do not disclose their Scope 1 and Scope 2 emissions data?

Answer 14: The SEC acknowledged in the Proposing Release that some portfolio companies do not report GHG emissions in regulatory reports or otherwise make the information publicly available. In the event that an environmentally-focused fund were invested in such a company, it must make a good faith estimate of the portfolio company's Scope 1 and Scope 2 emissions and briefly explain the process it used to calculate that estimate. This process could be very burdensome if different processes are used for different types of portfolio companies.

Question 15: How may an environmentally-focused fund-of-funds satisfy the disclosure requirements relating to GHG emissions if the underlying funds are not required to (or otherwise do not) report such data?

Answer 15: If an underlying fund itself were an environmentally focused fund required to report its carbon footprint and WACI, then the investing environmentally focused fund could determine the GHG emissions associated with the investment for purposes of calculating its carbon footprint and WACI by taking its pro rata share of the underlying fund's GHG emissions. If, however, the underlying fund is not required to disclose that information, then the investing fund could look through its investment in the fund or private fund and take the investing fund's pro rata share of the emissions of the portfolio holdings of the fund or private fund.[10] In the SEC's view, it would be sufficient to identify an underlying fund's holdings based on the underlying fund's most recent financial statements.[11] This “look through” requirement would impose an excessive burden on the investing fund-of-fund.

> Opportunity to Comment: The SEC is requesting comments on numerous aspects of the proposed GHG emissions requirements for environmentally focused funds, including whether the disclosure should be required generally, and whether the information would help investors select appropriate funds. In connection with the Scope 1 and Scope 2 emissions data specifically, the SEC is requesting comments on, among other things, (i) whether funds should be required to make disclosures using the carbon footprint and WACI metrics; (ii) the utility of the metrics for investors; (iii) the costs associated with requiring the disclosure; (iv) the appropriateness of the proposed methods of calculating the carbon footprint and WACI metrics and whether funds should be permitted to use any “reasonable methodology” to calculate the GHG emissions associated with their portfolios rather than being required to disclose the carbon footprint and WACI; (v) whether a fund’s investments in other funds (including, for this purpose, private funds) should be included in the GHG emissions calculations; and (vi) whether funds should be required to estimate Scope 3 emissions when they are not reported and the burden associated with doing so.

Question 16: Is an environmentally focused fund required to provide the GHG emissions data if its exposure to portfolio companies is derived solely through its use of derivatives?[11] If so, how would such a fund calculate its carbon footprint and WACI?

Answer 16: If a fund obtains exposure to a portfolio company by entering into a derivatives instrument, then the fund must treat the derivatives instrument as an equivalent position in the securities of the portfolio company underlying the derivative for purposes of the GHG metrics calculations. For example, if an environmentally focused fund enters into an equity total return swap on a consumer products company with a notional amount of US$100,000, then the fund would treat the position as an investment in US$100,000 of the consumer products company's equity securities for purposes of computing the fund's carbon footprint and WACI. In the SEC's view, requiring the fund to consider the reference asset's securities would discourage funds from investing in derivatives to avoid having to include the GHG emissions associated with the holdings in the portfolio-level GHG metric calculations. However, in the view of an environmentally focused fund that gains exposure to portfolio companies through the use of derivatives, complying with these requirements may be costly and create a false impression of the fund's actual carbon footprint and WACI.

The SEC acknowledged in the Proposing Release that “some costs” may be incurred by funds that would be required to calculate the values of the derivatives.[13] However, the SEC also stated its belief that ESG funds “currently hold relatively small derivatives positions.”[14] In the SEC's view, (i) the costs associated with incorporating derivatives in the GHG metrics would not be substantial, and (ii) investors seeking to understand the climate-related risks of their portfolio would benefit from the information.

> Opportunity to Comment: The SEC is seeking comments on whether its treatment of derivative instruments is appropriate. It is also seeking comments on whether derivatives instruments should be excluded entirely from the definition of a “portfolio company” or “portfolio holding.” The result of that exclusion would be that funds would not be required to attribute GHG emission to these investments. A fund may wish to consider commenting on, for example (and to the extent applicable), the costs associated with calculating derivative values, or the fund’s belief that treating the derivative as a position in the underlying asset’s securities for purposes of determining the fund’s carbon footprint and WACI would be misleading to investors. A fund may also wish to express support for the exclusion of derivative instruments and explain why, in the fund’s view, the benefits of such exclusion outweighs the costs, and how the exclusion would not be disadvantageous to investors seeking ESG-related information.

Question 17: Would a fund that (i) is required to make GHG emissions disclosures in its annual report, and (ii) makes a short sale of a security be permitted to subtract the GHG emissions associated with the security sold short when calculating the fund's carbon footprint or WACI? Similarly, would a fund that is required to make the GHG emissions disclosures in its annual report be permitted to reduce the GHG emissions associated with a portfolio company by taking into account the portfolio company's use of purchased or generated carbon offsets, which represent an emissions reduction or removal of greenhouse gases?

Answer 17: No. Under the Proposed Amendments, such reductions are not permitted for the carbon footprint or the WACI measures. With respect to short sales specifically, the SEC observed that while a short sale would allow a fund to profit from a decline in the value of a security, it would not reduce the extent of the fund's financed emissions and may not offset the transition risk expressed by the fund's WACI. The SEC acknowledged, however, that a fund could disclose carbon offsets separately from its financed emissions if the fund believes the information would be helpful to investors.

IV. FORM N-CEN REPORTING REQUIREMENTS

In addition to the proposed new disclosure requirements described above, the Proposed Amendments would also require funds to report to the SEC on Form N-CEN information relating to their use, if any, of ESG-related factors in their investment selection process.

Question 18: Would the proposed amendments to Form N-CEN require a fund that considers ESG-related scores from third-party providers but does not base an investment decision solely on such data, and uses such third party data in combination with the fund's internal research, to identify each third-party provider on its Form N-CEN reports? What if the fund receives data from a service provider whose principal business is unrelated to ESG, and therefore could arguably not be an "ESG service provider," which term is not defined in the Proposed Amendments?

Answer 18: A fund that "consider[s]" ESG information or scores received from one or more "ESG consultant(s)" or other "ESG service provider(s)" would be required to state so and identify such consultant or provider in the fund's report on Form N-CEN.[15] As proposed, a fund would not be exempt from this reporting requirement if it did not assign significant weight to the information received from the ESG service provider. In addition, as indicated in the question, the Proposed Amendments do not define the term "ESG service provider." However, the Proposing Release indicates that the SEC views an ESG service provider as an entity that offers at least some ESG-related data points, such as company ESG scores or ratings or GHG emissions data. There is no indication that a company must be dedicated solely to providing ESG information in order to be viewed as an "ESG service provider."

> Opportunity to Comment: The SEC is seeking comments on whether funds should be required to disclose the names of their ESG service providers only if the funds rely on the information provided "to a material extent," and if so, how the SEC should define "material."[16] The SEC is also requesting comments on whether it should define "ESG consultants or other ESG service providers" on Form N-CEN, and if so, what definition should be used. As the term "ESG provider" is used in the Proposing Release in connection with other proposed amendments affecting funds and their advisers, funds may wish to consider proposing a particular definition that should be assigned to provide greater clarity to the types of relationships they would have to disclose and report.

V. POTENTIAL IMPACT ON FUND NAMES

Question 19: Will a fund that has in its name the term "Sustainable", "Socially Responsible" or a similar term that conveys the use of ESG factors in the fund's investment strategy be required to change its name if the Proposed Amendments are adopted?

Answer 19: Some funds—particularly Integration Funds or funds with "Sustainable," "Responsible," "ESG," "Climate," "Clean," "Carbon," "Green," "Socially Responsible Investing," "Socially Conscious," "Ethical," "Impact," or "Good Governance" (or any derivation thereof) in their names—may wish to consider modifying their names if the Proposed Amendments are adopted without modification. In addition, funds should consider the requirements of Rule 35d-1 under the Investment Company Act of 1940 (the Names Rule) and the amendments thereto recently proposed by the SEC (Proposed Names Rule Amendments), which we summarized in client alerts dated 26 May 2022 and 9 June 2022.

Under the Proposed Amendments, a fund whose name includes "terms indicating that the [f]und's investment decisions incorporate one or more ESG factors" (ESG Terms) would be included in the definition of an "ESG-Focused Fund" and be required to satisfy all associated disclosure and reporting obligations. The SEC does not provide a list of ESG Terms or other guidance regarding whether a word would be deemed an ESG Term. However, in explaining its rationale for the Proposed Amendments, the SEC pointed to the fact that, based on its review of Form N-PORT filings as of September 2021, 2.4% of all funds had names had names containing "Sustainable," "Responsible," "ESG," "Climate," "Carbon," or "Green."[17] It also referred to the terms "Socially Conscious" and "Clean." In the release relating to the Proposed Names Rule Amendments, the SEC stated that the term "ESG" includes terms like "socially responsible investing,"..."ethical," "impact," or "good governance" to the extent they describe environmental, social, or governance factors that a fund may consider when making investment decisions. It follows that the SEC would consider such words to be ESG Terms, and a fund that includes such a term in its name would be deemed an ESG-Focused Fund subject to the disclosure and reporting requirements of such funds.

Furthermore, in the release relating to the Proposed Names Rule Amendments,[18] the SEC stated that it would be misleading for a fund for which ESG factors are no more significant than other factors in the fund's investment decision-making process to include "ESG terminology" in its name, as investors could misunderstand the importance of ESG factors in the fund's selection of investments. Accordingly, under the Proposed Names Rule Amendments, the SEC proposed to define the name of an Integration Fund as "materially deceptive and misleading" if the name includes terms indicating that the fund's investment decisions incorporate one or more ESG factors. In addition, the Proposed Names Rule Amendments provide that a fund whose name indicates that the fund's investment decisions incorporate one or more ESG factors must adopt a policy to invest, except under certain circumstances, at least 80% of the value of the fund's assets in investments "in accordance with the investment focus that the fund's name suggests."

> Opportunity to Comment: The SEC did not include a request for comment specifically relating to its proposed amendments relating to fund names. However, it did request a general comment on whether it correctly identified the costs and benefits of the proposed amendments, and whether there are additional costs that should be included in the SEC's economic analysis. Funds that believe they would have to modify their names if the Proposed Amendments were adopted could comment on, to the extent applicable, the potential confusion to investors of such a modification, the cost of incorporating that modification (*e.g.*, expenses relating to any required shareholder meetings, reprinting marketing materials and offering documents, mailing prospectus supplements, making regulatory and state filings, etc.) and the relative lack of benefit of the Proposed Amendments in light of the existing disclosure explaining the fund's investment strategies and use of ESG factors in connection therewith. In addition, funds that believe they would be deemed ESG-Focused Funds could comment on the estimated costs of complying with the disclosure and reporting requirements to which such funds would be subject under the Proposed Amendments and, to the extent applicable, the relatively minimal benefit of those requirements compared to such cost.

VI. COMPLIANCE DEADLINE

Question 20: If the Proposed Amendments are adopted, how long will funds have to comply with the new requirements?

Answer 20: If the Proposed Amendments are adopted, the SEC proposed that all funds, regardless of category, would have a transition period of one year following the effective date (*i.e.*, the date that is 60 days following the publication of the final rules in the Federal Register) before being required to comply with the new requirements, except that, with respect to disclosures in shareholder reports filed on Form N-CSR, the compliance date would be 18 months following the effective date.

> Opportunity to Comment: The SEC is seeking comments on whether the transition period to come into compliance with the proposed prospectus and registration statement requirements should be longer than one year. It is also requesting comments on whether the transition period should be the same for open-end funds, closed-end funds, and UITs, and whether Integration Funds and ESG-Focused Funds should have the same compliance period. A fund that believes one year is not a sufficiently long transition period should consider stating so and the reasons why it is insufficient in a comment letter.

FOOTNOTES

[1] Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, SEC Release No. IC-34594 (May 25, 2022).

[2] The requests for comment referenced in this Q&A are only some of those included in the release relating to the Proposed Amendments. We encourage readers to review the requests for comment included in the Proposing Release, as some may be more pertinent to a fund's or adviser's particular situation than those highlighted in this Q&A.

[3] The SEC notes in the Proposing Release that investors in insurance company separate accounts organized as UITs allocate their investments to subaccounts invested in mutual funds that, in turn, would provide any required disclosure under the Proposed Amendments about their ESG investment practices. It also notes that the Proposed Amendments do not have additional disclosure requirements for UITs operating as ETFs, because there were such few UITs operating as ETFs as of 1 December 2021, and none of them pursued ESG strategies. See footnote 98 of the Proposing Release at p. 68.

[4] See Proposing Release at p. 33.

[5] See Proposing Release at p. 33.

[6] See proposed Instr. 5(a) to Item 4.a.2.ii.B of Form N-1A and proposed Instr. 5.a to Item 8.2.e.2.B of Form N-2.

[7] Scope 1 emissions 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.

[8] Scope 2 emissions are indirect emissions primarily resulting from the generation of electricity purchased and consumed by the company.

[9] In addition, an environmentally-focused fund would be required to disclose its portfolio companies' Scope 3 emissions (i.e., all other indirect emissions not accounted for in Scope 2 emissions, which are a consequence of the portfolio company's activities but are generated from sources that are neither owned nor controlled by the company).

[10] Proposing Release at p. 101.

[11] Under the Proposed Amendments, an environmentally focused fund would not be required to consider the GHG emissions associated with its investment in underlying money market funds for cash management purposes.

[12] Under the Proposed Amendments, a "derivatives investment" would be defined to include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing instruments, or any similar instrument. The list of instruments would be consistent with Rule 18f-4 under the Investment Company Act of 1940.

[13] Proposing Release at p. 232.

[14] Proposing Release at p. 233.

[15] See Proposing Release at p. 349.

[16] See Proposing Release at p. 153.

[17] See Proposing Release at p. 13.

[18] U.S. Sec. & Exch. Comm'n, Investment Company Names (May 25, 2022), https://www.sec.gov/rules/proposed/2022/ic-34593.pdf.

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