Hogan Lovells

Private Capital Alert
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SEC releases long-awaited ESG proposal for investment companies and investment advisers

On 25 May, the Securities and Exchange Commission (the SEC) introduced a proposal to amend certain rules and forms under the U.S. Investment Advisers Act of 1940 (the Advisers Act) and the U.S. Investment Company Act of 1940 (the Company Act) to provide what the SEC describes as greater transparency to investors about the environmental, social, and governance (ESG) factors in certain investment products, especially for those investment funds marketing themselves as having ESG-focused strategies.

The SEC does not currently mandate specific disclosures by funds or advisers with respect to ESG, instead applying existing anti-fraud and marketing rules and regulations that apply to all disclosures, including ESG matters. In emphasizing special risks to investors in ESG-focused investment products, the SEC intends the proposed rules to provide investors with consistent, comparable and reliable information about funds and ESG strategies. In particular, the SEC expressed concern about "greenwashing," the notion that funds or advisers may overemphasize the role that ESG factors play in their investment decisions.

The SEC's proposal imposes the heaviest new burdens on registered investment companies (such as mutual funds, exchange-traded funds and other registered investment products), unit trust investments, and business development companies and not on private funds.

Nonetheless, the new rules would affect private funds through proposed amendments to Form ADV, with implications not only for registered investment advisers (RIAs) but also, in some cases, exempt reporting advisers (ERAs) relying on the venture capital fund adviser or private fund adviser exemptions from registration.

The ESG rules are the latest in a flurry of SEC rulemaking proposals, which follow (i) proposed Advisers Act rule amendments in January relating to Form PF reporting; (ii) proposed rules under the Company Act and Advisers Act in February bolstering cybersecurity practices and imposing sweeping new restrictions and regulations on private funds in February; and (iii) proposed Company Act rules in March enhancing disclosures and protections relating to special purpose acquisition companies (SPACs).

A new three-part spectrum

The proposed rules establish a common, three-part framework for ESG-related investment products that would apply in future to registered funds, private funds, and investment advisers alike:

— "ESG integration" strategies that consider one or more ESG factors alongside other, non-ESG factors in investment decisions; in such strategies, ESG factors may be considered in the investment selection process but are generally not dispositive compared to other factors when selecting or excluding a particular investment.

— "ESG-focused" strategies focus on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies; for example, such ESG-focused strategies might exclude or include certain investments based on particular ESG criteria.

— "ESG impact" strategies have a stated goal of seeking to achieve a specific ESG impact or impacts that generate specific ESG-related benefits; these impact strategies generally seek to target portfolio investments that drive specific and measurable environmental, social, or governance outcomes.

Proposed disclosures for registered investment companies

The SEC proposes to create a uniform system for disclosure about ESG strategies for registered funds, which would include requirements for information with respect to the role that ESG has on investment decision-making in a registered fund's prospectus. The SEC proposed a "layered" approach, such that "ESG integration" funds would provide less disclosure than "ESG-focused" (and "ESG impact") funds. In addition, some ESG-focused (including impact) funds would have an annual report ESG disclosure requirement. Furthermore, ESG-focused (including impact) environmental funds would have additional disclosure, including certain harmonized greenhouse gas (GHG) emissions metrics.

Proposed disclosures for investment advisers and private funds

While emphasizing the growth of ESG-focused investment strategies in recent years with respect to mutual funds and ETFs, the SEC noted that fewer than one percent of private funds had names suggesting ESG investments.[1] Nevertheless, the SEC believes that ESG considerations have become increasingly important to private fund sponsors and investors alike.

Accordingly, RIAs would be required to disclose certain ESG practices in Form ADV Part 2A (commonly referred to as the "brochure"). In addition, RIAs and ERAs alike would be required to provide summary, "census type" information about ESG-related matters as part of their annual amendments to Form ADV Part 1A.

Form ADV Part 2A

RIAs would be required to disclose with specificity their ESG investing approach in an attempt to help investors understand the adviser's ESG approach through the addition of several new items:

— Proposed sub-Item 8.D would require RIAs to describe each ESG factor or factors, if any, it considers for each significant investment strategies or methods of analysis, including any criteria or methodology the adviser uses to evaluate, select or exclude investments, such as internal or third-party methodologies, inclusionary or exclusionary screens, or any other index and how that index utilized ESG factors.

— Proposed sub-Item 10.C would require RIAs to describe any material relationships or arrangements that are either material to the adviser's advisory business or to its clients, or that the adviser or any of its management persons have with an ESG consultant or other ESG service provider (including ESG index providers or ESG scoring providers). This requirement in particular is designed to allow investors to assess conflicts of interest that might be created by an adviser's relationships or arrangements with related persons.

— Amended sub-Item 17.A would require RIAs that have specific voting policies or procedures that include one or more ESG considerations when voting client securities to include a description of which ESG factors they consider and how they consider them; for example, if an adviser has different voting policies and procedures for strategies that address ESG matters or for different clients or ESG strategies, the adviser should describe these differences.

Form ADV Part 1A

The SEC would also amend Items 5, 6, and 7 of the Form ADV Part 1A to require disclosures about the use of ESG factors for separately managed accounts (SMAs) and private funds, with the changes to Item 5 required for RIAs and the changes to Items 6 and 7 required for both RIAs and ERAs.

— Advisers would be required in Item 5.K for SMAs and in new question 29 of Item 7.B(1) of Schedule D for private funds to provide standardized, basic information about their uses of ESG factors in managing each reported private fund, including (i) whether each private fund considers ESG factors; (ii) if so, whether the fund deploys an ESG integration, focused or impact strategy; and (iii) whether the fund considers, in particular, environmental factors, social factors, governance factors, or a mix of all three.

— In addition, advisers would be required to report whether they follow any third-party ESG framework(s) in connection with their advisory services and, if so, to name the framework(s).

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1 The SEC counted 243 funds managed by RIAs and another 144 funds managed by ERAs that expressly held themselves out as having an ESG focus – i.e. containing the names "ESG," "Clean," "Environ(ment)," "Impact," "Responsible," "Social," or "Sustain(able)."

— Finally, in Items 6 and 7, advisers would be required to disclose whether they conduct business activities themselves as ESG providers or have related persons that are ESG providers, again to provide investors better understand of conflicts of interest.

Emphasizing existing regulations

In the proposal, the SEC reaffirmed its view that existing Advisers Act obligations, including the general anti-fraud provisions of Section 206, apply equally when advisers incorporate ESG factors. In particular, the SEC noted that existing regulations currently prevent false or misleading advertisements by advisers, including greenwashing, by prohibiting material misstatements and fraud. Rule 206(4)-8 prohibits all advisers, registered or otherwise, from making false or misleading statements to existing or prospective investors in pooled investment vehicles. Rule 206(4)-1, the newly adopted marketing rule that takes effect in November 2022 (with earlier adoption permitted, as advisers transition from the older advertising and cash solicitation rules), prohibits RIAs from, directly or indirectly, distributing advertisements that contain any untrue statement of material fact or any omission of a material fact.

Notably, the Division of Examinations added ESG investing to its list of “significant focus areas” in its 2022 examination priorities for investment advisers. The Division emphasized the risk of false and misleading statements or omissions by advisers in their disclosures, pointing to the potential compounding risks of (1) the lack of standardization in ESG investing terminology, (2) variety of approaches to ESG investing and (3) the failure to effectively address legal and compliance issues with new lines of business and products. The SEC’s proposal attempts to reduce each of these compounding risks.

In light of the SEC’s focus on existing requirements, and especially in light of the pending effective date of the new marketing rule, RIAs may wish to review their compliance policies and procedures relating to ESG disclosures for consistency with the adviser’s actual portfolio management processes.

Next Steps

Most of the ESG-related rules and amendments, including those relating to investment advisers and private funds, would take effect one year after the effective date of the amendments. Upon the publication of the proposed rules in the Federal Register, the public will have 60 days to submit comments in response to the rules.

Hogan Lovells regularly represents investment advisers and private funds to which these proposed ESG rules would apply. We also have a very active global regulatory practice, including with respect to ESG matters, that provides counsel to clients who deploy private capital across a broad range of regulated industries through a broad range of investment strategies. We are happy to discuss these and other proposed SEC rulemakings or other matters under the Advisers Act or otherwise within the broader securities regulatory matrix to which private capital is subject.

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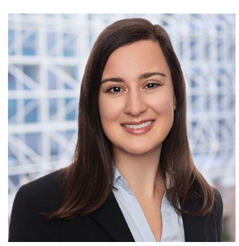

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