Professional Perspective

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Contributed by Nicholas DiLorenzo, Dechert

Neither asset managers nor U.S. registered investment funds are currently subject to ESG-specific regulatory requirements in the U.S. However, the U.S. Securities and Exchange Commission (SEC) is evaluating potential rulemaking regarding how investment managers and funds disclose their investment processes.

A rule proposal is currently on the SEC's regulatory agenda for April 2022. In advance of any such rulemaking, this article seeks to identify trends in SEC disclosure review staff comments to U.S. registered fund) registration statement disclosure related to environmental, social, and governance (ESG) investment processes. Such trends may be indicative of future SEC rulemaking and, in the shorter-term, may help guide fund sponsors in anticipating and responding to staff disclosure comments.

The article consists of three sections: an overview of existing ESG-related disclosure requirements applicable to funds, an analysis of staff comments from Jan. 1, 2017, through Nov. 1, 2021 (the Review Period), including trends in comments and responses provided, and other potential indicators of future SEC rulemaking.

Registered Fund Disclosure Requirements

U.S. asset managers and funds are not currently subject to any ESG-specific regulatory requirement, including with respect to product disclosures. However, fund registration statement disclosures are subject to general disclosure principles (i.e., they must provide full and fair disclosure and not be misleading), and the requirements of the applicable registration statement form (i.e., Form N-1A or N-2), which include requirements related to investment strategy and risk disclosures. The staff has also consistently sought to apply Rule 35d-1 under the Investment Company Act of 1940 (Names Rule) to ESG-related products.

In relevant part, the Names Rule provides that if a fund's name suggests that the fund focuses its investments in a particular type of investment, the name may be materially deceptive or misleading unless the fund adopts a policy to invest, under normal circumstances, at least 80% of the value of its assets in the particular type of investments suggested by the fund's name. The staff and fund sponsors typically diverge in whether they view ESG as an investment type or strategy.

Thus, the SEC and its staff's primary oversight mechanisms for ESG funds are the disclosure review process, examinations, and non-binding regulatory guidance such as "Risk Alerts" and other similar publications.

Observations of Trends in Disclosure Comments

Dechert's Financial Services Group has closely followed ESG-related comments provided by the staff to funds in connection with the standard registration statement disclosure review process.

During the Review Period, the staff's comments can be categorized into five areas—ESG criteria, Names Rule, ESG investment processes, ESG risk disclosure, and proxy voting. As a percentage of total comments identified, the relative mix of comments has been consistent across categories over time. For example, in the 2019, 2020, and 2021 calendar years, the categories represented approximately 40%, 20%, 20%, 15%, and 5% of comments identified, respectively.

However, consistent with the significant expansion in investor demand for and fund sponsor offering of ESG-related products, the analysis suggests that the nature and scope of comments provided in each category has evolved over time. Initially, comments were rooted in standard disclosure concepts (i.e., plain English, compliance with Form N-1A). More recently, staff comments reflect a more nuanced view of the intricacies of ESG products and strategies.

The following provides an overview of key themes identified in each category for the 2017-18 period, discusses trends in comments provided in each category since 2017, and provides hypothetical, sample comments in each category intended to highlight Dechert's assessment of the staff's areas of focus in 2021.

ESG Criteria

"ESG criteria" consists of comments related to the type and source of ESG information—factors, proprietary or third-party criteria or ratings, etc.—used by a fund or adviser.

Overview of Comments: 2017-18

Broadly speaking, ESG criteria-related comments identified request clarification of certain key aspects of an adviser's ESG investment process. The staff routinely sought clarification of statements that the staff thought could be construed as vague or ambiguous in disclosure related to the adviser's ESG process. This could relate to statements about the ESG characteristics of a permitted investment, ESG standards or criteria relied on, or more general statements about ESG factors considered.

The staff also routinely requested disclosure of the ESG investment process used. This could include a description of the ESG factors or criteria (collectively, criteria) used to evaluate portfolio holdings or, in the context of an exchange-traded fund (ETF), disclosure of the underlying index's selection criteria. Finally, where disclosure referenced the use of ESG data, the staff commonly requested confirmation of whether the adviser used proprietary or third-party data and, if the latter, the providers used. In many instances, these comments also requested that criteria disclosures be revised for plain English.

Summary of Trends Since 2017

The core themes identified above remained consistent during the review period. However, the volume of ESG criteria-related components increased and the nature of such comments expanded to reflect more nuanced considerations.

Specifically, the staff continued to seek clarification of potentially vague or ambiguous terminology. However, staff's focus appeared to shift from plain English considerations to more detailed requests for clarification of specific aspects of a fund's ESG investment process. For example:

- Where ESG investment criteria or factors are used, describe the criteria, how they are used and prioritized, whether the adviser has discretion in their utilization and constraints on that discretion, whether the criteria or factors rely on qualitative inputs and what they are, and whether ESG criteria are incorporated at a fund or position level.
- Where third-party data sources are used, disclose the "primary" data source and the methodologies used by such source.
- Where a proprietary model is used, disclose its role in the investment process.

The staff also began to provide comments for funds to:

- Clarify the ESG investment process used by sub-advisers or underlying funds.
- Describe how the process differed across asset classes, e.g., sovereign/corporate issuers.
- Disclose due diligence over ESG data.
- Disclose whether failure to meet ESG criteria results in a holding's exclusion or removal from the portfolio.
- For "impact" funds, describe the impact investing process, including desired impacts and whether they are primary to seeking return.

Comments in 2021 also began to reflect the ESG nomenclature reflected in the Investment Company Institute white paper on fund use of ESG strategies.

Hypothetical, Representative Comments: 2021

- Explain the fund's definition of "ESG" or "sustainable" and its specific areas of focus, if any.
- Describe the criteria used to determine whether an investment is consistent with the fund's definition of ESG or sustainable, including whether the fund selects investments utilizing an ESG index, third-party data provider, and/or proprietary screen.
- Describe any due diligence applied to the screening criteria—e.g., does the adviser conduct proprietary analysis or rely on third party screens.

- Where a third-party data provider/scorer is used, identify the provider/scorer or the primary provider/scorer and summarize the criteria/methodologies used by such third party.
- Explain whether the ESG criteria is applied to all or a portion of the fund's holdings and whether ESG criteria are the sole factor considered in portfolio management decisions.

The Names Rule

Names Rule comments refer to when a fund should adopt an 80% policy.

<u>Overview of Comments: 2017-18</u>

The Names Rule comments identified generally sought to require compliance with the Names Rule and disclosure of how the 80% test would be applied. The staff routinely commented that "ESG" or "sustainable" in a fund name triggered the Names Rule. For sustainable funds, the staff expressly stated that the Names Rule required investing 80% of the fund's assets in "environmentally friendly" or "ESG" issuers.

In requiring disclosure of how the 80% test would apply, the staff sought disclosure of how the adviser determines if a holding is 80% bucket eligible and whether derivatives, ETFs, and other investments are deemed to be 80% bucket eligible.

<u>Summary of Trends Since 2017</u>

The staff comments during the review period were generally consistent with those outlined above. However, the comments reflect a trend for the staff to: seek to identify other ESG-related Names Rule triggers, such as impact, water, social, Shariah, equality, and women; and require the adviser to define the eligibility criteria for 80% bucket eligibility instead of providing a definition via staff comment.

In certain instances, the staff has also sought further clarification on these eligibility criteria, including, for example, how an ETF's decision to weight a holding relative to the underlying index would affect 80% bucket eligibility. Consistent with the discussion under ESG criteria, the staff has also increasingly sought further clarification on potentially vague or ambiguous phrasing in fund 80% policies—e.g., companies deriving a "significant percentage of" profits/revenues/operations from [X].

During the review period, funds generally declined to accept Names Rule comments on the basis that ESG is an investment strategy. However, in certain circumstances, such as where automatic effectiveness is not available, funds have been more receptive to Names Rule comments.

Hypothetical, Representative Comments: 2021

- The fund's name includes the word "sustainable" or "impact" or "ESG." The staff believes that this suggests a type of investment and, therefore, the fund should have an 80% policy under the Names Rule. Please revise the registration statement accordingly, including by describing the criteria, factors, or other parameters for compliance with the 80% policy.
- Please disclose whether derivatives count towards the fund's 80% policy and, if so, how they are valued.
- The fund's disclosure states that an investment that does not meet the fund's ESG criteria may nevertheless be acquired—or not sold, for existing holdings that are downgraded. Disclose whether these holdings will be included in the fund's 80% test.

ESG Investment Process

ESG investment process comments refer to how ESG data is used in the investment process. This category is closely related to the ESG criteria category but there are certain differences.

<u>Overview of Comments: 2017-18</u>

The investment process comments seek to provide current or prospective shareholder with additional detail regarding how an adviser integrates ESG into its investment process. This included comments requesting disclosure of how and when ESG criteria are incorporated, whether they are applied to all or a portion of the portfolio, the relative weighting of criteria in investment decisions, and whether additional principal strategy disclosure is necessary or appropriate.

Paralleling themes in ESG criteria-related comments, the comments often sought to obtain detail regarding the nature of adviser discretion in implementing the ESG investment process. The staff's comments also regularly sought clarification on how sub-advisers integrate ESG criteria.

Summary of Trends Since 2017

The broad themes underlying the staff's ESG process-related comments have remained consistent but the detail requested has evolved. This evolution may be attributable to a maturation of common ESG investing terminology as, for example, comments now differentiate among funds that employ ESG screens, integration, and impact investing approaches and request associated disclosure.

Increasingly, comments appear to request disclosure of whether an ESG scoring process is used to rank investments, minimum ESG scores or ranks, and differing ESG processes by asset class or geographic region. Comments also increasingly request disclosure of how a fund complies with third-party frameworks or standards listed in registration statements.

The staff appears to have also shifted focus on where ESG investment strategy disclosure should be included, transitioning from primarily suggesting Item 9 disclosure under Form N-1A to requesting that funds consider whether Item 4 principal strategy and risk disclosure is appropriate.

Interestingly, comments in this category tend to request supplemental information for staff consideration in addition to disclosure enhancements.

Hypothetical, Representative Comments: 2021.

- Disclose whether the sustainability or ESG criteria are applied to every investment or only a subset.
- If the fund is permitted, but does not generally expect, to incorporate ESG investment processes in the selection, holding, and disposition of portfolio holdings, please remove the discussion of such investment strategies from the fund's principal investment strategy disclosure.
- Disclose whether an investment must obtain a specific "score" or criteria to be included in or excluded from the portfolio. If so, disclose the factors considered in the adviser's investment process when making such a determination.

ESG Risk Disclosure

ESG risk disclosure comments refer to instances where the staff requested that a fund add new or modify existing risk disclosure related to the ESG investment process.

Overview of Comments: 2017-18

The ESG risk-related comments identified generally request disclosure of the risks of ESG investing. Where strategy disclosure indicated an ESG-related process, the staff routinely requested associated risk disclosure. This included risks of the security selection process and risks based on a potentially limited investment universe. Comments also regularly focused the risk that ESG investing is related to long-term returns.

Consistent with an ongoing debate in the financial services industry and academic circles, the comments also requested disclosure that the consideration of ESG factors could negatively impact performance relative to funds that did not consider such factors. Where an ESG risk was proactively included without corresponding strategy disclosure, the staff routinely asked funds to revise the disclosure accordingly.

Summary of Trends Since 2017

There has been a marked shift in the nature of the comments provided.

Comments now tend to request more specialized risk disclosure. This includes disclosures related to:

- The risks of ESG data and third-party providers.
- Specific products, including risks of index construction and tracking for ETFs, the ESG risks of underlying funds in fund of funds arrangements—e.g., they may take differing approaches.
- Sub-adviser ESG investing processes.

However, more generalized comments related to the long-term nature of ESG returns and that ESG investing may exclude potential portfolio investments for non-financial reasons persist.

Staff comments have also increasingly sought to ensure consistency of ESG process discussion across strategy and risk disclosures including by, for example, commenting where risk disclosure uses different ESG terminology than the fund's strategy—socially responsible versus more generalized ESG process—or it is unclear whether statutory prospectus or statement of additional information ESG risk disclosure should apply to all funds in a combined registration statement.

Finally, there appears to be an increasing trend for fund sponsors to respond to these comments by adding new or revising existing ESG risk disclosures—including deleting immaterial ESG strategy risk disclosures.

Hypothetical, Representative Comments: 2021

- Disclose risks associated with ESG strategies related to data availability and reporting, including, if applicable, risks associated with:
  - ESG data—e.g., it may not always be available or reliable.
  - Third-party data providers—e.g., they may use differing methodologies to generate ESG scores, or scores can vary across providers.
  - ESG implementation—ESG analysis or scores may be incorrect, which could result in holding securities that do not meet stated ESG criteria, or may only take into account one of many ESG-related components of a portfolio company.

Proxy Voting

Proxy voting comments relate to a fund's stated use of proxy voting to advance ESG goals.

Proxy voting comments identified are substantially the same throughout the review period. The staff has consistently requested disclosure on how a fund will vote on portfolio company proxies related to ESG issues or supplemental discussion of why that disclosure is not required. The staff has also sought clarification of registration statement disclosures suggestive of proxy voting activities, such as statements that a fund will "pursue active ownership."

Fund sponsors have generally responded to these comments by either amending the applicable disclosure or confirming supplementally that existing proxy voting guidelines disclosed also apply to ESG proxy voting considerations.

What's Next

While it is not possible to predict the SEC's or its staff's specific actions in this area, it is reasonable to expect formal action in the near term. This may include a rulemaking proposal in 2022. While the staff's prior disclosure comments may be informative as a directional indicator, a November 2021 report from a global regulatory body may also be informative.

The International Organization of Securities Commissions (IOSCO), an international body of securities regulators, released a final report detailing recommendations for securities regulators developing sustainability-related rules, including with respect to product disclosures.

This development is significant because the SEC is a member of the IOSCO Board and because the SEC was a member of IOSCO's product disclosure recommendation working group. That recommendation paralleled in significant part the staff's disclosure comments during the review period. Specifically, IOSCO recommended that regulators establish processes related to:

- ***Naming.*** Ensuring that a product's name accurately reflects the nature and extent of a product's sustainability focus.
- ***Investment Objectives.*** Ensuring transparency around the nature and extent of a product's sustainability-related objectives, including which components of sustainability are a focus and whether sustainability is a primary focus of the product.
- ***Investment Strategies.*** Ensuring disclosure of sustainability strategies, including investment universe and selection process—e.g., types of strategies, use of ESG scores or ratings) and the extent of use.
- ***Risk Disclosure.*** Ensuring disclosure of material risks, including those specific to a product or sustainability strategy and those applicable to all sustainability-related products.
- ***Proxy Voting.*** Ensuring disclosure of a product's use of proxy voting and shareholder engagement, including access to associated policies; and information related to past proxy voting and shareholder engagement.

These categories also parallel concepts conveyed in an April 2021 staff Risk Alert on ESG Investing and by SEC Chair Gary Gensler in July 2021. Gensler expressed an intent for the SEC to assess the Names Rule's application in the ESG context and consider mandating ESG investment process-related disclosures for U.S. asset managers, including through transparency disclosure and specification of ESG factors/criteria used. The degree of overlap is strongly suggestive that the IOSCO recommendations could inform any SEC rulemaking proposal in this area.

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