

New Disclosure Rules Proposed by SEC for ESG-Focused Funds: What Investment Firms Should Know

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The Securities and Exchange Commission (SEC) has proposed changes to disclosure requirements for funds claiming to focus on environmental, social and corporate governance initiatives, aimed at promoting “consistent, comparable, and reliable information for investors” regarding [ESG-focused investment vehicles](#).

If adopted, the new rules would have a significant impact on investment firms offering mutual funds, ETFs, or any investment type that takes Environmental, Social and Governance (ESG) factors into consideration. Given the broad reach of the proposals as they currently stand, it’s critical that fund managers take the time to familiarize themselves with the new rules, and anticipate a considerable shift in how they market their products and disclose information to investors and the SEC.

Here’s a brief breakdown of the proposals and what they could mean for firms offering ESG-focused investments:

The ‘Names Rule’

The first of the SEC’s proposals would place new requirements on any fund with a

name that suggests an ESG-focused investment strategy. This is an extension of the longstanding “Names Rule,” which requires funds that mention a certain industry or asset class in their name and to allocate no less than 80% of their holdings to that specific area.

“What we’re trying to address is truth in advertising,” SEC Chair Gary Gensler said at a recent press conference following the announcement of the proposals, adding that “a fund’s name is often one of the most important pieces of information that investors use in selecting a fund.”

As expected, there has already been some pushback against the first proposal from investment firms and lobbying groups, including The Investment Company Institute’s CEO Eric Pan, who suggested to [The Wall Street Journal](#) that a fund name is merely “a tool for communicating to investors... not the sole source of information for investors about a fund’s investments and risks.”

Because ESG is meant to address a wide range of concerns and is generally thought to indicate a strategy rather than an investment in a specific industry, firms that utilize the label will need to demonstrate that 80% of their investments have been made with ESG initiatives as the central focus, which could prove challenging for more diversified funds. In anticipation of the new rule, fund managers should carefully review the [362-page rule](#) to determine specific disclosure requirements related to their strategy, in addition to preparing data that details exactly how that strategy is being implemented.

Enhanced Disclosure Requirements

The SEC’s second proposal would place even more complex and laborious demands on ESG funds regarding disclosure requirements. This includes providing additional information in “fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue.”

Specifically, the proposal would require any fund that considers environmental factors as part of its broader ESG strategy “to disclose the greenhouse gas emissions associated with their portfolio investments.” ESG “impact funds,” or investment vehicles aimed at achieving a specific impact, would also be required to regularly

provide data summarizing their progress on all relevant initiatives. And finally, funds that utilize proxy voting to determine their ESG strategy would need to provide information about the voting process, including historical data and ongoing communications that inform the fund's overall focus.

The rule has already been met with harsh criticism from fund advisors and investment lawyers, who contend the SEC is attempting to regulate ESG investments without first comprehensively defining the term. Moreover, many view the disclosure of greenhouse gas emissions to be untenable for many firms, with The Investment Company Institute [pointing out](#) that some of that information might not be publicly available. Others have raised additional questions about whether funds focused on environmental impacts beyond climate change, such as clean water initiatives, should also be required to report on emissions even though it is not their primary focus.

Regardless of these concerns, and pending clarification or further amendments to the proposal by the SEC, fund managers will need to review their portfolios and determine the most efficient and transparent way to meet these requirements. Specific investment strategies will need to be detailed concisely, and in many cases new processes will need to be implemented in order to quantify emissions across a variety of individual investments.

Getting Prepared

While the proposals have yet to be finalized, adequate preparation to comply with the SEC's new rules should become a priority of any firm utilizing an ESG strategy. Given the complexity of disclosure requirements as they are currently described, in addition to the commission's increased interest in cracking down on a lack of transparency in the ESG space, firms that haven't strategized in advance could find themselves facing significant operational hurdles in order to meet compliance, or else quickly fall under enhanced regulatory scrutiny.

In addition to performing a comprehensive review of existing investment practices, firms should consult with legal experts and accounting specialists to be sure that all potential obligations are understood, and to establish the best course of action

should the proposals be finalized.

We recommend that you keep current on the SEC's proposed disclosure rules and the potential impact it may have on your business. For further information, please contact your Anchin Relationship Partner or info@anchin.com.