GREEN BUT VERIFY: SEC PROPOSES ESG RULES FOR ADVISERS AND FUNDS

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Agenda

- SEC and ESG: Background
- ESG Rule Proposal for Advisers and Funds
- Names Rule Amendments Proposal – Potential Impacts to ESG Funds
- Next Steps
- Initial Reactions

SEC and ESG: Background

- Active regulatory and enforcement agendas
  - Exam priorities and risk alert warning against “greenwashing” and misstating sustainability practices
  - Division of Enforcement’s Climate and ESG Task Force
  - Proposed Rules on Climate-Related Disclosure and ESG Disclosures by Investment Advisers and Registered Funds

ESG Rule Proposal Summary

- Scope: Advisers, Open-end Funds, Closed-end Funds, BDCs
- Three types of ESG strategies would be defined:
  - ESG Integration
  - ESG-Focused
  - ESG Impact
- Prospectus Disclosure
- Annual Report Disclosure
- Adviser Disclosure Requirements
- Other Form Amendments and Compliance Guidance
- Timing:
  - Released May 25, 2022; comment deadline 60 days after publication in Federal Register

Defining Types of ESG Strategies/Funds

- **ESG Integration**
  - "Integration Fund" is a Fund that considers one or more ESG factors alongside other non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.
- **ESG-Focused**
  - An "ESG-focused Fund" is a Fund that focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its engagement strategy with the companies in which it invests. An ESG-focused Fund includes (i) any fund that has a name including terms indicating that the Fund's investment decisions incorporate one or more ESG factors; and (ii) any Fund whose advertisements, as defined pursuant to rule 482 under the Securities Act of 1933, or sales literature, as defined pursuant to rule 34b-1 under the 1940 Act, indicate that the Fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments.
- **ESG Impact**
  - "Impact Fund" is an ESG-focused Fund that seeks to achieve a specific ESG impact or impacts.
  - ESG Impact funds are a subset of ESG-focused funds.

Prospectus Disclosure

- **ESG Integration**
  - *Item 4*: Short narrative summarizing how the fund integrates ESG factors into its investment strategy
  - *Item 9*: More detailed description of how ESG factors are incorporated into the fund's investment strategy, including GHG emissions disclosure, if applicable
- **ESG-Focused**
  - *[ESG] Strategy Overview Table*: Provides prescriptive information about ESG aspects of a strategy
- **ESG Impact**
  - *Enhanced Requirements*: Additional specific information in the second row of the table, including what impact(s) the fund is seeking to achieve and how the fund measures progress toward these impacts

[ESG] Strategy Overview Table

Overview of the Fund's [ESG] strategy	The Fund engages in the following to implement its [ESG] strategy: ☐ Tracks an index ☐ Applies an inclusionary screen ☐ Applies an exclusionary screen ☐ Seeks to achieve a specific impact ☐ Proxy voting ☐ Engagement with issuers ☐ Other
How the Fund incorporates [ESG] factors in its investment decisions	
How the Fund votes proxies and/or engages with companies about [ESG] issues	

Annual Report Disclosure

- **Impact Funds**
  - Must disclose both qualitative and quantitative information in support of the fund's progress in achieving its stated impact objective
- **ESG Proxy-Voting Disclosure**
  - If proxy voting is significant to an ESG-focused fund's strategies, the fund must disclose specific information regarding how it voted on ESG-related proxies
- **ESG Engagement Disclosure**
  - If engagement is significant to an ESG-focused fund's strategies, the fund must disclose prescriptive information about progress on KPIs of the fund's engagement
- **GHG Emissions Reporting**
  - If an ESG-focused fund considers environmental factors as part of its strategies, the fund must report (1) carbon footprint and (2) weighted average carbon intensity (WACI) of its portfolio

Adviser Disclosure Requirements

- **Form ADV Part 2A – Adviser Brochure**
  - *Scope*: Advisers that consider ESG factors as part of their advisory business
  - *Methods of Analysis, Investment Strategies, and Risk of Loss*
    - New Item 8.D. would require disclosure describing the ESG factor(s) an adviser considers for each investment strategy or the method of analysis for which the adviser considers ESG factors
  - *Other Financial Industry Activities and Affiliations*
    - New Item 10.C. would require a description of any relationship or arrangement that is material to the adviser's business or its clients that the adviser or management persons have with any related person that is an ESG consultant or other ESG service provider
  - *Voting Client Securities* – Item 17 would be amended to require disclosure surrounding an adviser's ESG considerations when voting client securities
  - *Wrap-Fee Brochure* – Would include similar disclosures

Other Form Amendments and Compliance Guidance

- **N-CEN**
  - New Item C.3(j) would include ESG-specific information
  - All index funds would be required to report LEI of index
- **ADV Part 1A**
  - Would collect similar information from advisers to SMAs/private funds as Item C.3(j) of N-CEN
- **Compliance Guidance**
  - Proposal includes guidance reminding funds and advisers that they must have policies and procedures in place that address the accuracy of disclosures made to investors and the accuracy of portfolio-management processes, including their consistency with stated investment objectives and related disclosures
  - Expectation of policies that match level of ESG strategies employed
  - Cites to April 2021 ESG Risk Alert

Proposed Amendments to the Names Rule

- **Impacts to ESG Funds**
  - *Proposed Expansion of Scope*:
    - Would expand the universe of funds subject to the Names Rule to include funds with names that suggest focus in "investments that have, or whose issuers have, particular characteristics" and would capture some ESG-focused funds
    - 80% investment policy required if ESG term used in name of fund
  - *ESG Integration Funds*:
    - Would per se be materially misleading if ESG terms are included in the fund's name
  - *Other*:
    - Defining terms used in fund names
    - Decision not to adopt an 80% investment policy
    - No safe harbor – a fund in compliance with its 80% investment policy can still have a materially deceptive or misleading name

Next Steps

- **Climate Change Disclosure Proposal**
  - Released in March 2022; comment deadline extended to June 17, 2022
- **ESG Rule Proposal**
  - Released May 25, 2022
  - Comment deadline 60 days after publication in Federal Register
  - Final rule TBD; proposed compliance period one year or 18 months following effective date of final rule
- **Names Rule Amendments Proposal**
  - Released May 25, 2022
  - Comment deadline 60 days after publication in Federal Register
  - Final rule TBD; proposed compliance period one year after <u>publication</u> of final rule in Federal Register
- **Other**
  - Examinations, enforcement
  - Third-parties rulemaking forthcoming (timing TBD) – could impact ESG funds

Initial Reactions

- **Takeaways**
  - Regulatory trends in rulemakings
  - Challenges presented by proposed fund/strategy types
  - Intersection of ESG and Names Rule proposals
  - Exams and enforcement – not going away
- **Action Items**
  - Assess fund lineup – identify ESG strategies in each of the new categories
  - Review current ESG disclosure against proposed requirements – especially engagement, proxy voting, and GHG emissions
  - Review policies and procedures against investment practices (talk to investment management!)
  - Provide feedback on the proposals

Lance C. Dial

With more than a decade of experience as senior in-house counsel with global investment managers, **Lance Dial** has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury.

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Kelly Gibson is the co-leader of the firm's securities enforcement practice. She previously held numerous national and regional leadership roles at the US Securities and Exchange Commission (SEC), including serving as the acting deputy director of the Division of Enforcement, as leader of the Enforcement Division's nationwide Climate and Environmental, Social, and Governance (ESG) Task Force, and as director of the SEC's Philadelphia Regional Office. Kelly advises and defends public companies, financial services clients, and their executives in SEC, self-regulatory organization (SRO), and state enforcement matters, and in internal investigations. She is admitted in Pennsylvania and New Jersey only, and her practice is supervised by NY Bar members.

Leveraging her government and private practice experience, Kelly works in collaboration with the firm's corporate and business transactions, investment management, white collar defense, and labor and employment practices to advise clients on regulatory and litigation matters.

She also uses her broad ESG enforcement and policy experience to counsel public companies and registrants as they develop proactive ESG strategies, create investment products, consider disclosure requirements, and identify investment opportunities.

As acting deputy director of the SEC's Division of Enforcement, Kelly helped set enforcement priorities and assisted in supervising approximately 1,300 staff who investigate and litigate across a broad spectrum of nationwide securities matters, including issuer disclosure and accounting abuses; foreign bribery; investment advisory and broker-dealer violations; securities offering; market manipulation; insider trading; and crypto- and cyber-related misconduct. In this role, Kelly also oversaw the division's Office of Market Intelligence and Office of the Whistleblower.

In addition, Kelly served as leader of the Division of Enforcement's newly formed nationwide Climate and ESG Task Force, where she led task force members from across SEC headquarters, regional offices, and specialized units to evaluate tips, referrals, and whistleblower complaints on ESG-related issues, and to develop initiatives to proactively identify potential ESG-related misconduct involving public companies and registrants. Kelly also served as a resource for, and coordinated enforcement ESG efforts with, other SEC divisions and offices, and she met with other federal, state, and international officials regarding respective ESG priorities.

As director of the SEC's Philadelphia Regional Office, Kelly led a staff of approximately 160 enforcement lawyers, accountants, and industry specialists who investigate and litigate the federal securities laws nationwide, and examiners with oversight in the Mid-Atlantic region of nearly 1,200 investment advisers with more than $13.5 trillion in assets under management, over 150 investment fund complexes, and more than 290 broker-dealers with over 14,275 branch offices.

Earlier in her tenure, Kelly served in the Division of Enforcement's Market Abuse Unit as an assistant regional director and then as associate regional director of the SEC's Philadelphia office, where she supervised enforcement efforts. Kelly began her career at the SEC in 2008 as a staff attorney and received the SEC's Analytical Methods Award in 2016. During her tenure at the SEC, Kelly supervised, investigated, and filed actions involving a wide range of securities violations, and she closely coordinated with state and federal criminal authorities on numerous parallel investigations. Before joining the SEC, Kelly was in private practice, advising clients on internal investigations and commercial litigation matters.

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Christine Lombardo advises investment managers and broker-dealers on financial regulatory matters. She concentrates her practice on securities regulation for a broad range of financial firms including retail asset managers, private fund managers, family offices, broker-dealers, other professional traders, and high-net-worth individuals. Christine also counsels legal, compliance, and business personnel on the structure, operation, and distribution of advisory programs, including digital advisory offerings, and investment products, including hedge funds, private equity funds, venture capital funds, real estate funds, and other alternative investment products.

Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. She also serves as a co-leader of the firm's financial technology (fintech) industry team. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA.

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Amy McDonald advises registered funds, including mutual funds and exchange-traded funds (ETFs), and their investment advisers in a number of areas, such as US Securities and Exchange Commission (SEC) filings, regulatory and compliance issues, corporate matters, and Board governance. Amy also helps clients with advocacy efforts surrounding SEC rulemakings and advising on subsequent implementation and compliance questions. Amy is an active member of the firm's environmental, social, and governance (ESG) and sustainability working group, and frequently advises clients on ESG investing, disclosure, and compliance questions.

In addition to supporting clients in drafting fund documents, including registration statements, proxy materials, and exemptive applications, Amy has experience in a broad range of legal, regulatory, and transactional matters. Before joining Morgan Lewis, Amy spent almost 10 years practicing in house, serving most recently as legal counsel to the ETF business of a New York–based asset manager. Prior to this, Amy served in legal, regulatory and compliance roles for a Boston-based investment adviser/fund complex. Amy began her legal career as an associate in the financial services group of an international law firm, resident in Boston.

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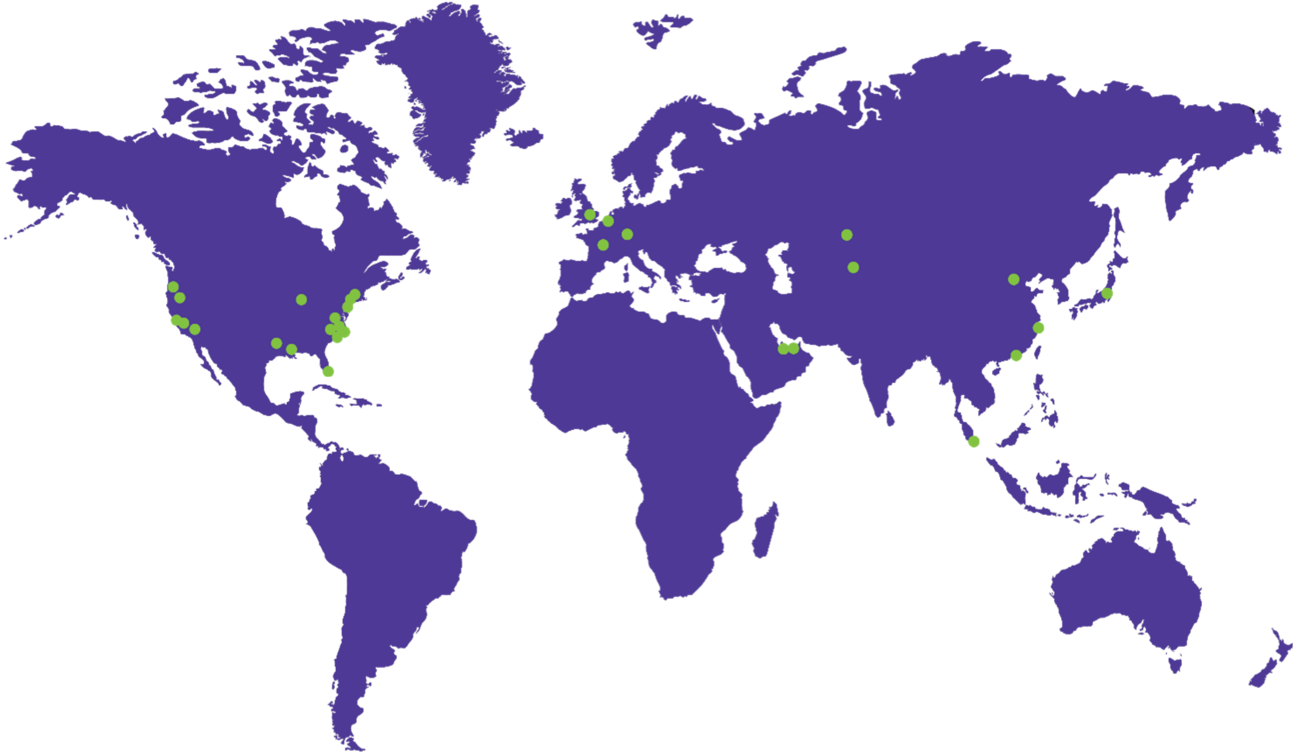

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