

Applicability of the SEC's Proposed ESG Rules to Private Fund Advisers

June 15, 2022

On May 25, 2022, the U.S. Securities and Exchange Commission (“SEC”) proposed two rules relating to Environmental, Social and Governance (“ESG”) practices by registered funds and investment advisers: (1) one relating to investment adviser and registered fund disclosures (the “Proposed ESG Rule”)¹ and (2) one relating to registered fund names (the “Proposed Names Rule”)² (collectively, the “Proposed Rules”).

These Proposed Rules appear intended to address potential “greenwashing,” a practice in which an investment adviser, for example, overstates or misrepresents the “E” (or environmental) ESG factors considered or incorporated into the adviser’s portfolio selection, such as in the adviser’s performance advertising and marketing. The Proposed Rules follow the SEC’s issuance of a separate proposal on climate-related disclosure for all SEC registrants, including public companies (“Proposed Climate Disclosure Rule”),³ which the SEC issued in March and is indicative of the SEC’s increasing focus on climate-related issues. Comments on the Proposed Rules will be due 60 days after the proposals’ publications in the Federal Register.

The majority of the Proposed Rules would not directly affect private funds, as most aspects of the rules target registered funds. However, certain parts of the Proposed ESG Rule would apply to advisers to private funds, specifically: (1) the proposed revisions to Form ADV and (2) guidance in the release proposing the Proposed ESG Rule (the “Proposing Release”) relating to compliance policies, procedures and marketing. On

¹ Securities & Exchange Commission, “Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices,” Proposed Rule (May 25, 2022), available at <https://www.sec.gov/rules/proposed/2022/ia-6034.pdf> [hereinafter *Proposing Release*].

² The Proposed Names Rule would amend Rule 35d-1 under the Investment Company Act of 1940 to require registered fund sponsors to consider various aspects, including the fund’s use of ESG factors, when selecting the fund’s name. See Securities & Exchange Commission, “Investment Company Names,” Proposed Rule (May 25, 2022), available at <https://www.sec.gov/rules/proposed/2022/ic-34593.pdf>. A discussion of the Proposed Names Rule, and the portions of the Proposed ESG Rule applicable to registered funds, is outside the scope of this Debevoise update.

³ 87 Fed. Reg. 21334 (2022). For the Debevoise In-Depth discussing the Proposed Climate Disclosure Rule, see “An In-Depth Review of the SEC Proposed Climate Change Disclosure Rule” (Apr. 25, 2022), available at <https://www.debevoise.com/insights/publications/2022/04/sec-issues-long-awaited-proposed-climate-change>.

balance, and as compared to other recently proposed rules applicable to private funds⁴ and to the Proposed Climate Disclosure Rule, the Proposed Rules are more measured in their introduction of new regulatory standards, and they contain helpful guidance as to compliance. We note that certain aspects of the Proposed ESG Rule has similarities with the European Union's Sustainable Finance Disclosure Regulation ("SFDR") and separate Taxonomy Regulation, which we discuss later in this Debevoise in-depth update.

This update discusses: (I) the Proposed ESG Rule's revisions to Form ADV, (II) the Proposed ESG Rule's guidance relating to compliance, (III) EU ESG regulations that may apply to private fund advisers and (IV) suggested next steps for private fund advisers.

Key Takeaways

- The Proposed ESG Rule represents a significant shift in private fund adviser disclosure requirements. If the Proposed ESG Rule is adopted as proposed, private fund advisers will be required to make, for the first time, disclosures based on SEC-enumerated strategies and factors rather than on broad materiality standards alone. This effectively forces advisers to highlight ESG factors more prominently than other factors, even if an adviser does not consider such factors to be material or does not market its funds and strategies as "ESG," which could potentially skew investor expectations.
- The Proposed ESG Rule does not define "ESG" or "E," "S," or "G," thus forcing private fund advisers to make subjective judgments about a particular factor's potential status as ESG related and effectively turning each strategy, at a minimum, into an "integration" strategy. Whether or not a definition of "ESG" is ultimately more helpful, the Proposed ESG Rule creates a higher level of ambiguity and a risk of second-guessing by the SEC and its staff on the nature and substance of ESG disclosures without the benefit of materiality as a threshold defense. The Proposing Release does, however, contain potentially helpful guidance with respect to

⁴ See, e.g., 87 Fed. Reg. 16866 (Proposed Rule: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews) (2022); 87 Fed. Reg. 9106 (Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers) (2022). For the Debevoise client updates on these rules, see "SEC Proposes Extensive New Rules Applicable to Private Fund Advisers" (Feb. 18, 2022), available at <https://www.debevoise.com/insights/publications/2022/02/sec-proposes-extensive-new-rules-applicable-to;> "Investment Management Regulatory Update: SEC Proposes Significant New Reporting Requirements under Form PF" (Feb. 24, 2022), available at <https://www.debevoise.com/-/media/files/insights/publications/2022/02/20220224-investment-management-regulatory.pdf>.

suggested language to describe ESG factors and their implementation, and to characterize strategies as “integration,” ESG-focused” and “impact.”

- While the Proposed ESG Rules are less onerous than the SFDR, the two regimes are similar in certain aspects, including the requirement to provide basic sustainability-related disclosures in some instances and to categorize funds based on ESG focus. Private fund advisers subject to both regimes thus should be in a position to use existing procedures and disclosures to demonstrate compliance with aspects of the Proposed ESG Rule.
- Private fund advisers will need to evaluate current ESG disclosures, determine what new disclosures would be required, and look to update, as necessary, compliance policies and processes with measures to specifically address the detailed requirements of the Proposed ESG Rule. While the Proposed ESG Rule does not expressly propose to adopt new specific compliance requirements, the SEC reaffirmed its expectations for ESG compliance as set out in a prior risk alert.

Proposed Revisions to Form ADV

The Proposed ESG Rule includes revisions to Form ADV Parts 1A⁵ and 2A.⁶ These proposed revisions would require additional disclosure of advisers’ consideration and use of ESG factors. The SEC stated in the Proposing Release that it intends for these proposed revisions to provide clients and prospective clients, as well as fund investors, with useful and comparable information with which to evaluate ESG-related services.⁷ Of note, the Proposed ESG Rule does not define “ESG” or similar terms, instead requiring advisers to describe the ESG factors considered and how they are considered. We note that the SEC specifically requests comment on whether it should define “ESG” for purposes of the Proposed ESG Rule.⁸

As a general matter, the SEC proposed three categories of “ESG” strategies” with respect to an adviser’s private funds and separately managed accounts (“SMAs”) for purposes of the Proposed ESG Rule: (i) an “integration” strategy, which considers ESG factors but

⁵ Proposing Release, pp. 354. See also Securities & Exchange Commission, “Form ADV (Paper Version) PART 1A,” Form, available at <https://www.sec.gov/about/forms/formadv-part1a.pdf>.

⁶ Proposing Release, pp. 358. See also Securities & Exchange Commission, “Form ADV (Paper Version) PART 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements,” Form, available at <https://www.sec.gov/about/forms/formadv-part2.pdf>.

⁷ Securities & Exchange Commission, “SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices,” Press Release (May 25, 2022), available at <https://www.sec.gov/news/press-release/2022-92>.

⁸ See, e.g., Proposing Release, Questions 1, 139.

does not place greater significance on such factors than non-ESG factors; (ii) an “ESG-focused” strategy, which uses ESG factors as significant or main considerations; and (iii) an “ESG impact” strategy, a subset of “ESG-focused” strategy, which seeks to achieve a specific ESG impact.

The SEC did not provide guidance on how to assess “significance” when categorizing strategies, although it did include in the Proposing Release regarding the classification of funds⁹ that the definitions for strategies are similar to those for funds.¹⁰ For example, integration funds would include those that “select investments because those investments met other criteria applied by the fund’s adviser (e.g., investments selected on the basis of macroeconomic trends or company-specific factors like a price-to-earnings ratio).”¹¹ Examples of ESG-focused funds include those that track ESG-focused indices, apply a screen to include or exclude investments based on ESG factors, or have policies of proxy voting or engaging with management of portfolio companies to encourage ESG practices.¹² Finally, examples of ESG impact funds include those that invest in portfolio companies in order to further the funds’ disclosed ESG goals, such as the construction of affordable housing units or improvement of the availability of clean water.¹³

If the Proposed ESG Rule is adopted, most of the requirements, including the Form ADV revisions discussed in this update, would take effect one year after adoption.¹⁴

Form ADV Part 1A

The Proposed ESG Rule would add new and amended questions to Part 1A of Form ADV (a “check-the-box” list of questions relating to investment advisers’ business, ownership, clients and other topics) relating to: separately managed account clients and private funds, third-party ESG frameworks, and the use of affiliated and unaffiliated ESG consultants or other ESG service providers.

ESG Disclosures for Separately Managed Account Clients and Private Fund Advisers
In Item 5.K (Separately Managed Account Clients) and Section 7.B.(1) of Schedule D (Private Fund Reporting), the Proposed ESG Rule would add new questions about how advisers use ESG factors in the advisory services that they provide to SMA clients or in managing private funds, as applicable.

⁹ See *id.* at pp. 25–66.

¹⁰ *Id.* at p. 129, FN 194.

¹¹ *Id.* at p. 26.

¹² *Id.* at p. 33.

¹³ *Id.* at p. 35.

¹⁴ *Id.* at p. 168.

Advisers would be required to disclose, for each SMA client or private fund managed, as applicable:

- whether they consider any ESG factors as one or more significant investment strategies or methods of analysis in: (A) the advisory services provided to SMA clients, including in the selection of other investment advisers if applicable, and/or as part of advisory services when requested by SMA clients (Item 5.K) and (B) the advisory services provided to private funds (Section 7.B.(1) of Schedule D);
- if yes, whether they use an integration, ESG-focused, and/or ESG impact approach; and
- which environmental, social or governance factors are considered.¹⁵

Third-Party ESG Frameworks

The Proposed ESG Rule would add a new Item 5.M, which includes a disclosure of whether the adviser follows any third-party ESG frameworks in connection with its advisory services and, if so, which frameworks.¹⁶

Use of ESG Consultants or Other ESG Service Providers

The Proposed ESG Rule would add new disclosures of whether funds use the services of ESG consultants or service providers, such as ESG index or scoring providers, in Items 6.A (Other Business Activities) and 7.A (Financial Industry Affiliations), as well as Sections 6.A and 7.A of Schedule D.¹⁷ Notably, however, the Proposed ESG Rule does not include a definition of the term “ESG consultant” or “ESG service provider.”

The SEC requests comment regarding whether each aspect of its proposed approach is appropriate. Examples of questions asked by the SEC include whether: (1) advisers should be required to indicate whether they consider E, S or G factors, as proposed, or, alternatively, only select an ESG factor if the advisor’s strategy or method of analysis considers the factor to a material degree;¹⁸ (2) additional information should be required (e.g., disclosures of advisers’ use of indices, use of inclusionary/exclusionary screens, or issuer engagement) or certain proposed information should not be required with respect to private funds;¹⁹ (3) advisers should be required to report the full name and LEI of ESG providers used for their SMA clients and private funds (currently not proposed), and, if so, whether this should only be limited to providers that the advisor relies on to a

¹⁵ See *id.* at pp. 354–355, 357–358.

¹⁶ *Id.* at p. 355.

¹⁷ *Id.* at p. 356.

¹⁸ *Id.* at Question 175.

¹⁹ *Id.* at Question 176–177.

material extent;²⁰ (4) advisers should disclose whether they consider ESG factors as part of the adviser's proxy voting policies and procedures (as proposed for registered funds but not currently proposed for advisers);²¹ (5) any proposed disclosures would reveal non-public information regarding private funds' trading strategies or other proprietary information;²² (6) both registered advisers and exempt reporting advisers should be required to complete the proposed new questions in Section 7.B.(1) of Schedule D about their reported private funds;²³ and (7) in lieu of the proposed amendments to Items 6 and 7, advisers should only be required to disclose the proposed information only if the adviser actually uses the services of the related person ESG provider (or provides its ESG provider services to its own advisory clients) to a material extent.²⁴

Form ADV Part 2A (the Adviser Brochure)

The Proposed Rule also would add new and amended instructions to Part 2 of Form ADV (instructions for mandatory narrative brochures that disclose the adviser's business practices, fees and other information) relating to methods of analysis, investment strategies, and risk of loss (Item 8), financial industry activities and affiliations (Item 10), and voting client securities (Item 17).

Item 8.D: Methods of Analysis, Investment Strategies, and Risk of Loss

The Proposed ESG Rule would add a new instruction to Item 8.D, which would require disclosure of each significant investment strategy or method of analysis for which the adviser considers ESG factors.²⁵ The adviser would be required to describe the ESG factor(s) considered and how the factors are incorporated when advising clients with respect to investments, including whether and how the adviser uses integration or ESG-focused (including ESG impact) strategies. In the Proposing Release, the SEC provides what could serve as a "model" disclosure of these factors.²⁶

For advisers that use criteria or methodologies for evaluating, selecting or excluding investments, the advisers must describe those criteria and/or methodologies, including a description of whether and how the adviser uses: an internal methodology, a third-party criterion or methodology (e.g., scoring provider or framework) or a combination of both; an inclusionary or exclusionary screen; and/or an index. We note that Item 8.B currently

²⁰ *Id.* at Question 181.

²¹ *Id.* at Question 182.

²² *Id.* at Question 183.

²³ *Id.* at, Question 184.

²⁴ *Id.* at Question 186.

²⁵ *Id.* at pp. 358–360.

²⁶ *See id.* at pp. 130–131.

requires advisers to explain material risks involved for each of its significant strategies, which the SEC believes include material risks associated with ESG investing.²⁷

Item 10.C: Other Financial Industry Activities and Affiliations

The Proposed ESG Rule would amend Item 10.C. to require a description of any material relationships with ESG consultants or ESG providers.²⁸

Item 17.A: Voting Client Securities

For advisers that have specific voting policies or procedures that include ESG considerations, the Proposed ESG Rule would amend Item 17.A. to include a description of which ESG factors are considered and how they are considered.²⁹

The SEC requests comment regarding whether each aspect of its proposed approach is appropriate. Of note, the SEC asks whether: (1) the proposed terms for “ESG integration,” “ESG-focused” and “ESG impact” are sufficiently clear;³⁰ (2) there should be an additional, separate disclosure requirement for advisers that primarily use shareholder engagement (as opposed to portfolio management) to implement their ESG priorities (which is not currently proposed);³¹ (3) as proposed, advisers should be required to disclose any relationships or arrangements with related person ESG providers that are “material” to the adviser’s business or clients;³² and (4) advisers that do not consider ESG factors when voting client securities are required to expressly disclose this fact (which is not currently proposed).³³

Exempt Reporting Advisers

Exempt reporting advisers (“ERAs”)³⁴ will be required to comply with the changes in Part 1A, Items 6 (Other Business Activities) and 7 (Financial Industry Affiliations and Private Fund Reporting), as well as in Section 7.B.(1) of Schedule D (Private Fund Reporting). ERAs are not required to complete ADV Part 2A and will not be affected by the changes to those sections.³⁵

²⁷ *Id.* at Question 139.

²⁸ *See id.* at p 360.

²⁹ *Id.*

³⁰ *Id.* at Questions 140–141.

³¹ *Id.* at Question 144.

³² *Id.* at Question 152.

³³ *Id.* at Question 155.

³⁴ The SEC does not define “exempt reporting adviser” in the regulation, but notes in the Proposing Release that exempt reporting advisers are “advisers exempt from registration under sections 203(l) and 203(m) of the Advisers Act.” *See* Proposing Release, pp. 148, FN 207.

³⁵ ERAs are required to submit the following items of Part 1A: 1 (Identifying Information), 2 (SEC Registration), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund

In its request for comment, the SEC asked whether both registered advisers and ERAs should be required to (1) complete the proposed new questions in Section 7.B.(1) of Schedule D about reported funds³⁶ and (2) report the proposed information in Items 6 and 7 of Form ADV Part 1A (and the corresponding Schedules) about other business activities as an ESG provider or any related person that is an ESG provider.³⁷

Guidance Relating to Compliance Policies, Procedures and Marketing

The Proposing Release also provides guidance relating to compliance, procedures and marketing, although it does not create or amend existing rules to incorporate such guidance. The guidance tracks substantially the SEC's recent ESG risk alert issued in April 2021³⁸ and provides helpful model language for advisers to consider as part of any amendments to their compliance policies and procedures.

Compliance Policy Reviews

In the Proposing Release, the SEC reminds advisers to annually review the adequacy and effectiveness of their compliance policies and procedures consistent with Rule 206(4)-(7) under the Investment Advisers Act of 1940 (the "Advisers Act"). With respect to ESG, advisers' compliance policies and procedures should address the accuracy of ESG-disclosures and ESG-related investment objectives in portfolio management processes.³⁹

Misleading Statements

The SEC also reminds advisers of their obligations under Rule 206(4)-(8) under the Advisers Act (prohibiting advisers to pooled investment vehicles from making false or misleading statements to existing or prospective investors) and the Marketing Rule (prohibiting advisers from distributing advertisements that contain any untrue statement of a material fact or material omissions), including with respect to ESG representations.⁴⁰ Examples of materially misleading actions cited in the Proposing Release include (1) overstating in an advertisement the extent to which ESG factors are considered in managing client portfolios and (2) overstating an adviser's contribution to

Reporting), 10 (Control Persons), and 11 (Disclosure Information), as well as corresponding schedules. See Proposing Release, pp. 155, FN 218.

³⁶ *Id.* at Question 184.

³⁷ *Id.* at Question 185.

³⁸ Securities & Exchange Commission, "The Division of Examinations' Review of ESG Investing," Risk Alert (Apr. 9, 2021), available at <https://www.sec.gov/files/esg-risk-alert.pdf>.

³⁹ See Proposing Release at pp. 165–167.

⁴⁰ *Id.* at pp. 167–168.

the development of specific governance practices (e.g., reduction in carbon emissions, at its portfolio company).⁴¹

Interaction with EU Regulations⁴²

Private fund advisers with operations in or marketing their funds into Europe would likely be covered by the European Union (EU)'s regulations in addition to the Proposed ESG Rule. Relevant EU regulations include the SFDR,⁴³ which recently entered into force on March 10, 2022, and the separate Taxonomy Regulation, which took effect between December 2021 and December 2022.⁴⁴ The SFDR (and the related Taxonomy Regulation) is more prescriptive than the Proposed ESG Rule. It provides for very specific definitions, for example of the term “sustainable investments,” and of ESG factors and terms must be used in line with that understanding. Like the Proposed ESG Rule, however, the SFDR distinguishes between three categories of disclosures for funds depending on the “ESG ambition” of the fund (and the firm):

- The SFDR requires basic sustainability-related disclosures from firms and their products within the regulation's scope, regardless of whether these firms represent themselves as providing ESG products.
- Funds that market themselves as having sustainable environmental or social characteristics (“Article 8 funds,” similar to “ESG-focused” funds under the Proposed ESG Rule), must report in addition to the basic disclosures on the sustainable characteristics promoted. The disclosure applies in that case not only as a precontractual matter but also on an ongoing basis: the annual report must include information about the performance of the fund in that regard.
- Funds that have “sustainable investment” objectives, as defined in the SFDR (“Article 9 funds,” similar to “ESG impact” funds), must, in addition to the basic disclosure, provide enhanced disclosures in the pre-contractual disclosure on the sustainability investments and the performance in the annual reports.

Funds disclosing under Article[s] 8 and 9 must also demonstrate that their investments follow “good governance” practices with respect to ESG matters. For Article 8 and 9 funds, the disclosure must be made in the form of certain mandatory templates/questionnaires.

⁴¹ *Id.*

⁴² Regulation (EU) 2019/2088; Regulation (EU) 2020/852.

⁴³ Regulation (EU) 2020/852.

⁴⁴ Regulation (EU) 2020/852.

It seems that there are some similarities as to the categories of fund products, but the SFDR seems more prescriptive in that it requires the use of specific terms with a specific meaning and also is more onerous generally. For private fund advisers that have already made disclosures in their fund documentation under the SFDR by marketing funds in the EU, the parallels between the SFDR and the Proposed ESG Rule may eventually inform those advisers' approach to the disclosure of consideration and use of ESG factors in the Proposed ESG Rule. If they comply with the SFDR, they may actually more easily be compliant with the Proposed ESG Rule.

Next Steps

In addition to submitting to the SEC a comment regarding the Proposed ESG Rule, private fund advisers should consider a number of actions to support compliance with the new disclosure rules and decrease potential enforcement risk.

The SEC's recent actions suggest that it is increasing regulatory scrutiny and enforcement activity regarding ESG matters. In addition to the Proposed Rules, the SEC published an ESG-focused risk alert in April 2021, noting that examiners would review investment advisers' and investment companies' portfolio management, performance advertising and marketing, and compliance procedures. The risk alert noted inadequacies in many of these categories.⁴⁵ In addition, the SEC's 2022 Examinations Priorities named ESG as one of the commission's priority examination areas.⁴⁶ Significantly, for the first time, the SEC included in its examination priorities a dedicated section on ESG, further indication of the agency's interest in the topic.⁴⁷

With respect to enforcement, in March 2021, the SEC established a dedicated task force focused on climate and ESG,⁴⁸ and, in May, charged an investment adviser affiliated with a large global bank with making misstatements and omissions regarding ESG considerations relating to investment choices for certain mutual funds that it managed.⁴⁹

⁴⁵ Securities & Exchange Commission, "The Division of Examinations' Review of ESG Investing," Risk Alert (Apr. 9, 2021), available at <https://www.sec.gov/files/esg-risk-alert.pdf>.

⁴⁶ Securities & Exchange Commission, "SEC Division of Examinations Announces 2022 Examination Priorities," Press Release (Mar. 30, 2022), available at <https://www.sec.gov/news/press-release/2022-57>.

⁴⁷ *Id.*

⁴⁸ Securities & Exchange Commission, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," Press Release (Mar. 4, 2021), available at <https://www.sec.gov/news/press-release/2021-42>.

⁴⁹ Securities & Exchange Commission, "SEC Charges BNY Mellon Investment Advisers for Misstatements and Omissions Concerning ESG Considerations," Press Release (May 23, 2022), available at <https://www.sec.gov/news/press-release/2022-86>.

Accordingly, we recommend that private fund advisers evaluate their current ESG disclosures on Form ADV for precision and consistency. To prevent allegations of greenwashing, advisers should ensure that their ESG disclosures on Form ADV, as well as any other public materials and statements relating to ESG, are clear, accurate and tailored to advisers' specific business practices and investment strategies. Advisers may wish to exercise caution when deciding whether to market their funds as ESG funds.

We also recommend that private fund advisers allocate sufficient resources to ensure they remain apprised of substantial regulatory developments, including anticipated revisions to the Proposed Rules. Advisers' management and compliance personnel should be well informed on the registrants' specific ESG and climate-related actions. Finally, advisers may wish to engage with accounting firms, outside counsel and other third parties for purposes of training their teams, as operative ESG, climate governance and regulatory compliance necessitates a multifaceted, coordinated effort.

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Please do not hesitate to contact us with any questions.

We would like to thank summer associate Ryan Katz for his contribution to this Debevoise In Depth.

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