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Kirkland AIM

SEC Proposes Enhanced Disclosure by Certain Advisers on ESG Investment Practices

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The SEC proposed on May 25, 2022, by a vote of 3-1, rule changes[1] that if adopted would require SEC-registered advisers to include new narrative disclosures in an adviser's Form ADV Part 2A brochure regarding Environmental, Social and Governance ("ESG") factors the adviser considers in implementing its investment strategies. Registered advisers and exempt reporting advisers ("ERAs") also would be required to report census-like information in Form ADV Part 1A concerning an adviser's ESG strategies, including separate ESG-related reporting for each private fund the adviser is required to identify in Part 1A.

The SEC's objective in proposing these changes is to promote consistent, comparable, and reliable information for investors and clients on ESG investment practices. The proposed disclosures would, according to the SEC, allow clients and investors to better compare ESG strategies across managers and to better protect themselves from "greenwashing" practices.[2]

The proposed rule, together with related proposed amendments to the Names Rule under the Investment Company Act of 1940, also includes a number of provisions that would enhance ESG disclosures by open-end and closed-end registered investment companies and business development companies ("BDCs"), which we discuss in a separate *Alert*. The proposed adviser ESG rule changes take a comparatively lighter touch with respect to advisers to private funds and separately managed accounts as compared to registered investment companies and BDCs. The rule proposal is open for public comment for **60 days** after publication in the Federal Register, which can take a couple of weeks from the date the SEC proposed the rules.[3]

Proposed Form ADV ESG Disclosure Requirements

The proposal would require a registered adviser to specifically address its ESG practices in several sections of both Form ADV Part 1A and the Part 2A brochure. Since ERAs only file Form ADV Part 1A, ERAs would only be required to complete the proposed revisions in Part 1A (described below). The SEC does not define E, S or G in the proposed rule, and, absent additional guidance, advisers will be tasked with assessing and potentially disclosing a panoply of factors regardless of whether they are actively marketing ESG strategies. For instance, if the proposal is adopted, an adviser that considers flood plain or hurricane data in making a real estate investment may be required to disclose these as environmental factors it uses in selecting its investments. Advisers solely to private funds or separately managed accounts would not, however, be required to disclose ESG metrics, such as greenhouse gas emissions for portfolio holdings, which is part of the SEC's more extensive proposal for registered investment companies and BDCs.

New Disclosures to Advisory Clients — Form ADV Part 2A Brochure

Piggybacking off the existing requirement for advisers to disclose significant investment strategies or methods of analysis, for each strategy or method of analysis for which an adviser considers any ESG factor, the adviser would be required to provide a description of each ESG factor it considers and how it incorporates those factors in the advice it provides to clients, including clients that are private funds.

For each strategy or method of analysis, an adviser must include an explanation of whether the strategy is one of three SEC-defined strategies, which are ESG-integration (ESG factors no more significant than other non-ESG factors), ESG-focused (ESG factor is significant or main consideration) or ESG-impact (a subset of a focused strategy designed to achieve a specific ESG impact). Additional details would be required regarding impact strategies, including how an adviser measures its progress in meeting ESG goals, such as the key performance indicators and time horizons the adviser uses in its analysis.

For each strategy or method of analysis based on ESG considerations, an adviser must describe any criteria or methodology used to evaluate, select or exclude investments and describe how it uses these criteria or methodologies. The disclosure must address the adviser's utilization of any internal or third-party methodologies or frameworks, scoring or rating providers, inclusionary or exclusionary screens, or ESG indexes.

Advisers also would be required to describe any securities voting policies and procedures that include ESG considerations, and any material arrangement with a related person ESG consultant or ESG service provider.

New Census Information — Form ADV Part 1A

The proposed amendments to Form ADV Part 1A would collect census-like information about the ESG-related advisory services provided to separately managed account clients (SMAs) and reported private funds in a check-the-box (Yes or No) format. In each case, an adviser would have to identify whether it uses an ESG integration, focused, or impact strategy (as defined by the SEC) in providing services to its SMA or fund clients and which factors it considers (E, S and/or G). The new reporting requirements are designed to capture the information above separately for each private fund, but in the aggregate for all SMA clients of the adviser. An adviser also would be required to report the name of any third-party ESG framework it follows, as well as whether the adviser or any of its related persons is an ESG consultant or other ESG service provider.

Compliance Program — ESG Requirements

The SEC also took the opportunity to **reaffirm** its view that existing obligations under the compliance rule under the Investment Advisers Act of 1940 (Rule 206(4)-7) require advisers' compliance programs to address the accuracy of ESG disclosures and to ensure portfolio management processes are consistent with disclosures. This view is consistent with the Division of Examination's ESG Risk Alert that was published in April 2021.[4]

Compliance Date

As proposed, advisers would be required to complete the new items and update their brochures one year after publication of an adopting release.

Takeaways

If adopted, the rule would reflect a significant shift in the SEC's current disclosure regime for private fund sponsors by focusing disclosure on a particular targeted aspect of the investment process. The proposal would require additional disclosure for any significant investment strategy where an ESG factor is considered regardless of ESG's overall significance or materiality to the strategy, thereby setting ESG apart from any other type or element of an investment strategy. Further, because the SEC has not defined the terms E, S or G, or what is scoped in as an ESG strategy, many private fund strategies may potentially be categorized as integration strategies under the proposal.

Private fund advisers should take the opportunity to review any disclosures or representations made regarding ESG practices and policies, particularly those with respect to ESG frameworks, screens, or engagement practices, and assess whether their ESG investment practices are consistent with disclosures and representations. In addition, private fund advisers may want to review their compliance programs to confirm that they address SEC hot button issues including marketing, portfolio management processes and investor disclosures regarding firm ESG practices.

If you have any questions about the matters addressed in this *Kirkland AIM*, please contact the following Kirkland attorneys or your regular Kirkland contact.

Regulatory: Norm Champ, Scott Moehrke, Diane Blizzard, Michael Chu, Matthew Cohen, Marian Fowler, Melissa Gainor, Phil Giglio, Nicholas Hemmingsen, Daniel Kahl, Alpa Patel, Eric Perelman, Noah Qiao, Jaime Schechter, Christopher Scully, Reed Schuster, Ryan Swan, Josh Westerholm

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1. The Proposing Release is available through this link.↩

2. The SEC specifically addressed greenwashing in the release, noting that the practice is already prohibited as a misleading practice under existing Advisers Act antifraud provisions. See also In the Matter of BNY Mellon Investment Adviser, Inc. (May 23, 2022) (charging an SEC-registered adviser for material misstatements and omissions concerning ESG principles in making investment decisions for certain registered funds the adviser manages). The SEC also specifically highlighted as a materially misleading practice an adviser overstating its contributions to portfolio company ESG practices (e.g., reduction in carbon emissions or enactment of specific governance practices) when actual advisory practice is limited or inconsequential.↩

3. A 60-day period of time reflects the traditional amount of time the SEC has historically granted for the submission of comments.↩

4. See Examinations Risk Alert: The Division of Examinations' Review of ESG Investing (April 9, 2021).↩

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Related Services

Practices

- Investment Funds
- ESG & Impact

Suggested Reading

- 16 November 2022 - 17 November 2022 Sponsored Event PEI Responsible Investment Forum Europe
- 08 November 2022 - 10 November 2022 Sponsored Event PERE America Summit 2022
- 25 July 2022 - 26 July 2022 Sponsored Event Pension Bridge Private Equity Exclusive