

June 7, 2022

SEC Proposes ESG-Related Disclosures by Registered Funds and Investment Advisers

On May 25, 2022, the SEC issued a [release](#) (the “Release”) containing proposed rule and form amendments under both the Advisers Act and the 1940 Act (the “Proposals”) to require registered investment advisers (“advisers”), registered investment companies and business development companies (collectively, “funds”) to disclose additional information about their ESG investment practices.

On the same day, the SEC issued a separate release containing proposals to substantially expand the applicability of Rule 35d-1 under the 1940 Act (the “Names Rule Release”) and require funds to amend their prospectus disclosure. The Names Rule Release is discussed in a prior Ropes & Gray [Alert](#).

If adopted as proposed, the Proposals would require specific disclosure regarding ESG strategies in fund registration statements, the management discussion of fund performance in fund annual reports, and adviser brochures.¹ Specifically, the Proposals would:

- Differentiate among three ESG investment strategies: “ESG Integration,” “ESG-Focused,” and “ESG Impact” and funds that employ each of these strategies. In general:
 - An ESG Integration strategy considers one or more ESG factors alongside other, non-ESG factors in its investment decisions, and the ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be dispositive with respect to any particular investment.²
 - An ESG-Focused strategy focuses on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies (*e.g.*, screens for carbon emissions, board or workforce diversity and inclusion, or industry-specific issues).
 - An ESG Impact strategy seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits (*e.g.*, financing the construction of affordable housing units or advancing the availability of clean water).
- Complement the proposed ESG disclosures in fund registration statements and annual reports and adviser brochures, by requiring certain ESG reporting on Forms N-CEN and ADV Part 1A.
- Amend advisers’ Form ADV Part 2A (the “brochure”) to include information about advisers’ ESG practices.
- Amend Form N-CEN to include items that are designed to collect census-type information regarding ESG-related funds and the ESG-related service providers they use, and amend Form ADV Part 1A to expand the ESG information collected about the advisory services provided to separately managed account (“SMA”) clients and reported private funds.

I. Prospectus ESG Disclosure Enhancements

In General. The Proposals’ disclosure requirements would apply to open-end funds (including ETFs) and closed-end funds (including BDCs) that incorporate one or more ESG factors in their investment selection process. The Proposals do not define “ESG” or similar terms but, instead, would “require funds to disclose to investors (1) how they incorporate ESG factors into their investment selection processes and (2) how they incorporate ESG factors in their investment

strategies.” Under the Proposals, funds that meet the proposed definition of “Integration Fund” would provide more limited disclosures. In contrast, “ESG-Focused” Funds (e.g., funds that apply inclusionary or exclusionary screens, funds that focus on ESG-related engagement with the issuers in which they invest and funds that seek to achieve a particular ESG impact) would be required to provide more detailed information in a tabular format.

Integration Funds. Under the Proposals, funds that meet the proposed definition of “Integration Fund” are required to provide fewer new disclosures.³

Specifically, the Proposals would require an Integration Fund to summarize in a few sentences how the fund incorporates ESG factors into its investment selection process, including disclosing the ESG factors considered. An Integration Fund would be permitted to provide a brief narrative of how it incorporates factors, or provide an example to illustrate how it considers ESG factors with other factors. This disclosure would be in addition to the information funds currently are required to provide in their prospectuses about their investments, risks and performance. Open-end funds would provide this information in the summary section of a fund’s prospectus. Closed-end funds, which do not use summary prospectuses, would be required to disclose this information within the prospectus’s general description of the fund.

The Release notes that while an Integration Fund will be required to summarize in a few sentences how it incorporates ESG factors into its investment selection process, the Proposals do not require more extensive disclosure in the summary prospectus. The Release notes that requiring a more detailed discussion of ESG factors could cause an Integration Fund to overemphasize the role ESG factors play in the fund’s investment selection process by adding ESG disclosure requirements that could result in a more detailed description of ESG factors than other factors, and this overemphasis could impede informed investment decisions because ESG factors discussed at length would not play a central role in the fund’s strategy. For these reasons, the Proposals contemplate a layered disclosure approach for Integration Funds. Specifically, the Proposals complement the concise description described above with a more detailed description of how an Integration Fund incorporates ESG factors into its investment selection process in an open-end fund’s statutory prospectus or later in a closed-end fund’s prospectus. This more detailed description would provide information about the fund’s integration of ESG factors in its investment strategy to facilitate informed decision-making by providing investors more detail about the extent to which the fund considers those ESG factors as compared to other factors in the fund’s investment selection process.

If an Integration Fund considers greenhouse gas (“GHG”) emissions, it will be required to provide more detailed information in its statutory prospectus or, in the case of a closed-end fund, later in its prospectus.⁴ Specifically, an Integration Fund that considers the GHG emissions of portfolio holdings as an ESG factor in its investment selection process would be required to describe how the fund considers the GHG emissions of its portfolio holdings.

ESG-Focused Funds. Under the Proposals, an ESG-Focused Fund,⁵ which would include any ESG Impact Fund,⁶ would be required to provide specific disclosure about how the fund focuses on ESG factors in its investment process.

- ESG-Focused Funds would be required to provide key information about their consideration of ESG factors in a table format (an “ESG Strategy Overview table”) in the fund’s prospectus. An open-end fund would be required to provide the table at the beginning of its “risk/return summary,” and a closed-end fund would provide the table at the beginning of the discussion of the fund’s organization and operation.⁷
- An Impact Fund would have additional disclosure requirements, described below, including how the Impact Fund measures progress towards its stated impact (including the key performance indicators the fund analyzes), the time horizon employed for measuring that progress and the relationship between the impact the fund seeks to achieve and the fund’s financial returns. As with other proposed requirements, the fund would provide a more detailed description later in the prospectus to complement the overview provided in the ESG Strategy Overview table.

The Proposals specify the following format for the required table. A fund may replace the term “ESG” with another term or phrase that more accurately describes the applicable ESG factors the fund considers.

[ESG] Strategy Overview

<p>Overview of the fund’s [ESG] strategy</p>	<p>Concise description of the factor(s) that are the focus of the fund’s strategy, plus check the applicable box(es):</p> <p>The fund engages in the following to implement its [ESG] Strategy:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Tracks an index <input type="checkbox"/> Applies an inclusionary screen <input type="checkbox"/> Applies an exclusionary screen <input type="checkbox"/> Seeks to achieve a specific impact <input type="checkbox"/> Proxy voting (if a “significant means” of implementing an identified ESG strategy) <input type="checkbox"/> Engagement with issuers (same) <input type="checkbox"/> Other
<p>How the fund incorporates [ESG] factors in its investment decisions</p>	<p>The summary must be in a disaggregated manner with respect to each of the common ESG strategies identified by the “check the box” disclosure</p> <p>Additional requirements apply for Impact Funds</p>
<p>How the fund votes proxies and/or engages with companies about [ESG] issues</p>	<p>Requirements vary differ depending upon whether fund has checked the boxes “proxy voting” or “engagement with issuers” in Row 1</p>

The Proposals would require an ESG-Focused Fund to complement each row’s brief disclosure with more-detailed disclosure or other available information required elsewhere in the prospectus. In an electronic version of the prospectus – posted on the fund’s website, delivered electronically or filed on EDGAR – the fund also would be required to provide hyperlinks in the table to the related, more-detailed disclosure appearing later in the prospectus. The disclosure that would be required in each row of the table follows.

Row 1: Overview of [the Fund’s] [ESG] Strategy. In this row, an ESG-Focused Fund would be required to provide:

- A concise description in a few sentences of the factor or factors that are the focus of the fund’s strategy (e.g., environmental factors, and in particular, on greenhouse gas emissions, if applicable).
- A list of common ESG strategies, as indicated in the ESG Strategy Overview table and in a “check the box” style, indicate all strategies in that list that apply. These check boxes would identify common ESG strategies such as the tracking of an index, the application of an exclusionary or inclusionary screen, impact investing, proxy voting,

and engagement with issuers. If none of the common ESG strategies applied to the ESG-Focused Fund, the fund would not be required to check any of the boxes and, instead, would check the “other” box.

- Checking the boxes “proxy voting” or “engagement with issuers” requires a fund to meet a minimum threshold. The Release states that “a fund would only check the boxes regarding proxy voting or engagement with issuers if either such strategy is a ‘significant’ means of implementing the fund’s ESG strategy.”
- In contrast, for the other common strategies represented by the check boxes in Row 1, a fund would be required to check a box if the fund merely employs the strategy described by the check box (*i.e.*, there is no “significant” requirement).
- The distinction is intended to cull funds that incorrectly believe that either (i) simply voting on ESG proxy matters or (ii) holding meetings with certain issuers on an infrequent or ad hoc basis would be sufficient for the fund to check the associated box in the ESG strategy overview in Row 1.
 - The Release states that the Proposals’ “significant” requirement (in order to check the associated box) “results in the strategy being appropriately limited to funds that proactively use proxy voting or engagement with issuers as a means of implementing of their ESG strategy.”
 - The Release states that a fund’s determination of whether either proxy voting or engagement with issuers is significant depends on the facts and circumstances. However, a fund that “regularly and proactively votes proxies or engages with issuers on ESG issues to advance one or more particular ESG goals the fund has identified in advance would be using voting and engagement as a significant means to implement its strategy.”

Row 2: How the Fund Incorporates [ESG] Factors in Its Investment Decisions. In this row, the Proposals would require an ESG-Focused Fund to summarize how it incorporates ESG factors into its investment decision-making. Funds would be required to provide specific information in this row and to supplement this row’s overview with a more detailed description later in the prospectus.⁸

The Release states that the fund “would provide specific information, in a disaggregated manner, with respect to each of the common ESG strategies applicable to the fund as identified by the ‘check the box’ disclosure.” For clarity, a fund would be permitted to use multiple rows in the table or other text features to clearly identify the disclosure related to each applicable common ESG strategy.

- If the fund applies an inclusionary or exclusionary screen to select or exclude investments, the fund’s summary must briefly explain the factors the screen applies, such as particular industries or business activities it seeks to include or exclude and, if applicable, what exceptions apply to the screen. The fund also would be required to state the percentage of the portfolio, in terms of NAV, to which the screen applies (if less than 100%, excluding cash and cash equivalents held for cash management) and to explain why the screen applies to less than 100% of the portfolio.
- If the fund uses an internal methodology, a third-party data provider or a combination of both in selecting or excluding investments, the fund’s summary must describe how the fund uses the methodology, third-party data provider or combination of both, as applicable.
- If the fund tracks an index, the fund’s summary must identify the index and briefly describe the index and how it utilizes ESG factors in determining its constituents.

- If applicable, the fund’s summary must provide an overview of any third-party ESG frameworks that the fund follows as part of its investment process (e.g., the United Nations Sustainable Development Goals or the United Nations Principles for Responsible Investing).

Additional requirements for Impact Funds. In addition to the proposed disclosures described above, an Impact Fund would be required to provide in the second row an overview of the impact(s) the fund is seeking to achieve, and how the fund seeks to achieve the impact(s). This overview must include (i) how the fund measures progress toward the specific impact (including the key performance indicators the fund analyzes), (ii) the time horizon the fund uses to analyze progress and (iii) the relationship between the impact the fund is seeking to achieve and financial return(s). Like the other proposed disclosure requirements, the Proposals would require the fund to provide a more detailed description later in the prospectus.⁹

In addition to disclosure in the ESG Strategy Overview table, the Proposals would require an Impact Fund to disclose in its investment objective the ESG impact that the fund seeks to result from its investments.¹⁰ The Release states that, for both open-end and closed-end funds, this requirement is designed “to highlight for investors any ESG-related impact an Impact Fund is seeking to achieve, given that such specific or measurable impacts differentiate Impact Funds from other ESG-Focused Funds.”

Row 3: Proxy Voting or Engagement with Companies. As described above, the Proposals would require ESG-Focused Funds, which include Impact Funds, for which engagement with issuers – either by voting proxies or otherwise – is a significant means of implementing their ESG strategy to check the appropriate box in Row 1 of the ESG Strategy Overview table. A fund that checks either the proxy voting or engagement box in the first row of the ESG Strategy Overview table (a “Proxy/Engaged Fund”) would be required to provide a brief narrative overview in Row 3 of the ESG Strategy Overview table disclosing how the fund engages with portfolio companies on ESG issues.

- The Proposals would require a Proxy/Engaged Fund to identify whether the fund has specific or supplemental proxy voting policies and procedures that include one or more ESG considerations for companies in its investment portfolio and, if so, state which ESG considerations those policies and procedures address.
- If a Proxy/Engaged Fund seeks to engage with issuers on ESG matters other than through voting proxies, such as through meetings with or advocacy to management, the fund would be required to disclose in Row 3 an overview of the objectives it seeks to achieve with its engagement strategy.
- An ESG-Focused Fund that does not check the proxy voting box or the engagement box in the first row would still be required to include this row in the ESG Strategy Overview table, and would disclose that neither proxy voting nor engagement with issuers is a significant means of implementing its investment strategy.¹¹

The brief narrative overview disclosure provided by a Proxy/Engaged Fund in its ESG Strategy Overview table’s Row 3 must be complemented by information in an open-end fund’s statutory prospectus and later in a closed-end fund’s prospectus. Specifically, the fund would be required to disclose specific information on the objectives it seeks to achieve with its engagement strategy, including the fund’s time horizon for progressing on such objectives and any key performance indicators that the fund uses to measure the effectiveness of this engagement.¹²

II. Unit Investment Trusts (“UITs”)

The Proposals would require any UIT with portfolio securities selected based on one or more ESG factors to explain how the factors were employed to select the portfolio securities.¹³ The Proposals would not differentiate disclosure based on whether a UIT’s selection process was ESG Integration or ESG-Focused. The Release notes that because UIT trustees generally engage in “mirror voting” of shares (i.e., vote the UIT’s shares in a portfolio company in the same proportion as

the vote of all other holders of the portfolio company's shares), the Proposals do not require disclosure of engagement with portfolio companies.

III. Fund Annual Report ESG Disclosure

Overview. In addition to the proposed amendments to fund prospectuses, the Proposals contain amendments to fund annual reports to provide additional ESG-related disclosure. For open-end funds and closed-end funds, the proposed disclosure would be included in the management's discussion of fund performance (the "MDFP") section of the fund's annual shareholder report. For BDCs, the proposed disclosure would be included in the management discussion and analysis (the "MD&A") in the BDC's annual report on Form 10-K.

Impact Fund Disclosure. The Proposals would require an Impact Fund to summarize briefly the fund's progress on achieving its specific impact(s) in both qualitative and quantitative terms during the reporting period, and the key factors that materially affected the fund's ability to achieve the specific impact(s), on an annual basis in its annual report.¹⁴

ESG Proxy Voting Disclosure. The Proposals would require an ESG-Focused Fund for which proxy voting is a significant means of implementing its ESG strategy to disclose specific information about how it voted proxies relating to portfolio securities on particular ESG-related voting matters. Specifically, the Proposals would require an ESG-Focused Fund to disclose, in the MDFP or MD&A section of its annual report, as applicable, the percentage of ESG-related voting matters during the reporting period for which the fund voted in furtherance of each ESG-related initiative.

- An ESG-Focused Fund would be permitted to limit the disclosure to voting matters involving ESG factors that the fund incorporates into its investment decisions.
- An ESG-Focused Fund would be required to refer investors to its full voting record filed on Form N-PX by providing a cross reference (for electronic versions of the annual report, by including a hyperlink) to the fund's most recent complete proxy voting record filed on Form N-PX.

ESG Engagement Disclosure. The Proposals contain amendments that apply only to annual reports of funds for which engagement with issuers through means other than proxy voting is a significant means of implementing their ESG strategy.¹⁵ These funds would be required to disclose (i) progress on any key performance indicators of such engagement and (ii) the number or percentage of issuers with whom the fund held ESG engagement meetings during the reporting period related to one or more ESG issues and total number of "ESG engagement meetings."

- The Proposals would define "ESG engagement meeting" to mean "a substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given time period, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal." The Release notes that this definition is intended to identify substantive interactions on ESG issues and distinguish an "ESG engagement meeting" for this purpose from other meetings or interactions for which advocacy on ESG issues is not a focus, or from aspects of a fund's ESG engagement strategy that are not directed to a particular company, such as letters to all issuers in a fund's portfolio or policy statements describing a fund's ESG priorities.
- According to the Release, to support compliance with the federal securities laws, funds should generally consider including in their compliance policies and procedures a requirement that employees memorialize the discussion of ESG issues (e.g., by creating and preserving meeting agendas and contemporaneous notes of engagements relating to ESG issues) to assure accurate reporting on the number of ESG engagement meetings.

GHG Emissions Disclosure. The Proposals would require an ESG-Focused Fund that considers environmental factors as part of its investment strategy to disclose the carbon footprint and the weighted average carbon intensity (“WACI”) of the fund’s portfolio in the MDP or MD&A section of the fund’s annual report, as applicable.

- This proposed requirement would apply to ESG-Focused Funds that indicate that they consider environmental factors in response to Item C.3(j)(ii) on Form N-CEN, but do not affirmatively state that they do not consider issuers’ GHG emissions as part of their investment strategy in the “ESG Strategy Overview” table in the fund’s prospectus (“environmentally focused fund”).
- These requirements also would apply to a BDC that considers environmental factors as part of its investment strategy. The SEC recently proposed to require BDCs (and publicly traded operating companies) to provide climate-related information in their annual reports on Form 10-K, including a BDC’s Scope 3 emissions if material or if Scope 3 emissions are part of an announced emissions reduction target.
- The methodologies to calculate an ESG-Focused Fund’s carbon footprint and its WACI are complex and are summarized in the Appendix to this Alert.

IV. Inline XBRL Data Tagging

The Proposals would require funds that include the Proposals’ ESG-related registration statement disclosure and fund annual report disclosure to file this information with the SEC using a structured, machine-readable data language (“Inline XBRL”).

V. Adviser Brochure (Form ADV Part 2A)

The Proposals would amend Form ADV Part 2A (the “brochure”) to include information about advisers’ ESG practices. These amendments share several elements with the requirements in the Proposals for funds that consider ESG factors.

Item 8: Methods of Analysis, Investment Strategies and Risk of Loss. The Proposals would add a new sub-Item 8.D that would require an adviser to provide a description of the ESG factor or factors it considers for each significant investment strategy or method of analysis (“significant strategies”) for which the adviser considers any ESG factors.

- Similar to the Proposals with regard to registered funds, the Proposals would not define “ESG” or similar terms. Instead, the Proposals would require advisers to provide a description of the ESG factor or factors they consider, and disclose how they incorporate these factors when providing investment advice, including when recommending or selecting other investment advisers.
- The Proposals contain definitions for ESG Integration, ESG-Focused and ESG Impact strategies, which are similar to the Proposals’ definitions of these terms for registered funds.
- Proposed sub-Item 8.D would require an explanation of whether and how the adviser incorporates a particular ESG factor (E, S, or G) and/or a combination of factors. The proposed disclosure would include an explanation of whether and how the adviser employs Integration and/or ESG-Focused strategies and, if ESG-Focused, whether and how the adviser also employs ESG Impact strategies. An adviser that considers different ESG factors for different strategies would include the proposed disclosures for each strategy.
 - If an adviser employs an ESG Integration strategy, the adviser would explain how it incorporates the ESG factors when making investment recommendations. This explanation would include that the adviser considers other, non-ESG factors alongside its consideration of the indicated ESG factors, but that the ESG factors are generally no more significant than the other factors when providing investment advice, such that ESG factors may not be dispositive in deciding whether to recommend any particular investment.

- If an adviser employs an ESG-Focused strategy (because it focuses on one or more ESG factors by using them as a significant or main consideration in providing investment advice or in its engagement strategy with the companies in which its clients invest), it would describe those ESG factors. It would also describe how the adviser incorporates those factors when providing investment advice.
- If an adviser employs an ESG-Focused approach that is also considered an ESG-Impact approach (because the adviser seeks to achieve a specific ESG impact or impacts for the significant strategy) the Proposals would require additional disclosures (i) an overview of the impact(s) the adviser is seeking to achieve, (ii) how the adviser is seeking to achieve the impact(s) and (iii) how the adviser measures progress toward the stated impact, including the key performance indicators the adviser analyzes, the time horizon the adviser uses to analyze progress, and the relationship between the impact the adviser is seeking to achieve and financial return(s).
- If an adviser employs, for any significant strategy, criteria or a methodology to select or exclude investments based on the consideration of ESG factors, the Proposal would require the adviser to describe the criteria and/or methodologies and how it uses them. An adviser that employs different criteria or methodologies for different strategies would include the proposed disclosures for each significant strategy.
- Similar to the Proposals' requirements for funds, the Proposals' sub-Item 8.D would provide a non-exclusive list of criteria and methodologies to address, as applicable:
 - An internal methodology, a third-party criterion or methodology such as a scoring provider or framework, or a combination of both, including an explanation of how the adviser evaluates the quality of relevant third-party data;
 - An inclusionary or exclusionary screen, including an explanation of the factors the screen applies, such as particular industries or business activities it seeks to include or exclude and, if applicable, what exceptions apply to the inclusionary or exclusionary screen; and
 - An index, including the name of the index and a description of the index and how the index utilizes ESG factors in determining its constituents.

Item 10: Other Financial Industry Activities and Affiliations. Advisers are currently required to disclose information about their financial industry activities and affiliations in Item 10 of Form ADV Part 2A. The Proposals would amend Item 10.C. to require an adviser to describe any relationship or arrangement that is material to the adviser's advisory business or to its clients, that the adviser or any of its management persons have with any related person that is an ESG consultant or other ESG service provider.¹⁷

Item 17: Voting Client Securities. Item 17 of the brochure requires advisers that have (or will accept) authority to vote client securities to briefly describe their voting policies and procedures. The Proposals would amend Item 17.A to require advisers that have specific voting policies or procedures that include one or more ESG considerations when voting client securities to include in their brochures a description of which ESG factors they consider and how they consider them. If an adviser has different voting policies and procedures for strategies that address ESG-related matters, or for different clients or different ESG-related strategies, the adviser generally would be required to describe those differences.

Wrap Fee Brochure (Form ADV Part 2A, Appendix 1). Advisers that sponsor wrap fee programs are required to prepare a specialized brochure that must be delivered to their wrap fee clients ("wrap fee program brochure").

- Advisers sponsoring wrap fee programs are required to describe in Item 4 of their wrap fee brochures the services, including the types of portfolio management services, provided under each program. Like the Proposals' brochure

disclosures, the Proposals would amend this Item to specify that advisers that consider ESG factors in their wrap fee programs must provide a description of what ESG factors they consider, and how they incorporate the factors under each program. E, S, or G would not be defined, but the Proposals would require advisers to discuss any ESG factors they consider.

- Advisers sponsoring wrap fee programs are required to describe in Item 6 of their wrap fee brochures how they select and review portfolio managers. The Proposals would amend Item 6 to require advisers that consider ESG factors when selecting, reviewing, or recommending portfolio managers within the wrap fee programs they sponsor, to describe in their wrap fee program brochures the ESG factors they consider and how they consider them. The description of ESG factors generally should include the types of ESG information the adviser considers and must include how the adviser considers the ESG factors.
- The Proposals also would add three Item 6 disclosure requirements as part of an adviser’s description of how they consider the relevant ESG factors described above. Specifically, advisers would be required:
 - To describe any criteria or methodology they use to assess portfolio managers’ applications of the relevant ESG factors into their portfolio management. This would include any industry or other standards for presenting the achievement of ESG impacts and/or third-party ESG frameworks, and any internal criteria or methodology.
 - To provide an explanation of whether they review, or whether a third party reviews, portfolio managers’ applications of the relevant ESG factors described above. If a review occurs, the Proposals would require a description of the nature of the review and the name of any third party conducting the review.
 - If applicable, to explain that neither the adviser nor a third party assesses portfolio managers’ applications of the relevant ESG factors into their portfolio management, and/or that the portfolio managers’ applications of the relevant ESG factors may not be calculated, compiled, assessed or presented on a uniform and consistent basis. As part of this disclosure item, the adviser would also be required to state and explain why, if applicable, any ESG factors it considers in evaluating portfolio managers may not be calculated, compiled, assessed or presented on a uniform and consistent basis.
- The Proposals would amend Item 6.C., which requires certain disclosures in the wrap fee brochure of any adviser that acts as a portfolio manager for a wrap fee program described in its wrap fee program brochure (a “sponsor-manager”). The Proposals would amend Item 6.C requiring sponsor-managers to respond to new Item 8.D from the sponsor-manager’s brochure (described above). Because wrap fee clients of sponsor-managers are generally not required to receive separate brochures from the sponsor-manager, this will provide these clients with the sponsor-manager’s ESG disclosures in the wrap fee brochure.

VI. Regulatory Reporting on Form N-CEN

The Proposals would amend Form N-CEN to include items that are designed to collect census-type information regarding ESG-related funds and the ESG-related service providers they use in a structured data language.

The Proposals would add Item C.3(j) to Form N-CEN containing questions tailored to ESG-related funds’ strategies and processes. A fund that indicates that it incorporates ESG factors would be required to report, among other things, (i) the type of ESG strategy it employs (*i.e.*, Integration, Focused or Impact) as those strategies are defined in the Proposals’ Item 4(a)(2)(i) of Form N-1A and Item 8.2.e of Form N-2, as applicable, (ii) the ESG factor(s) it considers (*i.e.*, E, S, and/or G) and (iii) the method it uses to implement its ESG strategy (*i.e.*, tracking an index, applying an inclusionary and/or exclusionary screen, proxy voting, engaging with issuers and/or other).

- In responding to proposed Item C.3(j) of Form N-CEN, an ESG-Impact Fund would be required to report that it is both an ESG-Focused Fund and an ESG-Impact Fund.
- The Proposals' amendments to Form N-CEN would also collect information regarding whether a fund considers ESG-related information or scores provided by ESG providers in implementing its investment strategy. If so, the fund would be required to provide the legal name and legal entity identifier ("LEI"), if any, or provide and describe an other identifying number of each such ESG provider. A fund would also be required to report whether the ESG provider is an affiliated person of the fund.
- The Proposals' amendments to Form N-CEN would require a fund to report whether the fund follows any third-party ESG frameworks. If so, the fund would be required to provide the full name of such frameworks.
- Form N-CEN currently requires any fund that tracks the performance of an index to identify itself as an index fund and to provide certain information about the index. The Proposals would amend Form N-CEN to require all index funds to report the name and LEI, if any, or provide and describe another identifying number of the index the fund tracks.

VII. Regulatory Reporting on Form ADV Part 1A

The Proposals' amendments to Form ADV Part 1A would expand the information collected about the ESG advisory services provided to separately managed account clients and reported private funds.

ESG Data for Separately Managed Account Clients and Private Funds. The Proposals' amendments to Form ADV Part 1A would lead to the collection of information about advisers' uses of ESG factors for their SMA clients and reported private funds.

- The Proposals would amend Form ADV Part 1A to Item 5.K. (Separately Managed Account Clients) and corresponding sections of Schedule D, which currently require advisers to provide information about their advisory businesses with respect to SMA clients. The amendments would collect aggregated information for an adviser's applicable SMA clients.
- The Proposals would make similar amendments to private fund reporting in Section 7.B.(1) of Schedule D to collect information from private fund advisers about their uses of ESG factors in managing each reported private fund. This information would be similar to the information the Proposals would collect on Form N-CEN regarding ESG factors and include, for example, the type of strategy (*i.e.*, Integration, ESG-Focused, and ESG Impact).
- The Proposals would require an adviser to disclose whether it considers ESG factors as part of one or more significant investment strategies or methods of analysis ("significant strategies") for which the adviser considers any ESG factors in the advisory services it provides to its separately managed account clients, including in its selection of other investment advisers and/or as part of their advisory services when requested by separately managed account clients (together with significant strategies, "SMA strategies").
 - If so, the amendments would require the adviser to indicate for its SMA strategies whether it employs an Integration or ESG-Focused approach and, if ESG-Focused, whether it also employs an ESG-Impact approach. These advisers would also report whether they incorporate one or more of E, S, and/or G factors into their SMA strategies.
 - Similarly, if an adviser considers any ESG factors as part of one or more significant investment strategies or methods of analysis in the advisory services it provides to a reported private fund, the Proposals would

require the adviser to report whether it employs in its management of that private fund an ESG-Integration or ESG-Focused approach and, if ESG-Focused, whether it also employs an ESG-Impact approach.

- An adviser would also be required to report whether it incorporates one or more of E, S, and/or G factors (and which factor(s)). The Release notes that this information is intended to help the SEC staff understand industry trends, as well as prepare for, conduct and implement its risk-based examination program.

Third-Party ESG Framework(s). The Proposals would require advisers, in their Form ADV Part 1A Item 5.M, to report whether they follow any third-party ESG framework(s) in connection with their advisory services and, if so, the name of the framework(s).

Additional Information about Other Business Activities and Financial Industry Affiliations. The Proposals would require advisers to disclose whether they or their related persons conduct other business activities as ESG providers by amending Items 6 and 7 of Part 1A (and Sections 6.A. and 7.A. of Schedule D). For each related person ESG provider, the adviser would be required to complete the relevant items in Section 7.A of Schedule D (e.g., the related person’s SEC File Number (if any) and additional information about the adviser’s control relationship (if any) with the related person).

VIII. Compliance Policies and Procedures and Marketing

The Release states that the SEC’s staff has observed a range of compliance practices that do not appear to fully address advisers’ incorporation of ESG factors into their advisory services. Based on these observations, as well as the “comprehensive nature of our proposed ESG-related amendments to required disclosures,” the Release reaffirms “existing obligations under the compliance rules when advisers and funds incorporate ESG factors.” Specifically, the Release states that:

- Advisers’ and funds’ compliance policies and procedures should address (i) the accuracy of ESG disclosures made to clients, investors and regulators and (ii) portfolio management processes to help assure that portfolios are managed in a manner that is consistent with the ESG-related investment objectives disclosed by the adviser and/or fund.
- Advisers may wish to consider the following specific examples of effective ESG-related disclosure, policies, procedures and practices.
 - If an adviser discloses to investors that it considers certain ESG factors as part of an ESG Integration strategy, the adviser’s compliance policies and procedures should be reasonably designed to ensure the adviser actually considers the ESG factors in the way it disclosed it considers them.
 - If a fund discloses to investors that it adheres to a particular global ESG framework, its policies and procedures should include controls that help to ensure client portfolios are managed in accordance with that framework.
 - If an adviser uses ESG-related positive and/or negative screens on client portfolios, the adviser should maintain adequate controls to maintain, monitor, implement and update those screens.
 - If an adviser discloses to investors that ESG-related proxy proposals will be independently evaluated on a case-by-case basis, the adviser should adopt and implement policies and procedures for such evaluations.
 - If an adviser advertises to its clients that they will have the opportunity to vote separately on ESG-related proxy proposals, the adviser must provide such opportunities to its clients and should maintain internal policies and procedures accordingly.

The Release notes that current regulations seek to prevent false or misleading advertisements by advisers, including greenwashing, by prohibiting material misstatements and fraud. Therefore, the Release states that “it generally would be materially misleading for an adviser materially to overstate in an advertisement the extent to which it utilizes or considers ESG factors in managing client portfolios.” The Release notes, for example, that it would be materially misleading if an adviser stated in its marketing materials that it has substantially contributed to the development of specific governance practices, or reduction in carbon emissions, at its portfolio company, if the adviser’s actual roles in the development or reduction in emissions were limited or inconsequential.

IX. Comment Deadline

The Release states that comments on the Proposals should be received by the SEC no later than 60 days after publication of the Release in the *Federal Register*. As of the date of this Alert, the Release has not been published therein.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

1. The forms that would be amended are Forms N-1A, N-2, N-CSR, N-8B-2, S-6, N-CEN and ADV.
2. This definition is identical to the definition used to identify “integration funds” in the Names Rule Release.
3. An “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.
4. Proposed Instruction 1(b) to Item 9(b)(2) of Form N-1A and Proposed Instruction 9.a(2) to proposed Item 8.2.e(2)(B) of Form N-2.
5. An “ESG-Focused Fund” is a fund that focuses on one or more ESG factors by using them as a significant or main consideration (i) in selecting investments or (ii) in its engagement strategy with the companies in which it invests. An ESG-Focused Fund includes (a) any fund that has a name including terms indicating that the fund’s investment decisions incorporate one or more ESG factors and (b) any fund whose advertisements or sales literature 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.
6. An “Impact Fund” is an ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts.
7. Proposed Item 4(a)(2)(ii)(B), Instruction 1 of Form N-1A and Proposed Item 8.2.e.(2)(B), Instruction 1 of Form N-2, which state that the ESG Strategy Overview table would precede the risk/return summary (for open-end funds) or discussion of the fund’s organization and operation (for closed-end funds), and disclosure in the table would not need to be repeated in the narrative disclosure that will follow the table in the risk/return summary of discussion of the fund’s organization and operation).
8. Proposed Item 9(b)(2), Instruction 2 of Form N-1A and Proposed Item 8.2.e.(2)(B), Instruction 9 of Form N-2.
9. Proposed Instruction 2(f), Item 9(b)(2) of Form N-1A and Proposed Item 8.2.e.(2)(B), Instruction 9.b.(5) of Form N-2.
10. Proposed Instruction to Item 2 of Form N-1A and Proposed Instruction 10 to Item 8.2.e.(2)(B) of Form N-2.
11. These are ESG-Focused Funds that may vote proxies (if they hold voting securities) or engage with issuers on a limited basis, but do not use proxy voting or engagement as a significant means of implementing the fund’s ESG strategy.
12. Proposed Instruction 2(f) to Item 9(b)(2) of Form N-1A and Proposed Instruction 9.b.(6) to Item 8.e.(2)(B) of Form N-2.
13. Proposed Instruction 2 to Item 11 of Form N-8B-2.
14. Proposed Item 27(b)(7)(i)(B) of Form N-1A and Proposed Instruction 4.(g)(1)(B) to Item 24 of Form N-2.
15. Proposed Item 27(b)(7)(i)(D) of Form N-1A and Proposed Instruction 4.(g)(1)(D) to Item 24 of Form N-2.
16. SEC Rel. No. 33-11042 (Mar. 21, 2022) discussed in a prior Ropes & Gray [Alert](#). In that release, the SEC stated that, under the GHG Protocol, “Scope 1 emissions are direct GHG emissions that occur from sources owned or controlled by the company . . . Scope 2 emissions are those emissions primarily resulting from the generation of electricity purchased and consumed by the company . . . Scope 3 emissions are all other indirect emissions not accounted for in Scope 2 emissions. These emissions are a consequence of the company’s activities but are generated from sources that are neither owned nor controlled by the company.”
17. The terms “management person” and “related person” are already defined in the Form ADV glossary of terms.

APPENDIX

Methodologies to Calculate an ESG-Focused Fund's Carbon Footprint and WACI

Disclosure of a fund's GHG metrics are required of any ESG-Focused Fund that considers environmental factors as part of its investment strategy, unless the fund affirmatively states in its ESG Strategy Overview table in the fund's prospectus that it does not consider issuers' GHG emissions as part of its investment strategy.

Carbon Footprint

- To calculate the fund's carbon footprint under the Proposals, a fund would first calculate each portfolio company's "enterprise value," where enterprise value is the sum of the portfolio company's equity value plus its total debt.
- A fund would then calculate the carbon emissions associated with each portfolio holding by dividing the current value of the fund's investment in the portfolio company by the portfolio company's enterprise value, then multiplying the resulting amount by the portfolio company's Scope 1 and Scope 2 GHG emissions.
- Finally, the fund would add up the carbon emissions associated with each portfolio holding and divide the resulting amount by the current NAV of the portfolio to derive the fund's carbon footprint. Carbon footprint is the total carbon emissions associated with the fund's portfolio, normalized by the fund's NAV expressed in tons of CO₂e per million dollars invested in the fund.

Weighted Average Carbon Intensity ("WACI")

- To calculate the fund's WACI under the Proposals, a fund would first calculate the portfolio weight of each portfolio holding by dividing the value of the fund's investment in the portfolio company by the fund's current NAV.
- A fund would then calculate the carbon emissions of each portfolio company by dividing the portfolio company's Scope 1 and Scope 2 GHG emissions by the portfolio company's total revenue (in millions of dollars).
- These emissions would then be attributed to the fund in proportion to the weight of the investment in the fund's portfolio. The fund would perform this calculation for each portfolio company in its portfolio, and the sum of the emissions attributable to the fund would be the fund's WACI.

Definitions and Additional Refinements. The Proposals contain several specific instructions that would apply to a fund's calculation of its carbon footprint and WACI.

- The Proposals would define (i) CO₂e to mean the common unit of measurement to indicate the global warming potential ("GWP") of each greenhouse gas, expressed in terms of the GWP of one unit of carbon dioxide and (ii) GHG emissions to mean the direct and indirect greenhouse gases expressed in metric tons of CO₂e.
- The Proposals also would provide definitions for the types of emissions that should be calculated within financed Scopes 1, 2 and 3. For purposes of the definition of Scope 3 emissions, the Proposals also define the term "value chain" to mean, in part, the upstream and downstream activities related to a portfolio company's operations, including activities by a party other than the portfolio company.
- For both the carbon footprint and WACI measures, the fund would determine the GHG emissions associated with each "portfolio company" (or "portfolio holding"), which the Proposals would define as: (i) an issuer that is

engaged in or operates a business or activity that generates GHG emissions or (ii) an investment company, or an entity that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the 1940 Act (a “private fund”), that invests in issuers described in clause (i), except for an investment in reliance on Rule 12d1-1 under the 1940 Act (*i.e.*, investments in money market funds).

- This definition would require a fund to take into account GHG emissions when the fund invests in other funds or private funds to ensure that a fund investing in portfolio companies through such a fund structure reflects the associated emissions in the investing fund’s GHG metrics.
- If the underlying fund itself were an environmentally focused fund required to report its carbon footprint and WACI, the investing fund could determine the GHG emissions associated with the investment for purposes of calculating the investing fund’s carbon footprint and WACI by taking its pro rata share of the underlying fund’s GHG emissions.
- If the underlying fund is not required to disclose its carbon footprint and WACI, the investing fund could look through its investment in the fund or private fund and take the investing fund’s pro rata share of the emissions of the portfolio holdings of the fund or private fund. The investing fund would be permitted to identify an underlying fund’s holdings based on the underlying fund’s most recent financial statements.
- If a fund obtains its exposure to a portfolio company by entering into a derivatives instrument, for purposes of the GHG metrics calculations, the derivatives instrument would be treated as an equivalent position in the securities of the portfolio company that are referenced in the derivatives instrument.
- The Proposals would specify where the fund must obtain information required to perform the calculations.
 - Funds would be required to obtain the information necessary to calculate a portfolio company’s enterprise value and the portfolio company’s total revenue from the company’s most recent public report required to be filed with the SEC pursuant to the Exchange Act or the Securities Act (a “regulatory report”), containing such information.
 - Absent a regulatory report containing the necessary information, the fund would calculate a portfolio company’s enterprise value and total revenue based on information provided by the company.
- The Proposals would specify that, where the calculations require the value of the fund’s holding in a portfolio company or the fund’s NAV, the Proposals specify that the fund would use the values as of the end of the fund’s most recently completed fiscal year (*i.e.*, the values included in the fund’s annual report in which the carbon footprint and WACI disclosure would appear).
- The Proposals’ instructions would address the sources of portfolio companies’ GHG emissions. Specifically, the Proposals include a data hierarchy for sources that funds would be required to use in obtaining portfolio company GHG emissions data.
 - If a portfolio company discloses its Scopes 1 and 2 emissions in a regulatory report, the fund would be required to use these disclosed emissions from the most recent regulatory report when calculating carbon footprint and WACI.
 - If a portfolio company does not file such regulatory reports, or they do not contain the GHG information necessary for the fund to calculate carbon footprint and WACI, the fund would be required to use GHG

emissions information that is otherwise publicly provided by the portfolio company, such as a publicly available sustainability report published by the company.

- If a fund, after conducting a reasonable search, does not identify Scope 1 and Scope 2 emissions information publicly provided by the portfolio company, the fund would use a good faith estimate of the portfolio company's Scope 1 and Scope 2 emissions.
- A fund that uses good faith estimates in these calculations would be required to disclose the percentage of the aggregate fund portfolio GHG emissions that was calculated using the fund's good faith estimation process. The fund also would be required to provide a brief explanation of the process it used to calculate its good faith estimates of its portfolio company GHG emissions, including the data sources the fund relied on to generate these estimates.
- The brief explanation also would be complemented by additional, more granular information about the fund's process for calculating and estimating its portfolio's GHG emissions. The Proposals would require a fund to provide additional information on Form N-CSR regarding any assumptions and methodologies the fund applied in calculating the portfolio's GHG emissions, and any limitations associated with the fund's methodologies and assumptions, as well as explanations of any good faith estimates of GHG emissions the fund was required to make.
- The Proposals also would require an ESG-Focused Fund to disclose the Scope 3 emissions of its portfolio companies, to the extent that Scope 3 emissions data is reported by the fund's portfolio companies. Scope 3 emissions would be disclosed separately for each industry sector in which the fund invests, and would be calculated using the carbon footprint methodology summarized above. In addition, the Proposals would not require funds to estimate the Scope 3 emissions of their portfolio companies.