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requirements for ESG disclosures, while the other would modernize and expand the SEC's Names Rule that covers fund names.

Jason Bramwell • Jun. 14, 2022

Even though a pair of proposed rules by the Securities and Exchange Commission (SEC)—intended to provide investors with more information about publicly offered investment funds that take into account environmental, social, and governance (ESG) factors—are still a ways away from being finalized, registered investment companies and advisers shouldn't procrastinate on the work that'll need to be done

was one of three KPMG executives who spoke about the SEC's proposed ESG fund rules during a LinkedIn Live session on June 8. "Think about what offerings do you have, what marketing materials do you have out there, what disclosures do you have out there, and finally there's the reporting side of this. Consider the things that you may now deem to be in the bucket of ESG and those that you don't. Then make sure you've got that risk management process, the quality reviews in place prior to issuance."

Anyone who follows the SEC closely shouldn't be surprised by these proposed ESG fund regulations seeing the light of day as they've been a top priority for the regulator, she said. The SEC indicated last year that these proposed rules would be coming in 2022, and they follow on the heels of the SEC proposing rule changes on climate-related disclosures and cybersecurity disclosures this past March.

Matsuo said the pace of regulatory for financial services this year has been "absolutely, incredibly robust" and called it "a bit unprecedented" since the Dodd-Frank days. She said at the essence of both the ESG disclosure and Names Rule proposals is the SEC saying, "Say what you do, and do what you say."

"There's a quote [SEC Chair] Gary Gensler gave earlier this year. He equated this Names Rule to labeling, in this case to milk, and I think it sums it up. He said, 'It's easy to tell if milk is fat free by just looking at the nutrition label. It might be time to make it easier to tell if green or sustainable funds are really what they say they are.'"

These two proposed rule changes come during significant growth of funds that use ESG terminology in their names and strategies. According to Morningstar, sustainably managed assets in the United States reached a record $357 billion in December 2021, an 8 percent increase over the previous quarter and more than four times the total three years ago. But that increased activity has also increased concerns about "greenwashing."

In a statement following the release of both proposals last month, Gensler said,

investment actions and strategies are consistent with investors' expectations based on all available information, including a fund's name, according to KPMG. The proposed changes to the rule would provide better investor clarity into a fund's investment strategy.

Under the rule's current iteration, if a registered investment company's name suggests it has a focus in particular investment types, industries, or geographies, or that it has tax-exempt status, the fund must adopt a policy to invest at least 80 percent of the value of its assets consistent with its name. Under the proposed changes, the SEC is expanding the requirements of the 80 percent investment policy to any fund names that include terminology "suggesting that the fund focuses on investments that have, or whose issuers have, particular characteristics." Those characteristics could include terms like "growth" or "value" or fund names with "ESG" or related terms, such as "sustainable" or "green." In addition, the proposal specifies that funds that consider ESG factors but not as a central feature—usually known as integration funds—would be prohibited from using ESG-related terms in their names.

The second ESG-related proposal would require funds and advisers that consider ESG factors in their investment processes to disclose specific information about their strategies.

"The old days of, 'Well, let's just leave it vague' isn't going to work. It'll leave you open to inspection and it's an enforcement risk," Sean McKee, KPMG's national practice leader—public investment management, said during the LinkedIn Live conversation.

Three types of funds are included in the disclosure proposal, according to KPMG:

Integration funds: Funds that integrate ESG factors alongside non-ESG factors in

Strategy Overview Table. Also, an ESG-focused fund that considers environmental factors in its investment strategy would need to disclose metrics regarding the greenhouse gas (GHG) emissions associated with their investments, such as:

- Weighted-average carbon intensity (using Scopes 1 and 2 emissions);
- Carbon footprint (using Scopes 1 and 2 emissions); and
- To the extent data is reported publicly, the carbon footprint of Scope 3 emissions of portfolio companies by industry sector invested.

Impact funds: A subset of ESG-focused funds that seek to achieve a particular ESG impact, impact funds would, in addition to the disclosures required of ESG-focused funds, be required to disclose how they measure progress on their specific impact objectives. Additionally, the proposal would require funds that use proxy voting or engagement with issuers as a significant means of implementing their ESG strategy to provide additional information about their proxy voting or ESG engagements.

"With respect to the classifications of the funds in the ESG disclosure rule, my observation is that many funds mention the consideration of environmental factors in their fund documents, so language around the extent to which those factors are considered and how that influences decision making is very critical with this rule because, to the extent that it is a deciding factor, that puts you into the ESG-focused or impact fund category," Liz Ming, a KPMG audit partner, said during the LinkedIn Live session. "From an adviser perspective, the spirit of [the proposed rule] is that it should be a consolidation of the commitments and disclosures you make around policies and ESG integration in one place for investors."

Speaking of advisers, those who consider ESG factors would be required to make similar disclosures in both their brochures (Form ADV Part 2A) and annual reports.

Hester Pierce was the only SEC commissioner who voted against both proposed ESG

and G, yet implicitly uses disclosure requirements to induce substantive changes in funds' and advisers' ESG practices. Investors will pick up the tab for our latest ESG exploits without seeing much benefit."

Matsuo has heard the grumbling about there not being universally defined definitions within the ESG space, but she said the ESG disclosure proposal is the beginning of a movement to get there.

"You see some synergies here between the SEC and SFDR [Sustainable Finance Disclosure Regulation], for example, in fund categorization," Matsuo said. "You see the SEC again bringing up GHG emissions and the references to those just like they did with climate, just like you see with TCFD [Task Force on Climate-related Financial Disclosures]. So I think you're starting to see some consistency coming together around those definitions and this is really to drive that forward."

The 60-day public comment period for each proposal concludes at the end of July. If both proposed rules are adopted by the SEC, funds will have one year to comply with the changes to the Names Rule, and a one-year transition period also has been proposed for the ESG disclosure rule, except for those disclosures made in the annual report to shareholders and Form N-CSR, which would be required 18 months from the effective date.

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