esgbook

What's your fund's ESG strategy?*

*** The SEC wants to know.**
Explaining the SEC's ESG Fund Labeling Disclosure Requirements.

Aishwarya Shukla

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Introduction

The U.S. Securities and Exchange Commission (SEC) has proposed changes to the 'Investment Company Act,' an umbrella fund labeling regulation that requires 80% of holdings to be invested in accordance with the fund's suggested investment focus. Funds that deem themselves 'ESG,' 'sustainable' or 'green' would be required, under the 'modernized' regulation, to identify securities included in the 80% basket. The proposed rule seeks to enhance data comparability and help investors differentiate between investment strategies. Given the investment industry's demand for quantitative data, the S.E.C. has also introduced a standardized methodology for reporting emissions metrics. The fund labeling rule will be opened for comment and subject to further amendments. If finalized, it would be enforced at the start of the upcoming fiscal year FY 2023. In its proposal, the S.E.C. notes the rapid expansion of the sustainable investment universe – a 25 times increase from $639 billion to $17.1 trillion. The regulator is presently undertaking multiple measures to protect investors from misleading or exaggerated ESG claims, including the recent climate disclosure rule. The S.E.C. is, however, facing backlash for extending its powers. Several republican treasurers are punishing big banks including Wells Fargo, JP Morgan, and Goldman Sachs for fossil fuel divestment and preventing them from obtaining government contracts. The governing landscape is undergoing a paradigm shift in the U.S. and progressive rulemaking is being blocked beyond the treasury in republican-led state legislatures.

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Notice of Proposed Rule-making	Proposed Rule: May 25,2022	Comment period: 60 days	Extended/re-opened comment	Final Rule/Supplemental Proposed Rule

Regulatory Timeline

*If the agency is not satisfied with the quality of comments, it may re-open or extend the comment period. Initial feedback may also lead to a series of proposed rules due to the complexity of issues. During this time, the agency may also hold public hearings to collect more data and establish a second period of reply for comments (this is not required by law).

1. https://www.govinfo.gov/help/fr#about

Define your fund's ESG strategy

The S.E.C. has defined three types of ESG funds – ESG Integration, ESG-Focused, and Impact Funds – to help investors identify and differentiate between actively managed funds. Enhanced disclosure requirements will enable investors to assess how and whether these funds incorporate ESG factors in their investment strategy. The rule describes an ESG Integration fund as a fund that selects sustainable investments in a 'non-dispositive' manner and its strategy remains agnostic to non-financial indicators of performance. As per the proposed rule, ESG Integration funds may be misleading if the fund name suggests that its investment strategy considers one or more ESG criteria. On the other hand, an ESG-Focused fund integrates one or more ESG factors in its investment strategy and has an active engagement policy with shareholders. ESG-Focused funds concentrate explicitly on incorporating sustainability assessment in the portfolio construction, examples include ESG Index tracking, exclusionary and inclusionary screening. Lastly, an ESG-focused fund that seeks to achieve specific ESG impact and positive measurable outcomes would be considered an Impact Fund.

Scope of ESG investment strategies

ESG Integration Funds	'Non-dispositive' focus on ESG factors
ESG-Focused Funds	Considers one or more ESG factors in a key or significant manner – ESG Impact unspecified
Impact Funds	Considers one or more ESG factors in a key or significant manner – ESG Impact specified

'Strategy-specific' disclosures

The proposed rule specifies a reporting format for each of the three fund types. ESG Integration funds must summarize the selection of ESG-aligned investments in the summary section of the fund prospectus and provide a more detailed disclosure in regulatory documents when considering environmental factors. For ESG-Focused and Impact Funds, the S.E.C. has provided a disclosure template that records the fund's ESG strategy, for example, whether the fund tracks an ESG Index or applies an inclusionary or exclusionary screen when picking investments. In addition to identifying the fund's strategy, the rule would require supporting evidence for each applicable row in the disclosure template.

In furtherance of climate disclosure standards, ESG-Focused Funds must also report two GHG emissions metrics considered for the portfolio in its annual reports. The S.E.C. has endorsed the use of carbon footprint and carbon intensity metrics as these are standardized and decision-useful information for investors who have made net zero commitments. All ESG-Focused funds (including Impact Funds) must also directly communicate an ESG-engagement policy to shareholders. Finally, Impact Funds must produce a progress report with quantitative analysis and disclosure of factors that materially affect the fund's ability to achieve its specified impact on an annual basis.

Disclosure Template

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

Conclusion

With increasing scrutiny of ESG labels, regulators are equipping investors with the tools to better navigate the sustainable investment landscape and avoid the pitfalls of greenwashing. The S.E.C. is no exception, as the latest rule sets a statutory obligation for funds to substantiate effective ESG strategies. As an alternative to overwrought regulation, this delineates investment conditions for ESG funds and prescribes a strategy-specific approach to disclosures. If adopted, the regulation will have profound implications for asset managers who are keen to invest in more funds that are environmentally and socially conscious.

Appendix: Summary of ESG Fund Disclosure Requirements

Fund Disclosure Requirement	ESG Integration Funds	ESG-Focused Funds	ESG Impact Funds
A description of how the fund incorporates ESG into investment selection and what factors it considers.	✓	✓	✓
A description of how the fund considers environmental factors and what data sources the fund may consider.	✓[1]	✓[1]	✓[1]
ESG Strategy Overview Table (see Appendix B)		✓	✓
Scope 1 & 2 carbon footprint		✓[1]	✓[1]
Scope 3 carbon footprint (by industry)		✓[1]	✓[1]
Weighted average carbon intensity		✓[1]	✓[1]
Number of total engagements[2] and % related to ESG		✓[3]	✓[3]
% of ESG proposals supported		✓[3]	✓[3]
Impacts sought to achieve, key metrics to access progress, time horizon and relationship between return and impact.			✓[1]

[1]Only required if the fund considers environmental/GHG emissions factors as part of its investment strategy.

[2]Defined as "substantive discussion advocating for specific ESG goals to be accomplished over a time period, where progress toward meeting such goal is measurable, that is part of an ongoing dialogue regarding this goal."

[3]Only required if either proxy voting and/or engagement is used as a means of implementing the fund's ESG strategy.

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