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## Responsible Investing

# How the SEC's Recent ESG Proposals May Impact Private Funds

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On May 25, 2022, the SEC proposed **amendments** to certain rules and forms under the Investment Advisers Act of 1940 (Advisers Act) and the Investment Company Act of 1940 (Investment Company Act) to require specific disclosures by registered investment companies and business development companies (Registered Funds), as well as SEC-registered advisers and certain exempt reporting advisers (Advisers) with respect to their incorporation of environmental, social and governance (ESG) factors into their investment decisions and strategies (the Disclosure Proposal). According to the SEC, the Disclosure Proposal aims to promote consistent, comparable and reliable ESG disclosures to investors, other market participants and the SEC, thereby reducing the risk of “greenwashing,” as well as better protecting and serving investors in the market for ESG-related investments.

The same day, the SEC **proposed** to amend Rule 35d-1 under the Investment Company Act applicable to Registered Funds (the Names Proposal and, together with the Disclosure Proposal, the Proposals). According to the SEC, the Names Proposal aims to ensure that a Registered Fund's name accurately reflects its investments and related risks.

Both Proposals were published in the Federal Register on June 17, 2022, and were open for public comment until August 16, 2022. All submitted comments are currently accessible on the SEC's website. The SEC will review and consider the concerns raised in the public comments in its process of crafting the final rule.

Although the Proposals specifically exclude private funds and certain investment advisers, they may still impact private funds. This article explains which investment funds and advisers are covered by the Proposals; discusses the impact of the Proposals on private funds – both directly and indirectly; presents several issues raised by the Proposals; and spells out the next steps private fund advisers should take.

For more on the Proposals, see [“A Roadmap to Proposed ESG Disclosures on Form ADV”](#) (Jul. 14, 2022).

## Not All Investment Funds and Advisers Are Covered

### Uncovered Investment Funds

The SEC clarified that the term “fund” used in the Disclosure Proposal is intended to refer to management investment companies registered on Form N-1A or Form N-2; unit investment trusts registered on Form S-6; and business development companies – but not private funds as defined under the Advisers Act. Section 202 of the Advisers Act defines a “private fund” as an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Similarly, the Names Proposal refers to registered investment companies and business development companies as “funds” but excludes private funds.

Although private funds are explicitly excluded from the Proposals, they nevertheless affect private funds because the Disclosure Proposal requires SEC-registered investment advisers and certain exempt-reporting advisers to disclose ESG-related information for their private fund clients and other clients. In addition, both Proposals may have certain sweeping impacts on private funds.

### Uncovered Investment Advisers

With respect to investment advisers, the SEC clarified that the Disclosure Proposal would not apply to investment advisers that are registered with one or more state securities authorities. In addition, small exempt reporting advisers having less than \$25 million in regulatory assets under management (RAUM) generally would not be subject to the Disclosure Proposal, unless they maintain their principal office and place of business outside the U.S. The Disclosure Proposal, however, may potentially affect all investment advisers – large or small; registered or exempt; SEC-registered or state-registered – to some degree.

## Disclosure Proposal: Impact on Private Funds Through Their Investment Advisers

One impact of the Disclosure Proposal on private funds is due to the proposed regulations’ direct application to disclosure and reporting filings by the investment advisers to those funds.

### Proposed ESG-Related Reporting and Disclosure Requirements Under Form ADV

The Disclosure Proposal would impose additional reporting requirements under Form ADV Part 1A, as well as additional disclosure requirements under Form ADV Part 2A (Form ADV Brochure) and Form ADV Part 2A, Appendix 1 (Wrap Fee Brochure and, together with the Form ADV Brochure, the Brochures) on Advisers that consider ESG factors when providing advisory services to their clients.

## Form ADV Part 1A

If an Adviser considers ESG factors as part of its investment strategies or advisory services, then Form ADV Part 1A would collect census-type data about the Adviser's uses of ESG factors for each private fund that the Adviser is required to identify in Part 1A and its separately managed account (SMA) clients. For example, the Adviser would be required to choose from the following three types of SEC-defined ESG strategies:

1. *Integration*: meaning the Adviser considers one or more ESG factors alongside other, non-ESG factors in its investment advice, but the ESG factors are generally no more significant than other factors in advising its clients with respect to investments, such that ESG factors may not be determinative in providing advice with respect to any particular investment;
2. *ESG-Focused*: meaning the Adviser focuses on ESG factors by using them as a significant or main consideration in advising its clients with respect to investments or in its engagement strategy with the companies in which its private funds or SMAs clients invest; and
3. *ESG-Impact*: meaning the Adviser's ESG strategies are ESG-focused, and it simultaneously seeks to achieve specific ESG impact(s).

Among other things, the Adviser would also be required to disclose whether it follows any third-party ESG framework(s) in connection with its advisory services and, if so, provide the name(s) of the framework(s).

For examples of ESG frameworks, see our two-part series on the Net Zero Asset Managers Initiative: "[What It Is and What It Requires](#)" (Feb. 3, 2022); and "[How to Make the Commitment](#)" (Feb. 10, 2022); as well as our two-part series on the SBAI Responsible Investment Policy Framework: "[Four Ways to Incorporate Into Investment Strategies](#)" (Apr. 15, 2021); and "[Three Key Considerations for Fund Managers](#)" (Apr. 22, 2021).

## Form ADV Brochure

With respect to each significant investment strategy or method of analysis for which an Adviser considers ESG factors as part of its advisory business, the SEC would require disclosures in the Form ADV Brochure on the following topics:

- *ESG Factors*: a description of the ESG factor(s) (i.e., E, S and/or G) the Adviser considers and how it incorporates those ESG factor(s) in the advice it provides clients – including clients that are private funds. The Disclosure Proposal, however, purposefully does not define the meaning or scope of E, S and G factors.
- *ESG Strategies*: a description of whether and how the Adviser employs integration and/or ESG-focused strategies, and if it uses ESG-focused strategies, whether and how the Adviser also employs ESG impact strategies. If an Adviser considers different ESG factors for different

strategies, then it would need to include the proposed disclosures for each significant strategy.

- *ESG Criteria and Methodologies*: a description of any criteria or methodologies the Adviser uses to evaluate, select or exclude investments. If an Adviser employs different criteria or methodologies for different strategies, then it would need to include the proposed disclosures for each significant strategy.
- *Related Person ESG Providers*: a description of any material relationship or arrangement that the Adviser or any of its management persons has with any related person that is an ESG consultant or other ESG service provider, such as an ESG index provider or an ESG scoring provider. If the relationship or arrangement creates a material conflict of interest with clients, the Adviser would need to describe the nature of the conflict and how the Adviser addresses it.
- *ESG Proxy Voting*: a description of which ESG factors the Adviser considers when voting client securities and how it considers those factors. If an Adviser has different voting policies and procedures for different ESG-related strategies or for different clients, the Adviser would need to describe those differences. For example, an Adviser would need to explain whether and how it allows its clients to direct its votes on ESG-related voting matters. If an Adviser provides such a description earlier in the Form ADV Brochure, then a cross reference would suffice.

For more on the Form ADV Brochure, see [“A Checklist for Fund Managers to Ensure Form ADV, Part 2A Is Complete and Accurate”](#) (May 6, 2021).

## Wrap Fee Brochure

If an Adviser’s wrap fee program incorporates ESG factors in the selection of portfolio managers for its wrap fee clients, the Disclosure Proposal would require the disclosures in the Adviser’s Wrap Fee Brochure on the following topics:

- *Portfolio Management Services*: a description of what ESG factors the Adviser considers and how it incorporates the factors under each program;
- *Selection and Evaluation of Portfolio Managers*: a description of what ESG factors the Adviser considers and how it considers them; and
- *Sponsor-Manager*: if an Adviser acts (whether itself or through its supervised persons) as a portfolio manager for a wrap-fee program described in its Wrap Fee Brochure, then the Adviser would need to disclose additional information in Item 8 (Methods of Analysis, Investment Strategies and Risk of Loss), as well as Item 17 (Voting Client Securities) of the Form ADV Brochure.

See “[Pair of Risk Alerts Focuses on Issues Associated With Cross Trades, Principal Transactions and Wrap Fees](#)” (Aug. 19, 2021).

## **Tiered Impact on Investment Advisers**

The Disclosure Proposal would impose additional reporting, recordkeeping and compliance burdens on investment advisers that consider ESG factors in their advisory services. The impact, however, differs depending on an adviser’s registration status.

### **SEC-Registered Investment Advisers**

SEC-registered investment advisers would need to comply fully with the Disclosure Proposal, including all requirements in Form ADV Part 1A and the Brochures. Because the Form ADV Brochure usually encompasses the entirety of an adviser’s lines of business, if an adviser also advises Registered Funds, its Form ADV Brochure may also include information about greenhouse gas (GHG) metrics for portfolio holdings, such as portfolio carbon footprint, weighted average carbon intensity and Scope 3 emissions. Advisers solely to private funds or SMAs, however, would not be required to disclose those GHG metrics, which is part of the SEC’s more extensive requirements on certain Registered Funds.

SEC-registered investment advisers would need to report and disclose ESG-related information in their initial filings and annual amendments to Form ADV Part 1A and the Brochures. In addition, if any ESG-related information provided in either of their Brochures becomes materially inaccurate, they would also need to make other-than-annual amendments.

See “[Unexpected Traps for Filing Other-Than-Annual Amendments Using the Revised Form ADV and How to Avoid Them](#)” (Jul. 13, 2017).

### **Covered Exempt Reporting Advisers**

The Disclosure Proposal would only cover a portion of exempt reporting advisers (ERAs), namely certain large and mid-sized ERAs and offshore small ERAs. Because ERAs only file census-type information in Form ADV Part 1A, covered ERAs would only be required to complete the ESG-related questions in Form ADV Part 1A – not the ESG-related disclosures in the Brochures. In addition, because ERAs are not currently required to complete Item 5 of Part 1A, they would not be required to report their third-party ESG frameworks.

Covered ERAs would need to report ESG-related information in their initial filings and annual amendments to Form ADV Part 1A. Covered ERAs have no obligation to make other-than-annual amendments.

## **State-Registered Investment Advisers and Uncovered ERAs**

State-registered investment advisers and uncovered ERAs would not be subject to the Disclosure Proposal. Because Form ADV may help clients select an adviser that meets their ESG investing needs and compare different advisers, however, certain advisers may choose to voluntarily include ESG-related reporting in Form ADV. In fact, according to the SEC, some advisers have already voluntarily disclosed in Form ADV their incorporation of ESG factors in investment strategies or analytical methods.

In addition, with their increase in RAUM or certain other changes in their businesses, some uncovered advisers may become SEC-registered investment advisers or covered ERAs in the future. Therefore, if those advisers' advisory practices consider ESG factors, to pave the way for future standardization, they should become familiar with the requirements under the Disclosure Proposal from day one and align their ESG-related policies, procedures, recordkeeping and marketing practices with the framework and hot button focuses of the Disclosure Proposal.

## **Disclosure Proposal: Impact on Private Funds Through Registered Funds**

The Disclosure Proposal would require Registered Funds to make certain reporting and disclosure about their ESG-related investments. Consistent with its proposed requirements for Advisers, the SEC similarly did not define the meaning of ESG or E, S and G for Registered Funds, but it did define three ESG strategies for Registered Funds: integration funds, ESG-focused funds and ESG-impact funds, proposing more significant disclosure obligations on ESG-focused and ESG-impact funds. The SEC also enumerated a non-exclusive list of ESG methodologies for Registered Funds, such as:

- tracking an index;
- inclusionary screening;
- exclusionary screening;
- seeking impact;
- proxy voting; and
- engaging with issuers.

Because private funds are exempt from those filings, the proposed ESG-related requirements on Registered Funds would not affect private funds directly. Certain investment advisers, however, simultaneously manage Registered Funds and private funds with the same or similar investment strategies. Those advisers may find it necessary to disclose and market those investment strategies consistently among Registered Funds and private funds. Accordingly, the above requirements applicable Registered Funds may impact how those advisers:



- disclose their ESG-related strategies and methodologies in their private placement memoranda (PPMs) for their private funds;
- market those private funds products to prospective investors; and
- describe their ESG practices in their Form ADV Brochures.

In addition, the ESG strategies and ESG mythologies applicable to Registered Funds may serve as a benchmark and referencing framework for private funds in their investment and marketing practices.

The more detailed requirements on ESG-focused funds, ESG-impact funds, proxy voting and issuer engagement also indicate the SEC's possible examination focuses. Thus, the ESG disclosure questions applicable to Registered Funds may provide a reference as to what questions the SEC may ask private fund advisers during examinations.

See [“SEC Exam and Enforcement Priorities: ESG, New Marketing Rule and Other Potential Focuses \(Part Two of Two\)”](#) (Jul. 29, 2021).

## **Names Proposal: Impact on Private Funds Through Registered Funds**

The Names Proposal would impose the following on Registered Funds:

- require any Registered Fund with a name that suggests it focuses on a particular type of investment; a particular industry; or a particular country or geographic region to invest at least 80% of its assets in that investment, industry, country or geographic region, as suggested by its name (80% Requirement);
- prohibit an “integration fund” from using ESG or similar terminology in its name;
- require a Registered Fund’s prospectus to define the terms used in its name;
- amend Form N-PORT to require greater transparency on how a Registered Fund’s investments match its investment focus;
- require a Registered Fund that temporarily departs from the 80% Requirement to come back into compliance with that requirement within 30 consecutive days, with limited exceptions; and
- impose shareholder vote and notice requirements on changes to a Registered Fund’s 80% investment policy.

Private funds are not subject to Rule 35d-1 under the Investment Company Act. Therefore, the Names Proposal would not impact private funds directly. Private funds, however, may also include ESG-related words in their fund names as a way to attract investors. According to the SEC, those private funds do exist. As of December 2020, approximately 3% of registered advisers and 2% of ERAs provided services to private funds with names containing ESG terms.

Private fund advisers are subject to Rule 206(4)-8 under the Advisers Act, which is designed to prevent fraudulent, deceptive or manipulative conduct. In addition, Rule 206(4)-1 prohibits false or misleading advertisements by registered advisers, and Rule 206(4)-7 requires registered advisers' compliance programs to address the accuracy of disclosures and to ensure portfolio management processes are consistent with disclosures. If a private fund's investment focus departs from the ESG-related words in its name, the fund's adviser may run the risk of "greenwashing" and violating the aforementioned rules.

More importantly, because the Names Proposal prohibits any Registered Fund that adopts integration strategies from using ESG or similar terminology in its name, advisers may want to review their private fund names and ESG strategies. If any of their fund names contains ESG or similar words but the fund itself is not ESG-focused, then the adviser may want to change its fund name to avoid suspicion of greenwashing.

See "IOSCO Consultation Report: Risk of Greenwashing and Regulatory Approaches (Part One of Two)" (Aug. 5, 2021).

## Potential Issues

The Proposals indicate the SEC's concerns of improving comparability, accuracy and consistency in ESG-related disclosures and naming practices; reducing greenwashing; and helping investors to make informed investment decisions and supervise their invested funds' ESG investment selection and engagement processes. Some proposed items in the Proposals, however, may create certain potential issues.

### Undefined ESG

The Disclosure Proposal does not define ESG – or E, S or G – but requires Advisers and Registered Funds that consider ESG factors to describe the factors they consider and how they implement those factors. According to the Fact Sheet on the Disclosure Proposal released by the SEC, however, "the ways that different funds and advisers define ESG can vary widely." That may potentially bring about three consequences:

1. Different Advisers and Registered Funds report and disclose ESG factors according to their own definitions and understanding, which may dilute the consistency and comparability of ESG reporting and disclosure.
2. Advisers and Registered Funds define ESG factors differently from how their clients or investors understand ESG factors, which may cause ESG reporting and disclosure to not match investor expectations and result in potential lawsuits.
3. Advisers and Registered Funds define ESG factors differently from the SEC examiners' or enforcement staff's understanding of ESG factors, which may result in alleged greenwashing en-



forcement actions.

See “[Asset Allocators Discuss the Evolution of ESG Data, Disclosure and Standards](#)” (Feb. 24, 2022).

## **Integration As Catchall Strategy**

Under the Disclosure Proposal, integration funds are ones that consider – but do not prioritize – one or more ESG factors along with other, non-ESG factors in their investment decisions. Considering many investors’ increased demand for ESG-related investments (whether due to investors’ reputation concerns, financed emissions quotas or ESG activist endeavors), it may become increasingly difficult for funds and their advisers to ignore ESG factors as part of their investment strategies. In this environment, because the SEC does not define ESG, funds and advisers that do not adopt ESG-focused strategies may default to reporting that they have adopted an “integration” strategy, regardless of whether they are actively marketing ESG strategies.

## **Name Restrictions**

The Names Proposal would prohibit any Registered Fund that adopts integration strategies from using ESG or similar terminology in its name. Considering that integration may potentially become a catchall ESG strategy, funds and advisers that are not ESG-focused would not be able to use ESG or similar terminology in their funds’ names.

## **Next Steps for Private Fund Advisers**

Although the SEC does not generally prescribe specific disclosures for particular investment strategies or prohibit using particular words in a fund’s name, the Proposals signal that the SEC treats ESG-related investments as a unique species of investments. Therefore, private fund advisers may want to take the following measures to be better prepared.

### **Increase Accuracy (“Say What You Do”)**

To increase the accuracy of their disclosures, filings and other documents, private fund advisers should:

- review their existing ESG-related PPM disclosures, Form ADV filings, contractual representations and marketing materials, and compare them with the funds’ and advisers’ investment practice. If inaccurate, advisers should update the information and, if material, possibly make an other-than-annual Form ADV filing;
- review and refine their existing ESG-related policies, programs and procedures to keep in line with their ESG practices; and

- compare public filings and disclosures with marketing materials to ensure the ESG-related information is consistent.

## Enhance Implementation (“Do What You Say”)

To ensure that advisers do what they say they do with regard to ESG, they should:

- compare ESG-related compliance policies, programs and procedures with their ESG practices and disclosures to ensure the policies, programs and procedures provide proper mechanisms to implement ESG-related disclosures;
- train the investment management team to ensure the team meets ESG-related due diligence, screens, issuer-engagement and monitoring requirements disclosed or marketed by the funds or advisers and follows clients’ or investors’ ESG investing guidelines, mandates or restrictions; and
- establish a system to aggregate and analyze ESG-related data and/or retain third-party ESG providers and keep records on how they implement ESG strategies.

See our two-part series on compliance training: “[SEC Expectations and Substantive Traps to Avoid](#)” (Sep. 23, 2021); and “[Who Conducts the Training and Five Traps to Avoid When Providing Training](#)” (Sep. 30, 2021).

## Change Fund’s Name, If Warranted

If an adviser does not adopt ESG-focused strategies for a private fund and the fund’s name contains ESG or related words, the adviser should consider changing the fund’s name to avoid confusion, litigation or an enforcement action.

## Improve Portfolio Engagement

An adviser should also ensure portfolio companies are managed consistently with the ESG-related investment objectives disclosed by it and/or its funds. If a private fund aims to actively contribute to its portfolio companies’ ESG practices, then the adviser may need mechanisms for proxy voting, screens, ESG investing analyses, decision-making processes and compliance review. It may also need to require portfolio companies to provide representations and warranties, indemnifications, information rights and audit rights.

## Conclusion

The SEC emphasized in its [2022 Examination Priorities](#) that the Division of Examinations will continue focusing on ESG-related advisory services and investment products, with particular focus on

the accuracy of ESG investing approach disclosures and the adoption and implementation of policies, procedures and practices to prevent violations of the federal securities laws in connection with ESG-related disclosures. The Proposals provide guidelines and reference points for private funds and their advisers on the proposed ESG-related reporting and disclosure standards.

See “[Private Funds Top the SEC’s 2022 Exam Priorities](#)” (Jun. 9, 2022).

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