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SEC Proposes Fund ESG Disclosure Channels: Different ESG Strategies Must Row in Their Lanes

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The SEC has proposed to require that mutual funds — including funds supporting variable insurance products — provide "consistent, comparable, and reliable" disclosure that is meaningful to investors about the role of environmental, social, and governance (ESG) factors as part of their investment program.

The SEC's task is complicated by the absence of any consensus among investors, funds, and advisers about what the meaning of "environmental," "social," or "governance" should be for this purpose and the almost limitless potential elasticity of those terms (which the SEC does not define). The difficulty is compounded by the absence of any consensus about what information on this subject would be most reliable and meaningful to investors.

The SEC's proposals would have the effect of requiring each fund to disclose whether, in connection with its portfolio investment decisions and its relations with portfolio companies, the fund:

- Considers one or more ESG factors, without those factors generally being dispositive (which the SEC calls an "ESG integration" strategy).
- Focuses on one or more ESG factors as a "significant or main consideration" (which the SEC calls an "ESG-focused" strategy).
- Seeks to achieve a specific ESG impact or impacts (which the SEC calls an "ESG impact" strategy).
- Does not consider ESG factors.

The SEC's proposals would require that funds make specified additional disclosures about any ESG integration, focused, or impact strategies that they employ. The specified new disclosures are most extensive in the case of ESG-focused or impact strategies. Among other objectives, the proposed new disclosures would make it more difficult for funds to engage in "greenwashing," i.e., exaggerating the role or relevance of a fund's ESG strategies, which is of especial concern for investors where the ESG strategies are associated with higher fund fees or expenses.

Although the proposals might provide some benefit to some investors, they have garnered much comment from interested parties, including a formal dissent by SEC Commissioner Hester Peirce. Peirce has suggested, among other things, that the proposals might be viewed as a misguided effort to regulate fund operations substantively, under the guise of requiring disclosure.

Certainly, compliance would be costly for some funds that employ ESG-focused or impact strategies. Also, if adopted, the proposed requirements could cause funds to revise their investment programs in ways that may not be in investors' best interest.

For example, the dividing line between an ESG integration strategy and an ESG-focused strategy seems unavoidably blurry. So it is foreseeable that some funds will revise their investment practices to ensure they fall on whichever side of the line they prefer. Similarly, funds that employ ESG-focused or impact strategies may be incentivized to modify their implementation of those strategies in ways that will make the new SEC-required disclosures as flattering to the fund as possible.

There is a danger that any such changes in a fund's investment program may make the program less suited to the adviser's experience and strengths or otherwise less aligned with the investors' best interest. Indeed, by defining several specific categories of ESG strategies and prescribing specific disclosure requirements to achieve consistency and comparability within each category, the SEC may unintentionally cause an undesirable narrowing of the range of variation in the ESG strategies that funds and their advisers will tend to employ.

The proposals also include requirements for other types of funds that are generally similar to the above-discussed proposals discussed for mutual funds. These include many private funds (via requirements imposed on their advisers), SEC-registered closed-end funds, and exchange-traded funds. All of these proposals were published in May 2022, together with proposed revisions to the SEC's rule relating to permitted names of investment companies. That names proposal dovetails with the other fund disclosure proposals in that it is intended in part to address SEC concerns over direct or indirect references to ESG considerations in fund names.

These May proposals followed, and are in important respects integrated with, proposals that the SEC published in March 2022 for the enhancement and standardization of climate-related disclosures by operating companies that are subject to the SEC's jurisdiction.

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