

Name That Boon: SEC Proposes Rules on ESG Fund Names & Disclosures

Teneo Insights / June 2022



On May 25th, the SEC proposed two rules that seek to provide the market with greater clarity on how funds incorporate ESG factors into their investment activities. While the SEC’s proposed rules are directed at investment companies and mutual funds, other companies are likely to be impacted as well. The proposed rules were also released at a time where the debate around the merits of ESG has greatly intensified.

To help companies make sense of all the recent ESG activity, we have provided our insights on:

1. The recently intensified ESG debate and the heightened focus on “greenwashing;”
2. The current state of “ESG funds;”
3. The proposed SEC rules on fund names and ESG fund disclosure;
4. How the proposed rules could potentially impact companies.

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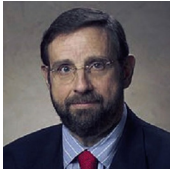
ESG – What is it Good For? The ESG Debate Intensifies

The amount of public debate regarding the merits of ESG has been quite remarkable in recent weeks. Tesla CEO Elon Musk tweeted that ESG is “a scam.” Former Vice President Mike Pence penned a *Wall Street Journal* op-ed calling ESG “a craze.” These grave concerns about ESG seem to focus on companies weighing in on political issues such as abortion or LGBTQ rights, the opacity and inconsistency of 3rd party ESG ratings and companies being forced by large investors to tackle societal issues such as climate change and employee diversity. Perhaps surprisingly, a few individuals at asset management firms have also expressed concerns about ESG investing, further evidence that the investor community is not monolithic in its ESG beliefs.

While the ESG debate will likely continue to cause confusion in the marketplace, it is clear that stakeholders are closely examining the potential misalignment between company or investor ESG claims and their actions (i.e.; “greenwashing”). For example, German and U.S. regulators are investigating Deutsche Bank’s asset management firm for allegedly overstating how the firm incorporated ESG factors into its investment decisions. The UK is moving towards a “green taxonomy” which the government hopes, once implemented, will play a central role in clamping down on unsubstantiated or exaggerated ESG claims. In a similar vein, the Financial Conduct Authority (FCA) in the UK published a discussion paper in November 2021 to help investors make more informed ESG investment decisions by establishing Sustainability Disclosure Requirements (SDRs) for asset managers and certain FCA-regulated asset owners, as well as the sustainable investment labelling system. The FCA hopes that these reforms will build trust in the market for ESG and sustainable investment products by combatting potential “greenwashing.”

We note that this is all happening at the same time that two major global initiatives are seeking to standardize more robust company ESG disclosures – the International Sustainability Standards Board (ISSB) and the European Union’s Corporate Sustainability Reporting Directive (CSRD).

In the U.S., the SEC’s Climate and ESG Task Force, a relatively new agency-wide task force overseen by the Deputy Director of Enforcement, has made similar allegations against BNY Mellon, while also alleging “greenwashing” at Brazilian mining company Vale. Given the resources that the SEC has put into this new task force, it is reasonable to expect that more enforcement actions, particularly involving “greenwashing” allegations, will follow in the period ahead. The SEC’s two proposed rules for ESG funds are yet another attempt to curb “greenwashing,” providing a clear pathway for future enforcement.



"The SEC's actions on climate-related disclosures may be deemed aggressive by, and may have a significant degree of opposition from, a variety of quarters, but it would be a mistake to believe that the SEC will not go forward with its proposed rules relating to investment funds and their ESG claims and names. There already have been several enforcement actions related to 'greenwashing' and the SEC's proposed rules attempt to correct those problems. Whatever one thinks, portfolio managers will need to be prepared to validate the names of their funds and demonstrate compliance with these new rules. The fact that the SEC's Climate and ESG Task Force is overseen by the Enforcement Division's Deputy Director is a clear signal that the SEC is girding for an increase in enforcement actions against portfolio managers."

- Harvey Pitt

Teneo Senior Advisor and 26th Chair of the U.S. Securities & Exchange Commission

Land of Confusion: The Current State of ESG Funds

According to a study by the U.S. Sustainable Investment Forum, \$1 out of every \$3 in the U.S. is invested in a fund with at least some ESG criteria within its investment strategy. However, how and to what degree investors apply ESG criteria has historically been very difficult to ascertain, especially for actively managed funds. While both passive and active funds typically cite robust proxy voting and engagement activities that advocate for specific ESG actions, there is a critical difference as to how ESG factors influence investing decisions. Passively managed ESG funds typically exclude companies from portfolios solely based on industry (e.g.; alcohol), ESG rating (e.g.; MSCI ESG rating), and/or "controversies" (e.g.; discrimination lawsuits). Actively managed funds typically do not implement a rules-based approach to portfolio construction. Almost all large, actively managed funds state that ESG factors may inform investment decisions either in the fund's prospectus or in the asset manager's sales literature. Very little detail is provided about how ESG factors impact the fund's investment decisions, and this opacity is precisely what the SEC is trying to solve with its proposed rules.

Name That Boon: SEC Proposes Expanding Fund Names Rule

An existing SEC rule requires certain types of mutual funds to comply with the "80% rule" whereby the fund must invest at least 80% of its assets in accordance with the investment focus the fund's name suggests. For example, ABC U.S. Equity Fund must invest at least 80% of its assets in U.S. equities. The SEC's proposed rule adds funds with ESG, sustainability and other similar terms in its name to this existing 80% rule for mutual funds.

In addition, mutual funds cannot use ESG or similar terms in their name unless ESG factors play a “central role in the fund’s strategy” and are used in a “dispositive” manner (i.e.; “ESG-focused” or “ESG Impact” funds, as defined by the SEC and summarized below).

Light, Medium and Heavy ESG: SEC Proposes ESG Fund Definitions & Disclosure

The SEC’s proposed rule places ESG funds into three categories: ESG Integration, ESG-Focused and ESG Impact Funds. A description of what qualifies a fund for each category is as follows:

1. ESG Integration Funds:
Funds that integrate ESG factors alongside non-ESG factors and such ESG factors are generally not determinative of the investment decision.
2. ESG-Focused Funds:
Funds that either have ESG (or similar term) in the fund’s name, use ESG factors as a significant/main investment consideration for the fund (e.g.; industry exclusions), utilize proxy voting and engagement as a significant means of implementing the fund’s ESG strategy or have sales literature that indicates the fund’s investment decisions incorporate one or more ESG factors as a main or significant consideration.
3. ESG Impact Funds:
A subset of ESG-Focused Funds, these are funds that seek to achieve returns and a particular ESG impact such as clean water, reduced emissions, etc. (i.e.; a double bottom line).

The SEC requires enhanced fund disclosure within prospectuses, annual reports and advisor brochures. Greater ESG disclosure is required for ESG-Focused and ESG Impact Funds

than for ESG Integration Funds. Generally, the enhanced fund disclosure includes the fund’s ESG strategy, proxy voting and engagement activities, carbon footprint including Scopes 1, 2 and 3 and weighted average carbon intensity (WACI).

Please see [Appendix A](#) and [Appendix B](#) for further detail of the enhanced ESG disclosure requirements for each category of ESG funds.

Attached at the Hip: SEC Proposal's Potential Impact on Companies

While the SEC’s proposed rules aim to help mutual fund investors, other companies will also likely be impacted. To comply with the rules, investors will need to ask companies for more ESG data and perhaps more progress on ESG issues.

1. More Requests for Scopes 1, 2 and 3 GHG Emissions Data
As we have observed with similar regulations globally, when investors are required to disclose more ESG information, companies will ultimately bear part of that burden. Pressure from investors will likely increase for climate data that is verified by a 3rd party, possibly accelerating the need for companies to gather this data prior to the timeline established by the SEC’s proposed rules on company climate disclosure.
2. More Pressure to Reduce GHG Emissions to Remain in Fund Portfolios
Many large asset managers have committed to net-zero for all portfolios by 2050. While the details as to how they plan to achieve that goal remain a bit murky, it is logical to assume that companies that also do not have plans to be net-zero by 2050 have significant challenges to being included in portfolios. The proposed rule expedites the portfolio exclusion risk for companies as now certain portfolios will

need to disclose details about their carbon footprint. These funds will have an incentive to keep that carbon footprint relatively low.

3. More Difficulty Defeating ESG Shareholder Proposals

We have already observed increased support from large investors on ESG shareholder proposals. The proposed rules permit funds to qualify for “ESG-Focused” status solely based on their proxy voting activities. Such funds are also required to disclose the percentage of ESG proposals supported. This may incentivize ESG-Focused funds to support ESG proposals at an even higher level than in the past to help combat any allegations of “greenwashing” from the SEC or other stakeholders.

4. More Engagement Requests from Investors with Increased Intensity

Similarly, ESG-Focused funds would be required to disclose engagement statistics. The SEC’s proposed rule even defines what constitutes an engagement for disclosure purposes as “substantive discussions 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.” This is likely to incentivize certain investors to not only engage more often, but to also increase the intensity of their dialogue.

5. Continued Uncertainty About How Investors Incorporate ESG

The enhanced ESG fund disclosure requirements are intended to provide greater clarity for investors in mutual funds. Investor Relations professionals may continue to be unclear as to how some investors factor ESG issues into investment decisions. Investor roadshows will need to continue to be targeted and robust to try and ascertain what impact ESG factors are having on the company’s inclusion in

portfolios. We do not expect large investors to pull back on their ESG initiatives and engagement because their clients will likely continue to push for progress.

Looking Ahead

The comment period for both SEC proposals is open to the public for 60 days. If past is precedent, the Commission will receive a significant number of comments on its proposals. More generally, the merits of ESG will likely be intensely debated for some time to come. Companies face significant challenges with balancing the increasing demands for more robust ESG disclosure with the increasing risk of “greenwashing” allegations. But there seems to be much agreement amongst regulators globally on the need to rid the world of “greenwashing” – both by investors as well as companies. As such, we recommend that companies:

- Understand what ESG disclosure may now be required of investors by the SEC;
- Continue gathering climate and other ESG data and explore possibilities for further assurance;
- Prepare for increased volume and intensity of shareholder engagement and shareholder proposal support; and
- Assemble an internal team to review all company ESG disclosures and balance the somewhat competing trends of increased ESG disclosure demands and allegations of “greenwashing.”

Appendix A: 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 A)		✓	✓
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.

Appendix B: ESG Strategy Overview Table

Overview of the Fund's [ESG] strategy	
How the Fund incorporates [ESG] factors in its investment decisions	<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<input type="checkbox"/> Engagement with issuers<input type="checkbox"/> Other
How the Fund votes proxies and/or engages with companies about [ESG] issues	



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