

Registered Funds and the New ESG Rule Proposals: Everything You Wanted to Know But Were Afraid to Ask

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INTRODUCTIONS

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OVERVIEW OF ESG PROPOSALS

- Proposed amendments concern the incorporation of ESG factors in investment selection process for registered funds
- Modify prospectus and shareholder report disclosure requirements for funds, including BDCs, registered under the 1940 Act
- Separate proposal would amend Rule 35d-1 (the Names Rule) to expand the scope of names covered by the rule, including names that indicate ESG-related investment strategies
- Comment period for both proposals closes on August 16

PROPOSED ESG TAXONOMY

| Type of Fund | Definition |
|-------------------|--|
| Integration Funds | Funds that consider one or more ESG factors alongside other, non-ESG factors in their investment decision-making process, but where such ESG factors are not dispositive in the funds' investment decisions. |
| ESG-Focused Funds | Funds that consider one or more ESG factors as significant or primary factors in selecting investments or in engagement with portfolio companies. |
| Impact Funds | Subset of ESG-Focused Funds that seek to achieve on or more specific ESG impacts. |

PROSPECTUS DISCLOSURES

| Type of Fund | Disclosure Requirements |
|-------------------|--|
| Integration Funds | <ul style="list-style-type: none"> ▪ How the Fund incorporates ESG factors into investment selection processes ▪ How such ESG factors are considered alongside other factors ▪ Methodology and data sources in considering GHG emissions (if applicable) |
| ESG-Focused Funds | <ul style="list-style-type: none"> ▪ Standardized “ESG Strategy Overview Table” consisting of a “check-box” format for funds to indicate which ESG strategies the fund employs ▪ Descriptions of internal methodology or third-party data provider used in selecting investments, identification of indices the fund tracks, and the participation of the fund and its adviser in any third-party ESG frameworks |
| Impact Funds | <ul style="list-style-type: none"> ▪ All disclosure requirements applicable to ESG-Focused Funds ▪ Also, disclose the ESG impact the fund seeks to generate with its investments ▪ How the fund measures progress toward the stated impact ▪ Time horizon used to measure that progress ▪ Relationship between the impact the fund is seeking to achieve and the fund’s financial returns |

ANNUAL REPORT DISCLOSURES

- Proposed amendments would require funds to include ESG-related information in annual shareholder reports
- Disclosure would appear in MDFPs (for registered funds) and MD&As (for business development companies)

| Type of Fund | Disclosure Requirements |
|-------------------|---|
| ESG-Focused Funds | <ul style="list-style-type: none"> ▪ Information regarding how the fund voted proxies on particular ESG-related voting matters (if applicable) ▪ Information regarding the fund's participation in ESG engagement meetings (if applicable) ▪ GHG emission metrics (if applicable) ▪ Carbon footprint and WACI (if applicable) |
| Impact Funds | <ul style="list-style-type: none"> ▪ Summary of progress towards achieving stated ESG impacts |

REPORTING ON FORM N-CEN

- Collects census-type information regarding funds and the ESG-related service providers they use
- Updates to Form N-CEN would include:
 - Type of ESG strategy a fund employs (i.e., integration, focused, or impact)
 - ESG factor(s) a fund considers
 - Methods a fund uses to implement its ESG strategy
 - Whether a fund considers ESG-related information or scores provided by ESG providers in implementing its investment strategy
 - Whether the fund follows any third-party ESG frameworks
 - Name and legal entity identifier, if any, of the index the funds track

EXPANSION OF THE NAMES RULE

- Broadens scope of the Names Rule to cover fund names that describe investment strategies as well as investment types or industries
- Funds with ESG-related terms in their names would need to adopt investment policies to ensure that 80% of their assets is invested in ESG-related or sustainable investments, or otherwise change their names
- Prohibits Integration Funds from using ESG-related terms in their names
- A fund cannot include ESG-related terms in its name if ESG factors are not the determinative consideration in investment decisions

DEPARTURES FROM 80% POLICY

- Current Names Rule only applies “under normal circumstances” and “at the time of investment”
- Proposal would specify particular circumstances in which a fund may depart from its 80% Policy
 - Specific time frames for coming back into compliance (generally, as soon as reasonably practicable but in any event within 30 consecutive days)
 - Funds would need to more frequently monitor their ESG-related investments to continue to qualify for the fund’s 80% policy

ESG & NAMES RULE DISCLOSURE

- Funds with an 80% Policy would have to disclose in its prospectus definitions of the terms in its name that are related to the fund's investment focus or strategies, including any specific criteria the fund uses to select the investments the term describes.
- 80% Policy would have to address all elements in the name

AREAS FOR POTENTIAL COMMENTS (ESG)

- Prescriptive regime under proposed taxonomy that may not align with the way funds manage their ESG investment programs.
- Overly broad in scope and require disclosures that will be costly to document and may not provide a commensurate benefit to investors
- Funds may not be able to appropriately measure, assess, and document the various ESG metrics

AREAS FOR POTENTIAL COMMENTS (NAMES RULE)

- Expansion to capture ESG-related strategies will require funds to review and determine changes to holdings or strategies will be needed
- Departure from “time of investment” standard would require funds to continually monitor whether an investment qualifies as ESG
- Given interplay between ESG and Names Rule proposals, funds may not have sufficient time to restructure their 80% policies

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