2022 Brings ESG Disclosure Challenges For Asset Managers

By **Celeste Koeleveld, David Adams and Karina Bashir** (February 3, 2022)

Celeste Koeleveld

David Adams

Karina Bashir

As 2021 drew to a close, the U.S. Securities and Exchange Commission quietly took one of its first concrete steps toward imposing mandatory environmental, social and governance, or ESG, regulatory requirements on investment managers.

SEC commissioners hinted throughout 2020 that their ambitions for ESG regulation and disclosure extended beyond the boardrooms of public companies and into the offices of investment advisers. It was not until December 2021, however, that the SEC added proposing ESG-specific rules for investment managers to its formal rulemaking agenda.

The SEC also plans to propose mandatory ESG disclosure requirements for public companies in early 2022, and a speech near the end of 2021 suggested that SEC commissioners may even incorporate ESG considerations into rulemaking proposals for private offerings under Rule 144A and Rule 506 to address ESG issues in the private markets.

Here are the key developments in 2021 that led up to the SEC's end-of-year announcements, including what U.S. and non-U.S. managers may be able to expect from the SEC in 2022 and beyond.

Key 2021 Investment Manager-Specific Developments

While proposed mandatory ESG disclosures for public companies took center stage in the U.S. throughout 2021, the SEC also laid the groundwork to propose mandatory disclosure requirements for investment managers.

The SEC started 2021 by announcing the formation of a Climate and ESG Task Force to, among other things, review "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[1]

The SEC also issued examination priorities[2] in early 2021 indicating that annual examinations of investment advisers would include ESG-related questions.

Shortly thereafter, the SEC issued a risk alert[3] highlighting adviser deficiencies and internal control weaknesses related to ESG products and services observed in recent examinations.

SEC Chair Gary Gensler publicly criticized certain practices by investment managers throughout 2021, as well, including their use of sustainability-related labels — e.g., "green," "sustainable" or "low carbon" — to describe investment funds or strategies without clearly explaining what these terms mean.[4]

Near the end of 2021, Gurbir Grewal, director of the SEC's Division of Enforcement, also struck an aggressive tone on ESG enforcement actions by devoting half of one of his first speeches to concerns about cross-border ESG regulatory and enforcement issues.[5]

Insights From SEC's Request for Input on Reporting Requirements

The SEC also requested public input on new disclosure requirements for public companies in 2021.[6]

Many mangers submitted comments, and any new disclosure requirements for investment managers are likely to be informed by what the SEC proposes for public companies — particularly if the SEC wants to ensure that certain information disclosed by public companies ultimately makes its way to fund investors.

The SEC received over 550 unique responses during the comment period, including from a large number of U.S. and global fund managers.[7]

The participation of so many investment managers in the comment process, and their overall support for SEC-mandated public company ESG disclosures, may make it easier for the SEC to apply similar disclosure requirements to managers.

Calibrating Qualitative and Quantitative Disclosures

Many fund managers emphasized the importance of comparable disclosure by public companies of both qualitative ESG risk factors — e.g., resource consumption, emissions, accident rates, diversity ratios — and more flexible qualitative requirements, e.g., how the company's leadership manages climate-related risks and opportunities, and how these factors feed into the company's strategy.

The use of a combination of qualitative and quantitative ESG disclosures for any investment manager disclosures may also make sense, particularly for advisers claiming to follow ESG-related investment strategies, or to have implemented human capital or diversity frameworks for the adviser's own day-to-day operations.

Some managers also encouraged the SEC to require disclosure about Scope 3 emissions. Scope 3 measurements seek to quantify the greenhouse gas emissions of companies in a public company's value chain.

Critics argue that accurately assessing the emissions of all companies in an issuer's value chain is difficult and that the data used to do so may be incomplete, inaccurate or unverifiable.

It remains unclear whether the SEC will impose Scope 3 emissions disclosures on public companies. If so, similar disclosures could be mandated for investment managers in the future, e.g., by affirmatively requiring fund managers to report the Scope 3 emissions metrics of companies that they invest in.

Global Coordination Is Avoiding Regulatory Confusion

Comments also encouraged the SEC to promote a global baseline of consistent and comparable sustainability-related disclosure.

Non-U.S. regulators and other well-established international ESG standard setters like the Task Force on Climate-Related Financial Disclosures, or TCFD, and the Global Sustainability Standards Board, which developed the Global Reporting Initiative, have established reporting standards that many investment managers already follow.

Significant divergence of U.S. disclosure requirements or definitional standards could require managers to overhaul procedures already adopted to comply with reporting requirements in other countries — e.g., the European Union's Sustainable Finance Disclosure Regulation — or to align with voluntary disclosure standards like the Global Reporting Initiative or the United Nations' Principles for Responsible Investment.

SEC members have acknowledged the importance of building on globally recognized standards.[8] For example, Gensler characterized the TCFD in positive terms in a December 2021 Q&A with The Wall Street Journal.[9]

That said, another development in 2021 suggests that the SEC may already be starting down a divergent path.

In October 2021, the SEC proposed adding ESG-specific disclosures to a form used by mutual funds, exchange traded funds, closed-end funds and certain other registered investment companies to report about their proxy voting practices.[10]

While some of the new disclosure topics are generally understood and/or defined — e.g., greenhouse gas emissions — other mandated topics are less familiar.

For example, the proposed rules would require disclosure of proxy voting by fund managers related to water issues and environmental justice. The proposing release does not define or reference an internationally accepted definition for these or any other terms in the proposed rules, which may lead to confusion among fund managers and the very investors intended to benefit from the new disclosures.

Moving Beyond Environmental Considerations

While the SEC's request for public comment and many of its questions focused on environmental disclosures — i.e., the E in ESG — commenters strongly encouraged the SEC to incorporate disclosures about social justice and other social disclosures, or the S, into a broader ESG disclosure framework.

Comments by Gensler suggest that he supports the disclosure of social considerations in the context of both public companies and investment managers.

Specifically, Gensler suggested requiring fund managers to disclose

> aggregated demographic information about an adviser's employees and owners ... [and] include information about an adviser's diversity and inclusion practices in its selection of other advisers.[11]

Thus, the SEC staff seems poised to require mandatory disclosure of more than just environmental considerations by public companies and potentially investment managers.

Mandatory and Standardized Sector-Specific Disclosures

Most investment managers voiced support for mandatory disclosure requirements over voluntary ones.

Gensler has voiced support for mandatory disclosure requirements on multiple occasions, and any disclosure regime adopted by the SEC for fund managers may also include mandatory disclosure requirements.

Several commenters advocated for mandatory disclosures tailored to specific industries, e.g., tracking energy-efficient buildings in real estate and progress on developing alternative fuel vehicles in the automotive industry.

Industry-specific disclosures seem likely to provide investors with the kind of "decision-useful" information that Gensler favors, and Gensler has acknowledged asking the SEC staff to consider industry-specific disclosure metrics for public companies, including for banking, insurance and transportation.

Like public companies, fund managers often specialize in specific types of investments or investing in specific industries. Thus, any industry-specific metrics adopted for public company disclosures are likely to be highly adaptable to managers.

The Potential for a Public/Private Fund Divide

Most commentors agreed that the SEC should implement mandatory climate change disclosures for public companies to include in their public reports, e.g., Form 10-K.

Some commenters also asked the SEC to impose mandatory disclosure requirements on private companies, because investors in private companies would benefit just as much as investors in public companies by having access to information about carbon emissions, energy efficiency and environmental risks to real assets.

SEC Commissioner Caroline Crenshaw raised similar concerns about the lack of information in private markets throughout 2021.[12] In a speech near the end of 2021, Crenshaw stated that "while the importance of [ESG] disclosure in the public markets cannot be overstated, the lack of similar information in the private markets poses its own obstacles."

She continued that the SEC had three rulemakings on its regulatory agenda through which it could address issues in the private markets: (1) the Rule 144 holding period and Form 144; (2) Regulation D and Form D improvements; and (3) revisions to the definition of "securities held of record."

Mandatory ESG disclosures for private offerings could impose significant new burdens on fund managers with respect to their own practices and to the companies in which they invest.

Many private fund managers have also historically struggled to obtain ESG-related information from private companies.

This could become a more significant issue if, for example, the SEC establishes mandatory reporting requirements for fund managers regarding all of their investments, without adopting corresponding reporting requirements for the private companies in which a manager invests.

While most of Gensler's comments to date have focused on reporting by registered investment companies and their managers, Crenshaw's comments at the end of 2021 suggest that ESG considerations may be infused into future Regulation D or other private offering rule proposals.

Implementation Considerations

Fund managers and other commenters suggested that the SEC adopt a phased implementation approach to give companies enough time to comply with the new requirements.

Commenters also suggested the use of a "comply and explain" framework to facilitate situations where companies have difficulty obtaining reportable information.

Such a framework would mirror existing voluntary frameworks like the Global Reporting Initiative and disclosure frameworks in the European corporate governance system, where companies often comply with disclosure requirements to avoid reputational costs and the experience of providing extensive explanations for their lack of compliance.

These same considerations would be of significant relevance in the context of mandatory ESG disclosures adopted for investment managers.

The Year Ahead — Snapshot Advice

Investment managers should closely monitor all ESG-related SEC rulemaking proposals in 2022 and consider participating in the rulemaking process by submitting comment letters.

The SEC is likely to propose mandatory disclosure requirements for investment managers in the future, and upcoming disclosure requirements for public companies may preview what is coming for investment managers.

Any proposal to insert ESG considerations into SEC Rule 506 would also have significant implications for private fund managers.

Moreover, public statements by both Gensler and the SEC's head of enforcement make clear that the SEC will continue aggressively investigating ESG-related funds, as well as U.S. and non-U.S. managers, to detect and prevent greenwashing.

Celeste Koeleveld is a partner, and David Adams and Karina Bashir are associates, at Clifford Chance LLP.

[1] SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021) available at https://www.sec.gov/news/press-release/2021-42.

[2] SEC Division of Examinations 2021 Examination Priorities (Mar. 3, 2021) available at https://www.sec.gov/files/2021-exam-priorities.pdf.

[3] SEC Division of Examinations Review of ESG Investing (April 9, 2021) available at https://www.sec.gov/files/esg-risk-alert.pdf.

[4] See, e.g., Prepared Remarks Before the Asset Management Advisory Committee (July 7,

2021) available at https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07; Remarks before the European Parliament Committee on Economic and Monetary (Sept. 1, 2021) available at https://www.sec.gov/news/speech/gensler-remarks-european-parliament-090121. Gensler has also asked the SEC staff to evaluate similar disclosure requirements with respect to human capital and board diversity.

[5] 2021 SEC Regulation Outside the United States - Scott Friestad Memorial Keynote Address (Nov. 8, 2021) available at https://www.sec.gov/news/speech/grewal-regulation-outside-united-states-110821?utm_medium=email&utm_source=govdelivery.

[6] Public Input Welcomed on Climate Change Disclosures (Mar. 15, 2021) available at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[7] Comments on Climate Change Disclosures available at https://www.sec.gov/comments/climate-disclosure/cll12.htm.

[8] Remarks at the PRI/LSEG Investor Action on Climate Webinar, Speech by SEC Commissioner Allison Herren Lee (Oct. 20, 2021) available at https://www.sec.gov/news/speech/lee-remarks-prilseg-investor-action-climate-webinar-102021.

[9] SEC Chairman on New Regulations on Cryptocurrencies and Climate Risk (Dec. 12, 2021) available at https://www.wsj.com/articles/sec-chairman-on-regulations-on-cryptocurrency-and-climate-risk-11639165931.

[10] Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Proposed Rule, SEC Rel. No. 34-93169 (Oct. 15, 2021) available at https://www.sec.gov/rules/proposed/2021/34-93169.pdf.

[11] See supra n.6.

[12] See, e.g., Remarks at Asset Management Advisory Committee Meeting (July 7, 2021) available at https://www.sec.gov/news/public-statement/crenshaw-amac-remarks-070721.