



The SEC's ESG Disclosure Rules

Implications for advisers, funds, and investment management liability insurance

In its most recent rule proposals, the SEC has set its sights on the use of Environmental, Social, and Governance (ESG) factors within the investment management industry. This bulletin provides an overview of the SEC's proposals, as well as the key issues advisers and funds should be mindful of when reviewing their private company directors' & officers' / errors & omissions (D&O/E&O) liability programs ("investment management liability insurance").

The Rise of ESG

ESG has rapidly become a highly desirable investment strategy for investors as well as a source of considerable growth for investment managers. According to a recent [report](#) by Bloomberg Intelligence, ESG assets surpassed \$35 trillion in 2020 and may exceed \$50 trillion, or one-third of total assets under management globally, by 2025. As the upward trend in ESG is expected to continue, regulators are taking steps to ensure investors are well protected.

ESG and the SEC

Given the substantial growth in these strategies, it is not surprising that ESG has risen to the top of the SEC's agenda. Under the Biden Administration, the regulator has made no secret of its intent to make ESG a priority. In February of 2021, the SEC's Office of Investor Education and Advocacy issued a [bulletin](#) outlining issues investors should be mindful of when investing in an ESG fund, while in March 2021, the SEC [announced](#) the creation of an enforcement task force focused on climate and ESG issues. These actions were followed by a risk [alert](#) in April 2021, in which the SEC identified deficiencies and weaknesses found in its examinations of advisers and funds related to ESG investing.

Now nearly halfway through 2022, the regulator's actions involving ESG continue to intensify. For the first time, the SEC included "greenwashing", or the overstatement or misrepresentation of the ESG factors considered or incorporated into portfolio selections, as a significant focus area in this year's [Examination Priorities](#). Further demonstrating the seriousness with which they view this issue, the SEC has recently brought actions against, or is conducting investigations into, investment advisers related to greenwashing and ESG misrepresentations.

New and modified rules

The actions taken by the SEC thus far have now culminated in the proposal of two rules intended to further protect investors in ESG-themed products:

Proposed Rule: ESG Disclosures for Investment Advisers and Investment Companies

On May 25, 2022, the SEC issued its proposed [rule](#) requiring enhanced ESG disclosures by certain registered and some unregistered investment advisers ("advisers"), and certain registered investment companies and business development companies ("funds"). The goal of this rule is to provide consistent, comparable, and reliable information that investors can consider when making ESG investment decisions.

The SEC's proposal focuses on three primary areas of disclosure. The first area requires advisers to disclose how they consider ESG factors in their investment strategies and analysis, while funds that consider ESG factors will need to disclose additional information on their investment strategy, with the level of such disclosure depending on how central such factors are to that strategy. The types of ESG funds contemplated by the rule have been broken into three categories:

- "Integration funds", which incorporate both ESG and non-ESG factors, would need to describe how ESG is factored into the fund's investment process;
- "ESG-Focused Funds", which utilize ESG factors as either the primary or a significant investment consideration, would need to provide disclosures in accordance with a standardized disclosure table; and
- "Impact Funds", which seek to attain a specific ESG goal, would be required to disclose how the fund measures its progress in achieving its stated impact objective.

The second area of disclosures focuses on funds that use engagement with issuers or proxy voting as a strategy to achieve its ESG objectives. Specific ESG-Focused Funds would also be required to make disclosures regarding the objective of the fund, the impact they are seeking to achieve, and how progress in achieving such goals are measured.

The third area of the proposed rule focuses on the disclosure of Greenhouse Gas (GHG) emissions. For those ESG-Focused Funds that incorporate environmental factors into their investment strategies, the carbon footprint, and the weighted average carbon intensity of the portfolio will need to be disclosed. Additional disclosure requirements will also be imposed on Integration funds that consider GHG emissions in their investment strategy, including the GHG emissions data sources and the methodology used to determine the emissions associated with the portfolio.

Proposed Rule: Amendments to the Fund "Names Rule"

Rule 35d-1 of the Investment Company Act of 1940, often referred to as the "Names Rule", is intended to ensure that the name of a registered investment company or a business development company ("fund") accurately reflects the investments of such funds. Further, the name of the fund must not be materially deceptive or misleading to investors. To support these efforts, the Names Rule requires that funds subject to the rule invest at least 80% of their assets in accordance with the investment focus suggested by the fund name.

The SEC's proposed **amendments** to the Names Rule would expand the applicability of the 80% requirement to apply to a fund name that includes terminology suggesting that it focuses in investments with a particular characteristic. An example would be a fund name that includes an Environmental, Social, and/or Governance factor. If an ESG factor is not considered more centrally than other factors in the investment decisions of the fund, then ESG or similar terminology cannot be utilized in its name.

Other notable aspects of the amended Names Rule include requiring funds with derivatives to utilize the notional value (not market value) of these instruments for purposes of complying with the rule, specifying the circumstances under which a fund can temporarily deviate from the 80% investment policy, requiring unlisted closed-end funds and BDCs to obtain shareholder approval before changing its 80% investment policy, and enhanced prospectus disclosure, reporting, and record keeping requirements .

Risk and insurance considerations

Greater regulatory scrutiny often equates to an increased risk of enforcement actions and possible follow-on civil litigation against advisers, funds and potentially fund directors. Given the ESG-related activity already taken by the SEC , these new rules, if adopted, may heighten the risk of regulatory actions in the future. It is therefore, important to be mindful of these risks when reviewing the coverage afforded under investment management liability policies.

While any claim must be assessed against an insured's specific insurance policy, the D&O component of investment management policies is intended to respond to claims made against the adviser's individual directors and officers, as well as the entity itself, alleging certain wrongful acts committed by them in their capacity as such, while the E&O component is generally intended to respond to claims made against the adviser alleging errors and/or omissions in the performance of, or failure to perform, investment management services.

Similarly, most investment management liability policies are intended to respond to claims made against the fund directors, as well as the funds themselves, alleging a failure to provide proper oversight of the fund and fund services providers, including the investment adviser.

Therefore, most well-endorsed investment management liability policy forms should generally respond to regulatory or investor claims, including claims alleging greenwashing and other ESG-related misrepresentations. However, with the frequency of such claims potentially increasing as a result of the SEC's proposed rules, reviewing the scope (and limitations) of coverage available for such matters is recommended. In particular, coverage for both formal and informal regulatory investigations, as well as the applicability and breadth of certain exclusions should be reviewed and modified where possible.

Lastly, as investment management liability policies are assessed in the context of ESG, reviewing the scope of Cost of Corrections coverage is also recommended. Either included within the policy form or added by endorsement, Cost of Corrections coverage is intended to reimburse the adviser for certain costs it incurs in correcting errors that, if not corrected, would result in an otherwise covered claim under the policy. Such coverage may be implicated if, for example, an adviser utilizes a screening approach in the

construction of an ESG investment portfolio and makes a trade error which, if not corrected, would result in a loss to the investor. The breadth and scope of Cost of Corrections coverage often varies by insurer, but most impose strict reporting obligations upon insureds. Being mindful of these obligations is an important step in mitigating the risk of Cost of Corrections claims being denied under these policies due to late reporting.

WTW's global Financial, Executive and Professional Risks team (FINEX) will continue to monitor the progress of this and other regulations as they develop. If you have any questions relating to the SEC's proposed rules, please contact your WTW broker.

Contact

Timothy M. Sullivan

Director, Asset Management Industry Leader

timothy.sullivan@willistowerswatson.com

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