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ESG as an asset: SEC's proposed rules mark an inflection point for asset managers

Registered investment advisers are increasing environmental, social and governance (ESG) offerings and evaluating how they employ ESG investment strategies to meet stakeholder demand. With the establishment of the International Sustainability Standards Board (ISSB), progress by the European Financial Reporting Advisory Group (EFRAG) and now, several proposed rules from the U.S. Securities and Exchange Commission (SEC), we are at a critical inflection point for ESG reporting. Asset managers need to prepare.

A growing field without a common rulebook

Demand for climate and socially conscious investments is ballooning. In 2021, there were 534 sustainable funds available to U.S. investors, up from 392 funds the prior year.[1] In response to increased stakeholder demand, the number of companies engaging in ESG reporting is also growing: 52 percent of U.S. CEOs recently surveyed by KPMG reported they are seeing significant demand for increased reporting and transparency on ESG issues, and 55 percent expect to rely increasingly on external assurance of their ESG data to meet stakeholder and investor expectations for consistent and robust sustainability reporting.[2]

From a reporting perspective, companies' current disclosures can vary significantly depending on the quality and volume of data they voluntarily disclose, and a robust compliance infrastructure may or may not exist to enforce stated ESG commitments. The asset management industry, for example, has used terms such as "sustainable," "ESG-conscious" and "impact" to describe funds. While they may sound equivalent, the terms have no uniform definition. Investors may be making decisions based on those terms, and inconsistencies are a source of risk.

In the first half of 2022, the SEC released several proposals designed to enhance ESG reporting. The first applies to public companies across industries, and the second two are designed to combat inconsistencies specific to the asset management sector. Governance and risk management are key themes in the SEC proposals, with an emphasis on enhancing investor protection and mitigating greenwashing concerns.

A quick look at the proposed SEC rules

Proposal #1: The enhancement and standardization of climate-related disclosures for investors would make climate-related financial disclosures a baseline requirement for public companies.[3] The foundational element of the proposal is the idea that standardization will clarify risk and growth opportunities related to

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[1] Rob Kozlowski, "Sustainable ETFs, Open-end Funds Hit Record Highs in 2021," *Pensions & Investments*, February 10, 2022, https://www.pionline.com/esg/sustainable-etfs-open-end-funds-hit-record-highs-2021.
[2] KPMG U.S., *KPMG 2021 U.S. CEO Outlook*, accessed June 13, 2022, https://home.kpmg/us/en/home/insights/2021/08/us-ceo-outlook-2021.html.
[3] U.S. Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-related Disclosures for Investors," March 21, 2022, https://www.sec.gov/news/press-release/2022-46.

climate. The proposal would increase transparency in companies' response to climate risk and quantify its financial impact. The rule can be seen through three angles:

- Financial impact, expenditure and assumption disclosures: Public companies would be required to disclose the financial impact of climate-related events, conditions and activities on their consolidated financial statements if the aggregate impact is 1 percent or more of any line item in the financial statements. Public companies would also need to disclose any related costs or expenditures if the aggregate impact meets the 1 percent threshold. To supplement these disclosures, companies would have to provide a description of any estimates or assumptions used to produce the consolidated financial statements.[4]

- Greenhouse gas (GHG) emissions disclosures: Companies would be required to report their Scope 1 emissions (direct GHG emissions) and Scope 2 emissions (indirect GHG emissions from purchased electricity or other acquired forms of energy). These disclosures could be subject to reasonable assurance by fiscal year 2026 for large accelerated filers, and by fiscal year 2027 for accelerated filers. Scope 3 emissions — emissions from upstream and downstream activities in a company's value chain — would also require disclosure if they are material or included in emissions targets. Smaller reporting companies would be exempt from Scope 3 disclosures.

- Other related disclosures: The SEC's proposal also includes provisions relating to governance and risk management; physical and transition risks; targets or goals of any transition plan; scenario analyses if used, carbon offsets or renewable energy certificates (RECs) in the plan to achieve carbon-related goals; and internal carbon pricing. These disclosures would sit outside financial statements but within Form 10-K.[5]

Proposal #2: An amendment to the Investment Company Act of 1940 seeks to expand the Names Rule,[6] requiring funds with names suggesting a focus on particular investments, industries or geographies to adopt an 80 percent investment policy in assets that reflect the fund's name.[7] Under the proposed amendment, the SEC would extend the reach of the Names Rule to include funds in the ESG space — a universe that has grown to $17.1 trillion in value[8] — to reduce the use of materially deceptive or misleading language suggesting a fund is more ESG-conscious than it truly is. It would also prohibit unlisted closed-end funds or business development companies (BDCs) from changing the 80 percent policy without a shareholder vote. This expansion of the Names Rule would extend to fund names utilizing terms such as "growth" or "value" since these terms suggest a specific investment strategy as well.

Proposal #3: The enhancement of disclosures by certain investment advisers and investment companies about ESG investment practices aims to establish standardized disclosures that explain how a company or adviser's ESG strategy is being deployed.[9] The rule acknowledges that there are varying degrees of commitments with respect to ESG. Therefore, it identifies three types of ESG funds — integration funds, ESG-focused funds and impact funds — with the intention of scaling disclosures in registration statements and annual reports depending on the significance of ESG factors to a fund's strategy.[10] Registered

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[4] KPMG U.S., *SEC Proposes Climate Reporting and Assurance Rules*, March 2022, https://frv.kpmg.us/reference-library/2022/sec-proposes-climate-reporting-requirements.html.
[5] KPMG U.S., *SEC Proposes Climate Reporting and Assurance Rules*.
[6] U.S. Securities and Exchange Commission, "SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names," May 25, 2022, https://www.sec.gov/news/press-release/2022-91.
[7] KPMG U.S., *Investor Protections: SEC Proposed Names Rule and ESG Investment Practices Disclosure*, May 2022, https://advisory.kpmg.us/articles/2022/sec-names-rule-reg-alert.html.
[8] "Report on US Sustainable and Impact Investing Trends 2020," *U.S. SIF Foundation*, 2020, https://www.ussif.org/currentandpast.
[9] U.S. Securities and Exchange Commission, "SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices," May 25, 2022, https://www.sec.gov/news/press-release/2022-92.
[10] KPMG U.S., *SEC Investment Management Proposals Focus on ESG*, May 2022, https://frv.kpmg.us/reference-library/2022/sec-investment-management-proposals-focus-on-esg.html.

investment advisers that consider ESG factors as part of their advisory business would be required to disclose certain information in their Form ADV.

Asset managers must prepare now

The SEC's proposed rules signal that companies need to approach ESG reporting with greater rigor and specificity. The reality is that companies and investors are no longer asking if ESG data matters. The focus has now shifted to what type of data is being collected and how it is being used to tell their stories and inform their business and investment decisions. With the emergence of formal rules that would mandate the reporting of climate data, risk and governance and enhance scrutiny of fund strategies and marketing, investment companies and advisers should prepare for this new frontier of ESG.

The interplay among different investment company proposals will require significant time and resources from advisers and should not be underestimated. Regardless of the form and content of the final rules, the demand for data and disclosures by key stakeholders is here to stay, and asset managers should take concrete steps to prepare:

— Expect a significant increase in demand for high-quality ESG data: Decisions made with data are only as good as the reliability of the data itself. As companies begin to increase their disclosures, ESG data will become more prevalent and precise. It will be important for asset managers to have a comprehensive understanding of the data — both its quality and definitions — and dedicate the necessary staff and resources to handle an unprecedented increase in volume.

— Understand the disclosure implications of an ESG investment strategy: In developing a robust ESG investment strategy, asset managers must consider both current and future reporting implications. Disclosure related to investment strategy should be clear and precise so that management can execute that strategy consistently and reliably. Is ESG the primary strategy or is it an overlay of an existing strategy? If it's part of the strategy, are the boundaries for investment and management clearly defined?

— Establish specific ESG policies and procedures: Asset managers will need to closely review their disclosure and portfolio management processes to comply with current and proposed rules. Conducting a gap analysis is key to understanding the processes, controls and infrastructure they will need to meet reporting requirements. Thorough documentation of these processes will be critical to enhance transparency, engender trust from stakeholders and limit regulatory issues. Internal alignment will be essential as well: Investment professionals, back-office staff and compliance teams should maintain close coordination to ensure all parties understand the company's ESG strategy and how to operationalize it.

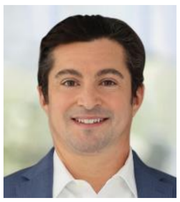
— Assess marketing materials for potential greenwashing: Asset managers will need to ensure that marketing of a firm and its funds accurately depicts consideration of ESG factors within the portfolio. There will be increased scrutiny and accountability for advisers to disclose an investment process consistent with fund names and investors' expectations.[11]

To drive buy-in to their ESG strategies and funds, asset managers will need to reconcile the priorities of both internal and external stakeholders while continuing to fulfill their fiduciary obligations. With the proposed Names Rule amendment in particular, the SEC has signaled that investors are craving greater transparency around their holdings.

[11] KPMG U.S., "Four Quick Reactions from KPMG on SEC Proposed Rules for Investment Companies," *News and Perspectives*, May 26, 2022, https://info.kpmg.us/news-perspectives/industry-insights-research/kpmg-reactions-sec-investment-companies.html.

The bottom line is clarity

As asset managers and investors prepare for the next frontier of ESG investing and reporting, the key ingredient to any reporting strategy will be authenticity: Say what you do and do what you say. This directive extends to board members who, according to the newly proposed rules, would be required to disclose expertise in areas such as climate risk. For years, asset managers have been investing in the ESG future. Their disclosures will soon reflect these efforts as ESG reporting acquires the timeliness and rigor of financial reporting.



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