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**Strategic Perspectives**

# SEC targets ESG asset managers and fuels critics

*By Lene Powell, J.D., Brad Rosen, J.D., and Matthew Garza, J.D.*

As the ESG investing boom continues, the SEC wants to make information clearer for investors.

## CALL FOR ESG STANDARDS

With "sustainable" U.S. investments at $17.1 trillion by one estimate, an enormous pool of money is at stake. Yet there are few standards for marketing investments that consider environmental, social, and governance factors. In crackdowns on exaggerated ESG claims, the SEC issued a risk alert in 2021 and brought two enforcement actions against advisers in 2022.

Now, the SEC has issued two new rulemaking proposals and a request for comment. The comment period for the releases ended August 16.

**Strong views abound.** While most commenters support the goal of clearing up the current haze of ESG claims, opinions vary widely as to the best approach.

- The proposals drew strong critiques from a key stakeholder: the Investment Company Institute. Along with objections from conservative groups, this could signal legal challenges if the proposals are adopted.
- Many commenters raised concerns about proposed fund categories. In particular, many commenters from across the spectrum believe the broadest category, Integrated Funds, is meaningless and should be eliminated.
- Some asset managers are concerned that incorporating ESG analysis may expose them to possible claims for breach of fiduciary duty. Clarifying that ESG-Focused funds use ESG methods to maximize financial returns could assuage these concerns.
- Index providers and other information providers do not see possible registration as investment advisers as necessary or helpful to investors.

In this analysis, we examine reactions to the proposals, including the likelihood of adoption and legal challenge, and offer practical steps for funds and advisers to take now.

### Growth of ESG investing

Two factors are really driving ESG investing and the SEC proposals, said Gwen Williamson, partner in the Investment Management group at Perkins Coie.

First, there is tremendous interest among both retail and institutional investors.

"There is an extraordinary popularity of ESG strategies," said Williamson. "At every level, there's been demand."

According to a recent Gallup poll of retail investors:

- 48 percent of investors said they are "very" or "somewhat" interested in purchasing sustainable investing funds.
- Seven in 10 investors who are employed full or part time say they would definitely (13 percent) or probably (57 percent) include sustainable investing funds as part of their 401(k)s if their employer's plan were to offer them.
- A significant percentage said they consider ESG factors in researching investments: governance (41 percent), social values (38 percent), or environmental impact (35 percent).

Investment products have responded to investor demand. According to the U.S. Forum for Sustainable and Responsible Investment, since 1995 the "U.S. sustainable investment universe" has increased more than 25 times from $639 billion to $17.1 trillion. According to a Morningstar report, sustainable funds have set records for inflows in each of the past five years, with significant increases in 2019 and 2020.

Another factor is that ESG investing is farther along in Europe, said Williamson. U.S. institutional investors are looking at ESG fund offerings on the European side and asking for equivalent ESG investment opportunities. Also, global financial firms are leveraging expertise developed in complying with the E.U.'s Sustainable Finance Disclosure Regulation (SFDR), which imposes comprehensive disclosure obligations relating to sustainability.

### Greenwashing

Eyeing investor demand for ESG investments, funds and advisers have ramped up ESG-themed marketing.

Morningstar, Inc. found the first mention of "ESG" in a fund prospectus in 2016. Three years later, close to 600 funds included some mention of ESG in their prospectus—not counting ESG-Focused and Impact Funds. Morningstar stopped tracking this metric after 2019 because it was too ubiquitous to be helpful to investors.

Funds are increasingly selecting fund names to signal ESG consideration, as well as converting existing funds into ESG or "sustainable" funds. According to the SEC, as of September 2021, 2.4 percent of all funds had names containing "Sustainable," "Responsible," "ESG," "Climate," "Carbon," or "Green."

As fund marketing has gone increasingly green, concerns have arisen that some funds may be overstating the extent they use ESG criteria in selecting investments.

In a recent survey by Capital Group, 57 percent of investors in North America said they believed that greenwashing is "prevalent" in the asset management industry. (See graphic below.)

**SEC actions on greenwashing.** Leading up to the rulemaking proposals, the SEC highlighted and cracked down on the problem of greenwashing.

First, the SEC issued a risk alert in April 2021 listing issues staff has observed relating particularly to ESG practices. The SEC observed:

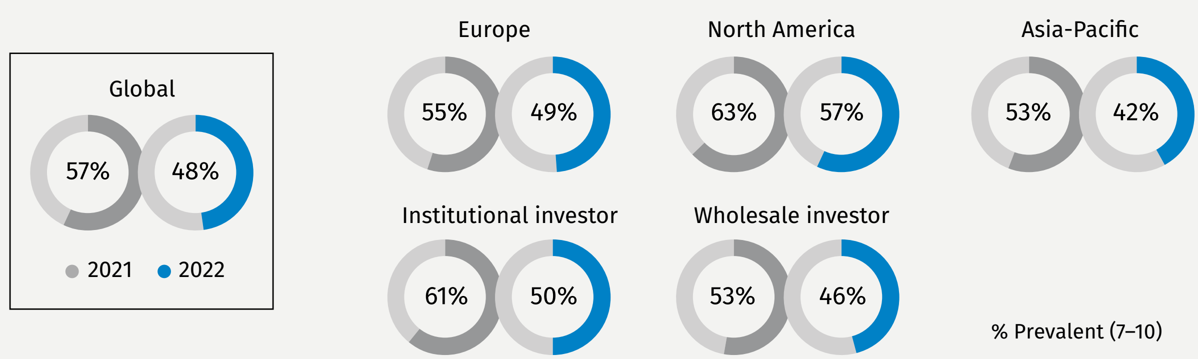
- Portfolio management practices that were inconsistent with disclosures about ESG approaches;
- Inadequate controls to maintain, monitor and update clients' ESG-related investing guidelines, mandates, and restrictions;
- Proxy voting that may have been inconsistent with advisers' stated approaches;
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches;
- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices; and
- Compliance programs that did not adequately address relevant ESG issues.

Second, the SEC brought two enforcement actions in 2022 against investment advisers which the SEC explicitly identified as related to ESG practices. Both actions were settled.

In the first action, the SEC ordered New York-based robo-adviser Wahed Invest, LLC to pay a $300,000 penalty in February for misleading marketing relating to compliance with Islamic or Shari'ah law, among other misstatements.

In the second, the SEC ordered BNY Mellon Investment Adviser, Inc. to pay a $1.5 million penalty in May for making misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds that it managed. The adviser represented or implied in various statements that all investments in the funds had undergo ne an ESG quality review, even though that was not always the case.

## Perceived prevalence of greenwashing




*How prevalent do you think greenwashing is within the asset management industry? (Rate on a scale of 0-10.)*

*Source: ESG Global Study 2022, Capital Group℠*

The BNY Mellon action showed the SEC is ready to take on major advisers relating to ESG claims. It also showed the lengths to which the SEC will go in making these cases.

"The SEC is really taking a forensic approach here," said Gwen Williamson. "In BNY Mellon they went through mountains of data to show that ESG review had not occurred."

**What investors want.** Ultimately, all SEC efforts are aimed at protecting investors, along with protecting market integrity and promoting capital formation. But what are investors looking for when it comes to ESG information?

In the Capital Group survey, more than half of investors thought fund managers should increase transparency about ESG strategies and holdings. Four in 10 investors globally believe minimum regulatory standards and better enforcement are needed. (See graphic below.)

## ESG DISCLOSURES: INVESTMENT FUNDS AND ADVISERS

In May, the SEC formally proposed ESG-related disclosure requirements for funds and advisers, as well as requirements for fund names. The SEC is also looking at whether "information providers" may be acting as advisers in providing indexing and modeling services, including in relation to ESG.

According to SEC Chair Gary Gensler, it can be very difficult for investors to know what funds mean when they say they're an ESG fund. Different funds might use different terms to describe their investing strategies or might not be transparent. Funds and advisers might also exaggerate their ESG focus.

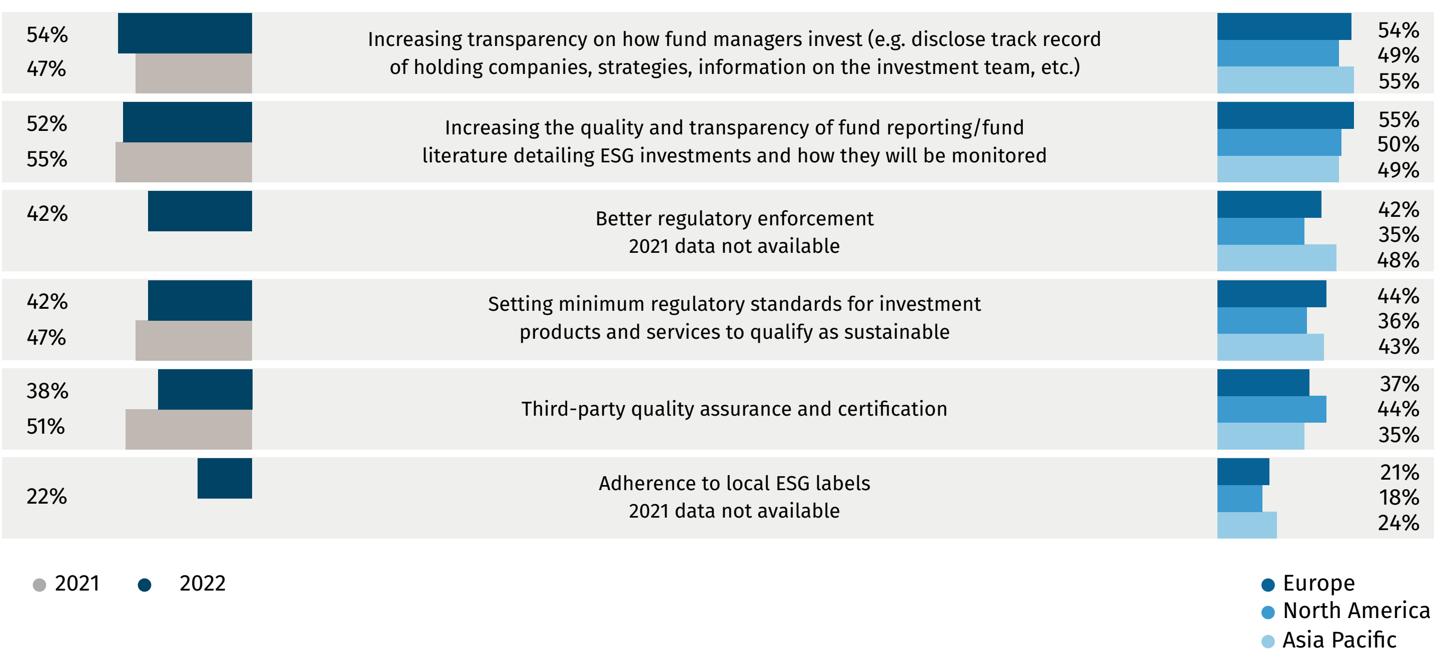
Another factor driving the proposal is the E.U. disclosure regime,  said Williamson. While the SEC has not gone so far as to propose affirmative ESG disclosure obligations across the board as the E.U. has, SEC commissioners are looking at E.U. requirements.

"They're feeling pressure," said Williamson.

### Proposed rules

With the aim of making ESG-related disclosures available in a standard, "layered" way, the SEC proposes to make ESG-related fund information more comparable and reliable by creating a common disclosure framework for investment funds and advisers.

## Tackling greenwashing




*What do you think are the best ways to tackle the challenge of greenwashing? (Select up to three answers.)*

*Source: ESG Global Study 2022, Capital Group℠*

The proposed framework is set forth in *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices,* Release No. IA-6034, May 25, 2022.

The SEC proposes three categories of ESG-related funds and different disclosures for each:

- **Integration Funds.** Funds that integrate ESG factors alongside non-ESG factors in investment decisions would have to describe how ESG factors are incorporated into their investment process.
- **ESG-Focused Funds.** Funds for which ESG factors are a significant or main consideration would have to provide detailed disclosure, including a standardized ESG strategy overview table.
- **Impact Funds.** A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would have to disclose how it measures progress on its objective.

Advisers that consider ESG factors would have to disclose generally similar information in brochures and report certain ESG information in their annual filings with the Commission.

Also, funds that use proxy voting or engagement with issuers as a significant means of implementing their ESG strategy would be required to provide additional information about these activities.

There are extra disclosure requirements relating to greenhouse gas (GHG) emissions for funds that consider these as factors in investment decisions.

### Reaction

The SEC posted 186 comments on its comment page as of August 18, most from or on behalf of organizations. In addition, a petition signed by 19,390 individuals was submitted by Americans for Financial Reform and Public Citizen, and a petition signed by 6,079 individuals was submitted by Sierra Club.

> *The SEC proposes three categories of ESG-related funds and different disclosures for each.*

**ESG flashpoint.** Reflecting a broader escalating conflict, some comments express an overall opposition to ESG investing.

A coalition of 21 Republican attorneys general led by West Virginia Attorney General Patrick Morrisey criticized the proposal as "deeply problematic" and "illegal and misguided." The coalition said the proposal largely ignores the interests of investors and financial interests by proposing disclosures that are "distant from areas of ordinary finance."

"[T]he SEC has imagined that the market requires more Environmental, Social, and Governance (ESG) disclosures from investment managers," wrote the attorneys general. "The Proposed Rule may not be as egregious as some of the SEC's other recent efforts in that it does not purport to regulate essentially the entire American economy—but that is about the most that can be said for it."

The Republican officials argue the proposed rulemaking exceeds the agency's authority, violates the First Amendment, and is arbitrary and capricious. The officials point to the Supreme Court's recent ruling in *West Virginia v. EPA* for support.

"The SEC is tackling a major question—but Congress has not given it the clear go-ahead to do so," wrote the West Virginia-led coalition.

But others say investor demand for ESG investing and burgeoning product offerings are creating a need for a standardized disclosure framework. Better Markets, a public interest group, pointed to recent survey findings that 60 percent of all adults considered ESG ratings important in making investment decisions. The group added that 3,400 signatories representing more than $121 trillion in assets under management had signed the Principles for Responsible Investment (PRI) as of March 2021.

Moreover, legal uncertainty around ESG investing is creating unease for asset managers, said Ceres, a nonprofit sustainability advocacy organization.

"In conversations with dozens of asset managers who offer ESG funds or advisory strategies, it has become clear that they are concerned that their funds and strategies could be viewed as subjugating financial concerns to other factors if they label them as ESG-Focused Funds or strategies," Ceres wrote.

But investors are interested in investing along ESG lines due to beliefs about long-term market directions, said Ceres. Accordingly, the group believes it is "essential" that the SEC clarify that ESG-Focused Funds use ESG analysis in service of maximizing long-term risk adjusted returns in accordance with fiduciary duty.

**Fund categories.** Many commenters raised objections to the proposed fund categories.

Some commenters believe the ESG Integration category is essentially meaningless and should be eliminated, *According to Ceres, ESG-Focused Funds use an ESG approach to achieve financial returns, whereas Impact Funds may or may not focus exclusively on financial returns.*

including Investment Company Institute (ICI), NASAA, SIFMA AMG, Morningstar, and BlackRock.

"Disclosing that a fund considers ESG is not informative for investors," Morningstar wrote. "Morningstar recommends that the Commission eliminate the ESG-Integration category for disclosure purposes because, as proposed, it would encompass too many funds to be helpful to investors and impose an unnecessary burden of disclosure on funds."

ICI noted that the SEC estimates that 80 percent of all open-end funds will incur burdens due to the proposed Integration Fund disclosure.

Ceres agreed that the Integration Funds category is overly broad and inclusive. From the group's discussions with institutional investors and others, they understand that many funds employ at least some ESG analysis in their investment decision-making, and it would be very difficult to differentiate between ESG Integration Funds and funds that are not in any ESG category based solely on investment practices.

As a result, Ceres recommended an "opt-in" approach in which funds themselves identify to which category they belong. If this recommendation is not followed, Ceres recommends that the SEC drop the Integration Fund category entirely, along with all its disclosure requirements.

Similarly, the Environmental Defense Fund suggests that, following the principle of "truth in advertising," categories could be based on claims or representations made by funds.

"For example, if a fund makes claims regarding use of ESG factors in its investment selection process, that would trigger a requirement to make the proposed disclosures regarding investment selection methodology; if a fund claims that its strategy involves engagement, that would trigger a requirement to make the proposed disclosures regarding engagement; and so on," wrote the Environmental Defense Fund.

From the regulatory side, another critic of the Integration Funds category is North American Securities Administrators Association, Inc. (NASAA).

"We are concerned that the definition [of Integration Funds] may be overinclusive, and that the proposed imposition of disclosure burdens on Funds and Advisers that neither purport nor attempt to engage in ESG-related focuses and strategies is unwarranted," wrote Melanie Senter Lubin, NASAA president and Maryland securities commissioner.

Another concern is that funds could be swept into an ESG fund category even if they do not market or consider themselves as "ESG" funds. According to ICI, funds typically consider governance aspects of portfolio companies and may consider other factors that could be deemed ESG-related, like geopolitical risks, climate-related risks, and employee benefits. Funds may be included in the Integration Fund category as a result, triggering ESG-related disclosure obligations, even without marketing themselves as ESG funds. Such disclosures could mislead investors into thinking a fund has a more significant commitment to sustainable investing than it does, said ICI and others.

Regarding the ESG-Focused category, some commenters think it is also overly broad. ICI is concerned that a broad interpretation of "significant or main consideration" in relation to engagement strategies could sweep in funds whose advisers are merely engaging with companies in the regular course. Accordingly, ICI recommends ESG-Focused Fund should be defined as a fund whose stated principal investment strategies focus on one or more ESG factors in the selection of investments.

As to Impact Funds, Ceres believes these should be a separate category rather than included in the ESG-Focused category. In their view, grouping the two could create confusion because ESG-Focused Funds use an ESG approach to achieve financial returns, whereas Impact Funds may or may not focus exclusively on financial returns.

**Disclosures.** Some commenters supported the proposed disclosure framework.

Others do not see a need for new disclosure requirements because existing anti-fraud provisions already prohibit false statements.

Williamson noted that Commissioner Hester Peirce has pointed out that existing securities laws and regulations already address greenwashing. In particular, the BNY Mellon enforcement matter shows that the SEC is able to bring enforcement actions involving exaggerated ESG claims.

**GHG emissions disclosures.** Requirements relating to disclosure of greenhouse gas (GHG) emissions generally received support from impact investors and public interest groups.

According to Ceres, it is widely recognized that GHG emissions are a critical measure of transition risk, but the current regulatory regime does not provide fund investors enough transparency or consistent information about this risk. The group believes that GHG disclosure in annual reports would protect investors from undisclosed transition risk and greenwashing. In particular, Ceres supports the proposed detailed emissions disclosure for the category of ESG-Focused Funds, brief GHG emissions disclosure by Integration Funds that consider GHG emissions in their analysis, disclosures of asset managers' engagement strategies as to climate risk, and disclosure by asset managers of their carbon footprint and weighted average carbon intensity (WACI).

NASAA generally supports the goal of uniformity in GHG emissions disclosures, but is concerned that the data for such disclosures may not be widely available for all potential holdings. In this case, funds would have to estimate this data, undermining the goal of uniformity and increasing costs for investors. NASAA is also concerned that the proposed GHG emissions metrics might not adequately account for the rationale behind including certain portfolio companies in an ESG-"focused" fund. Further, NASAA believes the prescribed metrics could become obsolete or stale in the future. Accordingly, NASAA recommends reframing the required GHG disclosure requirements as a principles-based requirements, rather than black-line rules.

Similarly, ICI believes that the proposed requirement that a fund report aggregate its GHG emissions with respect to its entire portfolio, regardless of the availability of the data from portfolio companies, would not produce consistent, comparable or reliable metrics for the benefit of fund investors. It would also impose an inappropriate burden on funds, said ICI.

**Proxy voting and engagement strategies.** Responses were mixed on the issue of disclosure of proxy voting and engagement strategies relating to ESG.

> *Disclosures of greenhouse gas emissions raise questions of data availability.*

In ICI's view, proposed requirements for ESG-Focused Funds annual shareholder report are overly prescriptive. The group believes that requiring an ESG-Focused Fund to disclose quantitative data regarding proxy voting and engagement would produce overly granular details that would not necessarily enhance investor understanding of an ESG-Focused Fund's proxy voting and engagement activities. Accordingly, ICI recommends that the proposed disclosure requirements be eliminated or changed to narrative rather than quantitative disclosures.

In contrast, Ceres and Better Markets support the engagement disclosure requirements as proposed.

## FUND NAMES: PROPOSAL TO SHARPEN NAMES RULE

Along with the proposed rules on ESG disclosures by investment advisers and investment companies, the SEC also issued a proposed rule amending Investment Company Act's "Names Rule." That rule, originally adopted in 2001, prohibits certain categories of investment company names that can potentially mislead investors about an investment company's investments and risks.

By a 3-1 vote, the SEC approved the proposal updating the Names Rules on May 25, 2022. The proposed amendments are intended to address changes in the market since the rule was adopted over 20 years ago, as noted by Chair Gensler. The comment period for the proposed rule, which concluded on August 16, 2022 drew 64 comment letters according to the SEC's website. Those comments came from a diverse array of stakeholders, including industry associations, asset managers, advocacy organizations, constituencies associated with the money management industry, and members of the general public. Highlights from some of the comments submitted to the SEC are discussed below.

### Proposed rules

The proposed amendments would amend Investment Company Act Rule 35d-1, and are designed to advance investor protection, and to address the explosive growth in ESG investing, as previously noted. The proposal provides new disclosure, reporting, and recordkeeping provisions and update the current notice requirements. Specifically, the proposal seeks to achieve these four objectives:

- It would broaden the scope of the Names Rule's 80 percent requirement. The expanded requirement would apply to funds whose names suggest that they invest in issuers or investments with particular characteristics. This would include, for example, ESG-related fund names.
- It would require funds that fall below the 80 percent requirement to come back into compliance in a timely manner — in most cases, within 30 days.
- It would enhance transparency around how a fund's investment methods match its name. In particular, it would require a fund to disclose how it defines the terms in its name and selects investments in line with its name. It also would require a fund to indicate on an existing Form N-PORT which holdings count toward

the 80 percent requirement, and update recordkeeping processes around Names Rule compliance.
- It would require funds to use the notional value of derivatives, rather than the market value, for determining compliance with the 80 percent requirement.

The proposal would also make two changes with respect to the growing ESG funds space. First, it would specify that ESG-related fund names are subject to the 80 percent requirement because their names suggest that they invest in issuers or investments with particular characteristics.

Additionally, the proposal would prohibit funds that considering ESG factors along with, but not more significantly than, other factors (referred to as "integration funds"), from using "ESG" or similar terminology in their names. Doing so would be defined as materially deceptive or misleading.

**Reaction**

The proposal drew a diverse array of responses.

**Investment Company Institute sees proposed rule as introducing confusion and complexity without corresponding benefits.** ICI states in its comment letter that the proposed changes to the Names Rule risk producing investor confusion. Instead, the ICI asserts, "the proposed amendments introduce new interpretative issues along with substantial and unnecessary complexity, burden, and cost without commensurate benefits."

In the association's view, the proposal "sets forth vast, fundamental changes – sweeping in numerous funds never covered before under expansive yet vague criteria, changing the operation of the rule for all funds and imposing significant new compliance and reporting requirements."

The ICI favors a more targeted approach whereby the name of a fund is recognized as a tool for communicating with investors, yet also recognizes that investors should not place undue reliance on a fund's name.

*According to ICI, investors should not place undue reliance on a fund's name.*

The ICI also observes that a fund's name can only be a starting point for investors and must be read in conjunction with other important, more detailed, information about a fund's investment objectives and strategies, fees and expenses, performance and other matters of importance to investors. The association further notes that investors would be well served if the SEC on prioritized communicating this key message.

A number of ICI members stated their broad support for the association comments on the Names Rule and provided additional comments of their own. These firms include T. Rowe Price, Putnam Investments, and Calamos Investments.

**SIFMA AMG criticizes name rule as overly prescriptive, arbitrary, and burdensome.** The Securities Industry and Financial Markets Association's Asset Management Group (SIFMA AMG) argues in its comment letter that the proposal includes overly prescriptive, and at times , arbitrary requirements, which introduces a new level of subjectivity that would likely contribute to investor confusion. Moreover, the association questions whether existing risks to investors justify what it characterizes as the "sweeping and disruptive changes proposed", expressing its concern that implementation of the proposal "could lead to unintended consequences that might ultimately be harmful to investors."

The association also believes that the cost-benefit analysis in the proposal contained fundamental flaws in that it underestimated the costs associated with certain of the newly proposed requirements, and omitted other costs entirely, all of which seem likely to adversely impact funds and their shareholders, with questionable associated benefit.

Moreover, SIFMA AMG asserts that the SEC should focus on improving disclosure and therefore require funds to describe what is meant by subjective terms used in their names, such as growth, value, and global, rather than applying 80 percent investment policies to funds using such terms. In the association's view, the Names Rule's 80 percent investment provision should only apply to objectively measurable and well-defined investment attributes.

**Ceres views proposal as an appropriate way to prevent investor confusion and greenwashing.** Ceres states its general support for the SEC's proposal in its comment letter, expressing its belief that when funds are marketed as a climate-aware funds, those portfolios should contain assets that are consistent with that marketing. Furthermore, Ceres notes its support for the 80 percent test for funds that use climate terms in their names. The organization also backs the SEC's decision not to prescribe what securities a climate portfolio must contain, but rather leave it to individual funds insofar as how they comply with the 80 percent test in a fundamental investment policy. Additionally, Ceres supports the proposed prohibition on using ESG terms in the names of integration funds.

Ceres also recommends a change in the proposed rule, observing that that there may be some climate-aware portfolios that do not comply with the 80 percent test, but, when viewed as a whole, are consistent with a climate term. Accordingly, the organization urges the SEC to allow funds to have terms, including climate terms, that apply based on their aggregate portfolios, without complying with the 80% test for individual securities.

**Environmental Defense Fund applauds SEC approach and favors swift rule finalization.** EDF supports the swift finalization of the proposal. In its comment letter, EDF pointed out that the proposal would require "a fund to define the terms used in its name, including the criteria the fund uses to select the investments that the term describes." EDF agrees with this approach, noting that it sensibly allows funds to define their own terms, so long as those definitions align with "plain English meaning or established industry use," rather than attempting to standardize definitions for terms. EDF observes that while this approach may somewhat reduce comparability across funds and advisers, it permits funds the flexibility to accurately reflect their investment strategies, and avoids unnecessary and wasteful efforts to categorize funds.

**Heritage Foundation asserts proposed rule to be "built on sand" and incoherent.** The Heritage Foundation, the conservative think tank whose mission includes the formulation and promotion of public policies based on the principles of free enterprise, limited government, individual freedom, and traditional American values, issued a highly critical comment letter opposing the proposal. The foundation states that ESG fund names pose a difficult problem for the SEC because, as it asserts, "ESG is built on sand and there is nothing close to a consensus about what the term means."

Heritage notes at the outset that "[n]either ESG nor "ESG factors" are defined in the rulemaking, and the companion rulemaking, "Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices" does not define these terms either. Heritage concludes that the failure to define the central terms renders the rulemaking intellectually, analytically and legally incoherent. Heritage asks how it is possible to determine that "the use of terms in the fund's name indicating that the fund's investment decisions incorporate one or more ESG factors is materially deceptive and misleading" if we have no idea what an ESG factor is? Heritage answers its own question, and submits it cannot be done.

*Heritage notes that neither ESG nor ESG factors are defined in the rulemaking.*

Heritage predicts, if the proposal becomes a final rule, a gloomy scenario where the SEC will engage in "many years of regulation by enforcement," since the Commission has chosen to not regulate by regulation. The letter continues, "Market actors will only determine what the Commission actually means by ESG or 'ESG factors' by watching what enforcement actions it launches over a period of years and adjusting their naming accordingly. Uncertainty will be much higher. Clarity regarding what is expected of regulated parties will be markedly reduced." Heritage concludes, "This is not how a responsible agency regulates."

## INFORMATION PROVIDERS: ACTING AS INVESTMENT ADVISERS?

Finally, by highlighting some investments as ESG-related, index providers, model portfolio providers, and pricing services all provide information relating to ESG investments. But are information providers acting as investment advisers in connection with ESG product offerings?

The SEC has questions.

**Request for comment**

On June 15, the SEC issued a Request for Comment and opened a potential path toward regulation of financial data publishers operating broad-based and specialty indexes, model portfolios, and pricing services. These yet unregulated entities have found new business and new controversy in ESG and sustainability investing. As their influence grows, the SEC is wondering if they continue to serve strictly as information providers to advisers and funds, or if, through the administration of bespoke ratings and indexes, they are acting as advisers themselves.

In the request for comment, the SEC asked well over 100 questions that dig into the industry and its practices and drive toward the big question of whether regulatory action aimed at these companies "is necessary and appropriate to further the Commission's mission." (*Request for Comment on Certain Information Providers Acting as Investment Advisers,* Release No. IA-6050, June 15, 2022).

The SEC's foray into the financial information publishing business is well short of the rulemaking stage but the request for comment nonetheless is a shot across the bow for companies like S&P Dow Jones, MSCI, Bloomberg, Morningstar, and others collectively referred to in the request for comment with the generic term "information providers."

These companies have moved aggressively to create, market, and refine investment products with ESG, sustainability, and other specialty investing strategies because, they say, demand from the investing public is great and it continues to grow.

Chair Gensler pointed to the size and influence of these companies, saying they have grown tremendously in recent decades.

"The role of these information providers in today's markets raises important questions under the securities laws as to if they are providing investment advice rather than merely information," Gensler said.

**Focus of attention.** These financial publishers have been weathering attacks from state attorneys general, conservative politicians, right-leaning media, Tesla Motors CEO Elon Musk, and even some academic circles, and now they find the SEC's nose sniffing around their tent.

Comments filed by the index arms of each company opposed application of the status of investment adviser, although the companies said they are sensitive to the SEC's investor protection concerns. Regulation under the Investment Advisers Act would add costs but not end up benefiting investors, the critics say, partially because fund boards already carry the necessary obligations.

The companies disputed Gensler's central claim that indexing constitutes advice, but notably, several expressed support for more targeted regulation in the nature of European benchmark standards they already meet.

**Current status of publishers as advisers.** Investment Advisers Act Section 202(a)(11) defines investment adviser as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;

No-action letters and interpretative positions taken in the 1980s and 90s by the SEC's Division of Investment Management[1] frame out the staff's interpretation of securities data or information that constitutes an "analysis or report" for purposes of section 202(a)(11).

The staff has taken the position that information relating to securities does *not* constitute an analysis or report under the definition if:
1) the information is readily available to the public in its raw state;
2) the categories of information presented are not highly selective; and
3) the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security or securities.

**Publisher's exclusion.** The agency said it believes that index providers and pricing services have historically concluded that even if they meet the adviser definition, they may rely on the exclusion for publishers in Investment Advisers Act Sec. 202(a)(11)(D) to avoid registration requirements. This provision excludes from the definition of investment adviser "any bona fide newspaper, news magazine or business or financial publication of general and regular circulation."

The Supreme Court in *Lowe v. SEC* (472 U.S. 181, 84-85 CCH Dec., FSLR ¶92,062) interpreted this to mean that the publication:
1) provides only impersonal advice;
2) is "bona fide," meaning it provides "genuine and disinterested" commentary;
3) is of general and regular circulation, as opposed to being issued in response to episodic market activity.

**Authority.** The SEC's release recounted that in 1996 the Investment Advisers Supervision Coordination Act amended the Advisers Act to require advisers with assets under management of $25M or more to register exclusively with the SEC, with smaller advisers required to register with their state. But Congress granted the SEC the right to permit registration as an adviser where strict application of the dollar threshold would be unfair, a burden on interstate commerce, or inconsistent with the Act's intended split in jurisdictional oversight. Advisers with national presence, they said, are intended to be overseen by the SEC.

"Certain providers, if they are investment advisers, may not have significant AUM, or regulatory assets under management ("RAUM"), depending on how those terms are used, but could service a significant portion of the financial intermediaries and other players in the national financial markets with broad market effects," wrote the staff.

1 Citing Statement of Staff Interpretive Position, Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987); EJV Partners, Univu System (Dec. 7, 1992); Datastream International (Mar. 15, 1993); Missouri Innovation Center (Oct. 17, 1995); and RDM Infodustries (Mar. 25, 1996).

Registered funds that track indexes now represent over $10 trillion of assets under management, including specialized indexes as well as broad based indexes, said Gensler. And it can be very difficult for investors to understand what some funds mean when they say they're an ESG fund. He said some funds screen out or specifically include certain industries, some make specific assertions about greenhouse gas emissions, labor practices, water sustainability, some use human judgment while others track an outside index. Some may claim to have a particular impact on an issue.

Index investing may be seen as passive investing but index providers are making active decisions in administering the index, and inclusion or exclusion of a security leads advisers with clients tracking that index to buy or sell to stay in alignment with the index, he said. The SEC asked for feedback on dozens of questions specific to index providers, like how many of their index customers are funds, and if bespoke indexes implicate a different adviser status than broad-based indexes.

**Index rebalancing courts controversy.** Moves like the elimination of Tesla from the S&P 500 ESG index in May of this year have upped the pressure on index providers, who seem to be collecting challengers.

When it added Tesla to the ESG 500 index in May 2021 S&P Global explained in a blog article the main reason for its inclusion — despite having the worst ESG score of the top 5 automakers, it needed to keep the auto industry group weighted like the S&P 500, which added Tesla in December 2021. The S&P 500 ESG index targets 75 percent of the float-adjusted market capitalization for a given industry in order to allow it to show the same "industry or sector risk characteristics" as the S&P 500. Tesla's market cap in March 2021 was $513B and the nearest industry peer, GM, had a market cap of $73B.

*Moves like the elimination of Tesla from the S&P 500 ESG index in May of this year have upped the pressure on index providers.*

But Tesla's market cap did not guarantee it a spot in the index "in perpetuity," said the S&P Global article at the time, as the company must pass minimum ESG score thresholds at each annual rebalance. And "of course must not become involved in controversial weapons, tobacco, or thermal coal." It must also remain in good standing with the UN Global Compact. In 2022 the financial publisher dropped the electric carmaker for an overall lack of disclosure, lacking a low carbon strategy and codes of business conduct, racial discrimination claims, poor working conditions at its California factory, deaths related to its autopilot technology, and because its competitors improved their ESG scores more.

Margaret Dorn, Head of ESG Indices at S&P, was unapologetic, saying "while Tesla and others may not have been included in the index this year, the beauty of the annual rebalance is that they will once again have an opportunity to be reviewed for inclusion in years to come."

Elon Musk immediately tweeted that ESG was a "scam" that had been "weaponized by phony social justice warriors."

State Attorneys General are also attacking index firms. Missouri Attorney General Eric Schmitt recently announced that he and 18 other state attorneys general are investigating Morningstar Inc. and its ESG ratings subsidiary Sustainalytics for consumer fraud or unfair trade practices.

"These ESG investing firms are playing politics with pensions and real people's livelihoods. Missouri has been a leader in pushing back against woke ESG investing and our fight will continue," said Schmitt.

**Reaction**

**Is demand overstated?** A group of 22 law professors led by Lawrence Cunningham of George Washington University challenged the true demand present for ESG products in the market and took a shot at the companies selling them.

They wrote in their April 25, 2022 comment letter on the SEC's proposal to mandate and standardize climate-related disclosures that demand for this information is driven by a "small but powerful cohort of environmental activists and institutional investors," not the everyday retail investor. Companies in the business of selling ESG ratings, model portfolios, and indexes are pursuing an opportunity to provide a simple form of active investing to millennial investors, where ESG values are favored, they asserted, and driving up costs for regular investors.

**Meanwhile, in Europe.** Asset managers in Europe are moving more assets into the "sustainable" realm and seeking credentials that qualify them as such. Morningstar data on Q2 2022 reveals that asset managers have reclassified over 700 funds previously listed as Article 6 to Article 8 within the EU's Sustainable Finance Disclosure Regulation (SFDR). Article 6 funds are funds with no ESG objectives, Article 8 funds promote environmental and social goals (aka “light green”), and Article 9 funds have sustainability as their objective (aka “dark green”). Under the SFDR, funds have been classified as Article 6, 8, or 9 since March 2021. The article 8 “light green” funds had outflows of EUR 30.3B in Q2, while the stricter “dark green” funds in Article 9 saw inflows of EUR 5.9B.

The flight from Article 6 to 8 is notable as Morningstar now measures above 50 percent of funds available in the EU as qualified for Article 8 or 9 status. This happened ahead of recent amendments to Markets in Financial Instruments Directive II (MiFID II), which places an obligation on advisers to consider their client’s sustainability preferences and provide qualified funds to them if they express interest. Morningstar predicted that advisers in Europe would struggle with this new obligation because of a lack of data and comparability between products.

**Morningstar comment.** The company is “confident that Morningstar Indexes does not give advice,” said Gareth Parker, Chief Indexing Officer, and Aron Szapiro, the company’s head of retirement studies and public policy. It does not give advice regarding the suitability of indexes for investment product usage, nor does it exercise discretion in the management of those indexes, so applying the status of investment adviser to the company would not be appropriate.

The company said the SEC should look to clarify obligations on fund boards rather than force new regulation on index providers. That approach is more efficient and “does not dramatically increase the regulatory burden on any market participant.” That approach is also already anticipated by the agency on page 165 of proposed rule Release 33-11068, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices.

The fund data company said it supports investor protection via “robust, transparent and well-governed indexes” and suggested that registration is not appropriate for index providers that use an objective and transparent index methodology, or meet the obligations of the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks, or is regulated under one of the existing benchmark regulations. Morningstar is a regulated benchmark administrator under the EU and UK benchmark regulations, so hinted at moving in that direction, “ if the SEC feels it must move ahead with regulatory proposals in respect of index providers.”

Morningstar acknowledged that a risk “owing to the inappropriate exercise of discretion” could exist where index providers are also providers of the data used to determine the makeup and weighting of the index. But Morningstar effectively mitigates this risk through transparent methodologies and appropriately designed governance processes, it said, such as “ensuring that clients who provide data have suitable arrangements to separate staff involved in their index responsibilities from their data provision responsibilities.”

The Chicago-based company also commented that regulation restricting competition in the U.S. market would not serve U.S. investors well, as has been shown in Europe where the costs of hiring legal teams and building out internal compliance systems has discouraged competition and innovation, which has in turn reduced investor access to these index strategies. The company also cautioned against allowing competition from foreign information providers that do not hold the same obligations as U.S. providers.

**S&P Dow Jones comment.** Imposing an additional layer of regulation under the Investment Advisers Act would add considerable costs to their business, S&P Dow Jones Indices (S&P DJI) cautioned, which would inevitably be passed on to investors. It touted the impact low-cost index-based investing has had in lowering costs for all investment products. “It is important to avoid unintended consequences that could disrupt the dramatic benefits of access and savings index innovation has brought to investors, particularly retail investors. We urge the SEC to act cautiously and begin robust engagement with the industry.”

Like Morningstar, S&P DJI is already compliant with benchmark regulation in Europe, which it believes addresses the SEC’s core policy concerns of transparency and the mitigation of conflicts of interest. The company acknowledged potential conflicts of interest, saying “where methodologies are not sufficiently transparent and/or permit broad use of discretion by the index provider, some risk may exist.” The company believes it effectively manages this by using transparent and objective index methodologies and through a practice of segregating commercial and analytical activities to prevent “undue commercial influence” on its analytical process. Its indices are governed by independent committees as well.

S&P DJI also pointed to compliance programs already required of investment companies and their boards. Funds must implement written policies and procedures designed to prevent violations of the securities laws and the fund’s board must approve them, as well as the policies and procedures of the fund’s adviser and other service providers. Because of this, the index maker said fund advisers routinely review its annual IOSCO Statement and its internal controls as part of the due diligence review on the company. “In light of this review, we can see why the Commission would consider incorporating index providers into a fund's compliance program as a means to address the SEC's concern with protecting fund shareholders," it wrote.

**Bloomberg comment.** "While there may be a case to be made for more targeted regulation, we believe the investment adviser regime, if applied to index providers, would be ill-suited, burdensome, and would yield few, if any, benefits to the market," commented Bloomberg Index Services Limited ("BISL"). The company, which said it publishes more than 100,000 unique indices daily, fell basically in line with Morningstar and S&P by encouraging any regulation to build on existing international standards to "minimize regulatory fragmentation and arbitrage, as well as market fragmentation."

BISL said it has aligned its policies with European regulation and has internal controls in place to detect actual and potential conflicts of interest, has policies and procedures to address information security, confidential information, personal account dealing, and disclosure of outside interests. In practice this means BISL bans employees engaged in index design or calculation from buying securities that track the indices BISL administers. The employees are also subject to holding periods and pre-approval requirements for other securities transactions, and are not compensated based on the performance of the benchmarks. Employees are explicitly prohibited from misusing confidential information for their personal gain or improper purposes.

**MSCI comment.** MSCI's comment largely echoed the view of the other index providers in standing against the extension of adviser status to it and its peers. MSCI touted the IOSCO principles, and added a belt to the publisher's exemption suspenders by noting Justice White's concurring opinion in *Lowe* that a prohibition on the publishing of investment newsletters was a first amendment violation.

**Pricing services.** Pricing services have similarly grown and evolved and caught the attention of the SEC. Bloomberg L.P. commented that its Bloomberg Evaluated Pricing service provides pricing for over 2.5 million securities across asset classes, including thinly-traded and hard to price securities. The company said its services are used by mutual funds to calculate their net asset values and have been increasingly used since the financial crisis to more accurately value securities.

*Many commenters took issue with the idea of making funds make ESG disclosures when the funds have not marketed or otherwise held themselves out to be ESG-related.*

Like the index arm of Bloomberg, the pricing service said additional regulation of its business adds costs but not benefits to the investing public. The service holds no assets under management and does not control how customers use its pricing, it said, and in fact most customers use prices from multiple services in their valuation process, underscoring the company's lack of control on how customers use their service.

Valuation was a function of advisers in the past, but Bloomberg said since the financial crisis there has been a stricter approach to "mark-to-market" accounting practices around asset valuations. This increased focus on valuations has helped grow an industry of distinct index providers, valuation services, model providers, risk managers, and data analysts, they said, which has increased investor protections by reducing conflicts of interest and producing independent, transparent, and objective prices.

The Independent Directors Council noted in its comment that the SEC's newly adopted Investment Company Act Rule 2a-5 on fair value determination represents "the culmination of decades of industry input" and provides carefully crafted framework for director oversight of pricing services. "To designate pricing service providers as investment advisers would upend this framework without giving it a chance to succeed," the Council said.

## TAKEAWAYS

The SEC is currently in the process of evaluating public comment on the proposals. From here, the SEC may decide to adopt the proposed rules as final, revise and repropose the rules, or hold off on acting.

### Highlights: support and opposition

Broadly, the proposed rules received both support and opposition. Most commenters support at least the SEC's aim to bring clarity to what currently can be a murky area. Many commenters support the general idea of an ESG disclosure regime for funds and advisers that market themselves as ESG-related. And asset managers appear to be looking for legal certainty out of concern that considering ESG factors could expose them to potential breach of fiduciary duty claims.

One area of broad concern was on the issue of fund categories. In general, many commenters took issue with the idea of requiring funds tomake ESG disclosures when the funds have not marketed or otherwise held themselves out to be ESG-related.

In addition, many commenters believe the lowest tier of ESG funds, "ESG Integrated funds", is so overinclusive that it is meaningless. Many recommended that this category be scrapped altogether. The fact that this view was held across the spectrum by industry groups, impact investor groups, regulators, and public interest groups alike could indicate a possible area for revision or re-proposal.

Another area of interest was the question of investment aims. Some commenters touched on the issue that ESG-Focused Funds use an ESG approach to achieve financial returns, whereas Impact Funds may or may not focus exclusively on financial returns. As a result, grouping the two together could result in investor confusion.

On restricting fund names, while the proposal faced opposition from various industry associations, it did receive support from impact investors and public interest groups. This support suggests that the fund names proposal may have a chance at adoption.

Finally, on the question of whether index providers and other information providers are acting as investment advisers in relation to ESG and other information, entities in this line of business are unsurprisingly not keen on being classed as advisers and subjected to additional regulation. Time will tell whether this issue will progress beyond the request for comment stage.

**Potential legal challenges**

If the SEC does adopt the proposals as final rules, will there be legal challenges?

The strong criticism by the Investment Company Institute and several other groups suggest that legal challenges are a possibility.

On the prospect of litigation, Howard Sidman, partner in the Financial Markets practice at Jones Day, said:

"We are entering a period during which the major questions doctrine, as announced by the Supreme Court this past term in *West Virginia v. EPA*, will likely be raised as a line of attack against most major rulemaking. The adviser/fund ESG-related proposals are not likely to be an exception."

*"Any litigation will likely focus on whether the mandates in the proposed rules go beyond what Congress has clearly authorized," said Sidman.*

Sidman continued, "Whether courts will find this challenge has currency in the context of the adviser/fund ESG-related proposals will turn on the extent to which the SEC can point to a clear congressional mandate to regulate in this area. The SEC does have a long history of promulgating rules requiring funds and advisers to provide particular information to investors; any litigation will likely focus on whether the mandates in the proposed rules go beyond what Congress has clearly authorized."

Sidman added that legal challenges to the proposals will likely also focus on allegations that the rules are arbitrary and capricious and that the costs of compliance outweigh the purported benefits of the rule. The comment letters written by industry associations in response to the adviser/fund ESG-related proposals highlight many of these evidence-based arguments, said Sidman.

Finally, Sidman noted that we could see challenges to aspects of the proposals as impermissibly vague.

**Action steps for funds and advisers**

While funds and advisers wait to see if the SEC will adopt final rules, there are things they can do to ensure their portfolio management practices are consistent with ESG-related disclosures.

According to Sidman, one way that advisers and funds can take positive steps to potentially protect themselves from greenwashing liability is to analyze their practices and disclosures with a focus on the SEC's April 2021 Risk Alert. The alert identified a series of factors that investment advisers and funds should consider in implementing policies and procedures that accord with their ESG-related disclosures.

Sidman explained that being able to provide a clear account of how disclosure determinations are reached, and the bases for the substantive disclosure claims, is an important safeguard against allegations of greenwashing, whether by the SEC or by private litigants.

**Conclusion**

Investors want ESG investment options, and they want clearer information about those options. In turn, investment managers and funds want to offer ESG investment products that investors are interested in. And, funds and advisers agree at least in principle that ESG information provided to investors should be useful to investors.

Whether the SEC proceeds with these particular proposals—and if so whether final rules may be challenged in court—this area will clearly continue to be a focus for the SEC.