Securities Regulation Daily Wrap Up, TOP STORY—SEC proposes rules on ESG disclosures by investment advisers and investment companies, (May 25, 2022)

Securities Regulation Daily Wrap Up

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For funds and advisers that incorporate ESG considerations, the proposal aims to give investors specific information on what data and criteria stand behind investment decisions.

The SEC proposed to amend rules and forms to enhance disclosures by certain investment advisers and investment companies about environmental, social, and governance (ESG) investment practices. The proposed amendments aim to promote consistent, comparable, and reliable information for investors about how funds and advisers incorporate ESG factors in investment decisions. The proposal requires different disclosures depending on the types of ESG strategies funds pursue, including environmental, specific ESG impact, and engagement approach (*Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, Release No. 33-11068, May 25, 2022).

"ESG encompasses a wide variety of investments and strategies," said SEC Chair Gary Gensler. "I think investors should be able to drill down to see what's under the hood of these strategies. This gets to the heart of the SEC's mission to protect investors, allowing them to allocate their capital efficiently and meet their needs."

The proposal was issued by a 3-1 vote, with Gensler, Commissioners Allison Herren Lee and Caroline Crenshaw supporting and Commissioner Hester Peirce dissenting.

Transparency for investors. According to Gensler, there are hundreds of funds and potentially trillions of dollars under management in "U.S. sustainable investment universe," with one estimate putting the value at $17.1 trillion. As investor appetite for ESG investments has grown, an increasing number of funds market themselves as "green," "sustainable," "low-carbon," and similar descriptions.

However, it can be very difficult for investors to understand what some funds mean when they say they're an ESG fund, said Gensler. Some funds screen out certain industries, while others specifically include certain industries. Some may make assertions about the greenhouse gas emissions, labor practices, or water sustainability of their underlying assets. Some funds involve human judgments, while others might track an outside index. Some may claim to have a particular impact on an issue.

With such a wide range of ESG strategies, investors should be able to "drill down" to see what's under the hood of these funds, said Gensler. He believes this goes to the heart of the SEC's mission to protect investors, allowing them to allocate their capital efficiently and meet their needs. In particular, investors should be able to know:

- What information stands behind funds' claims?
- Which data and criteria are funds using to ensure they're meeting investors' targets?

Enhanced ESG disclosures. According to a fact sheet, the proposal would require funds that consider ESG factors in their investment process to disclose information according to the type of fund. The amount of disclosure required depends on how central ESG factors are to a fund's strategy.

- Integration Funds. Funds that integrate ESG factors alongside non-ESG factors in investment decisions would be required 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 be required to provide detailed disclosure, including a standardized ESG strategy overview table.

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- Impact Funds. A subset of ESG-Focused Funds that seek to achieve a particular ESG impact would be required to disclose how it measures progress on its objective.

Funds would disclose information using a "layered" framework, with a concise overview in the prospectus supplemented by more detailed information in other sections of the prospectus or in other disclosure documents. All information would be reported in a structured data language.

Advisers that consider ESG factors would need to generally align disclosures in brochures with information they report in SEC filings regarding significant ESG investment strategies or methods of analysis.

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 their proxy voting or ESG engagements, as applicable.

ESG-Focused Funds that consider environmental factors in their investment strategies would be required to disclose additional information regarding the greenhouse gas (GHG) emissions associated with their investments, including carbon footprint and the weighted average carbon intensity of their portfolio. Funds that disclose that they do not consider GHG emissions as part of their ESG strategy would not be required to report this information.

Commissioner statements. Commissioner Lee supported the proposal, pointing to "explosive" growth in investor interest and demand around ESG investments. She stated that global ESG fund assets were at roughly $2.7 trillion at the end of last year. U.S. ESG fund assets accounted for about $357 billion of that, representing 51 percent year-over-year growth. With this increasing demand comes increasing need for consistent, comparable and reliable information to help protect investors from greenwashing or exaggerating or making false claims about the ESG practices. Greenwashing can mislead investors as to the true risk, rewards and pricing of investment assets, said Lee.

Lee believes public input on the proposal is critical in three key areas: (1) How to categorize the various types of funds that are engaged in ESG investing; (2) Whether disclosures are calibrated sensibly per each category; and (3) When and how to require disclosure of greenhouse gas emissions data.

Commissioner Crenshaw also supported the proposal, stating that with the spike in investor ESG demand, funds and advisers may be incentivized to overemphasize the role that ESG factors play in their portfolio management decisions spike. Without a specific disclosure regime, funds and advisers employing ESG practices do not have clear guidance as to what information should be disclosed and in what manner. These factors can lead to funds and advisers using ESG terms like "sustainable" and "green" with a marketing view rather than investment thesis.

The Division of Examinations has made such findings in the field, said Crenshaw. Last year the Division issued an alert that staff were observing, for example: portfolio management practices that differed from client ESG disclosures; misleading claims relating to ESG approaches; and, proxy voting practices that were inconsistent with advisers' stated approaches. Clear and standardized disclosures would allow investors to compare products and accurately price risks and opportunities associated with ESG practices. This would help not only the investor who places a premium on ESG investing, but also potentially the investor who thinks an ESG issue is being *over*priced, said Crenshaw, adding that the rule is neutral as to the benefits or risks of ESG investing.

Commissioner Peirce dissented from the proposal, stating that although greenwashing by investment advisors and investment companies is a legitimate concern, there is already a solution. On May 23, the SEC announced a settled enforcement action in which BNY Mellon Investment Adviser, Inc. agreed to pay a $1.5 million for misrepresenting that certain funds under management had undergone ESG review when they had not. The showed that existing enforcement proceedings are a solution, said Peirce.

Peirce said she could have supported a proposal to require advisors and funds to answer three basic questions about their ESG products and services:

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1. If you offer products or services you label as some formulation of E, S, or G, what does that label mean with respect to each product or service that you offer? What do you do?
2. What do you do to make your product or service line up with E, S, or G, as you have defined it for that product or service?
3. For each such product or service what if any, is the cost to investors, including in terms of foregone financial returns and pursuing E, S, or G objectives alongside of or instead of financial objectives?

“Questioning the wisdom of any initiative labeled ESG is hard enough as it is. This proposal would only make it harder,” said Peirce.

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