

Insights

THE SEC'S CONTINUED EFFORTS TO DIVE FEET FIRST INTO CLIMATE CONTROL AND ESG INITIATIVES

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SUMMARY

- On May 25, 2022, the U.S. Securities and Exchange Commission (“SEC”) provided notice of proposed rulemaking aimed at Investment Advisers (“Advisers”), Investment Companies and Business Development Companies (collectively “Funds”) that market themselves as incorporating environmental, social and governance (“ESG”) factors into their investment selection process or overall investment strategies. The public comment period will be open for 60 days following the SEC’s announcement.
- The proposed rules seek to standardize the categorization of ESG strategies and require Advisers and Funds to provide more specific disclosures in their fund prospectuses, annual reports, and brochures, as well as enhanced ESG reporting requirements on Forms N-CEN and ADV Part 1A, with the quantity of disclosures commensurate with the standardized categorizations.
- The SEC’s proposed rules follow a related announcement of a regulatory enforcement action wherein it charged an investment adviser for misrepresenting the extent it reviewed ESG factors in the investment selection process. Ultimately, that case settled with a public censure, a cease and desist order and a penalty of \$1.5 million.
- Given the SEC’s recent efforts to dive feet first into climate control and ESG initiatives, we fully anticipate that the SEC’s efforts will have a ripple effect throughout the retail distribution of ESG products by broker/dealers. In our opinion, the SEC and other regulators will later look to broker/dealers to exercise a reasonable amount of due diligence to ensure that certain products are in fact “green” before onboarding and advertising products as such. We discuss our thoughts in more detail below.

Prior SEC Climate Control and ESG Regulation

The SEC began highlighting climate control and ESG concerns as a hot topic in February 2021. In that month, the SEC announced the appointment of Satyam Khanna in a newly created role of Senior Policy Advisor for Climate and ESG. The stated purpose of her new role was to advise the agency on ESG matters and to advance future SEC initiatives.

In March 2021, the SEC announced the creation of a Climate and ESG Task Force led by Kelly L. Gibson and composed of another 22 members chosen from within the SEC, including within its Enforcement Division. The Climate and ESG Task Force's stated purpose was to develop initiatives that would proactively identify ESG-related misconduct and to coordinate the effective use of Division resources, including through the use of sophisticated data analysis to mine and assess information across registrants, to identify potential securities violations.

In the same month, the SEC also announced the launch of a new page on its website for the purpose of bringing together agency actions and reporting the latest information about climate and ESG investing and initiatives.

With Gary Gensler's appointment as Chair of the SEC in April 2021, the topic has only grown in prevalence within the agency. Mr. Gensler has repeatedly spoken on the topic at industry conferences and even issued short videos posted on the web wherein he lobbies for legislative and investor support for future SEC initiatives and rule proposals.

The continued ESG focus began to largely materialize in March of 2022. On March 21, 2022, the Securities and Exchange Commission announced proposed rule changes that would require registrants to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements. The required information about climate-related risks also would include disclosure of a registrant's greenhouse gas emissions. Such action was met with stark industry critique and opposition with many in the industry arguing that the SEC does not have the authority to seek to regulate or create new rules on this topic.

This sets the backdrop for the SEC's latest attempt to pursue its ESG and climate control initiatives and the announcement of the newly released May 25th proposed rules.

Summary of SEC's Most Recent Proposal for Increased ESG Transparency

According to the SEC, investors are becoming increasingly interested in investments that focus their goals, objectives and strategies around environmental awareness, protections and sustainability. Given such increased popularity, the SEC has repeatedly expressed concerns as to the possibility of Advisers and Funds exploiting customer sentiment by exaggerating their actual consideration of ESG factors in the investment selection process or while designing investment strategies. This is commonly referred to as greenwashing.

In order to address these concerns, the SEC's rule proposal seeks to promote uniformity in categorizations and disclosures so that investors can objectively compare Advisers and Funds, hold them accountable to their objectives, and make informed investment choices based on concrete and uniform ESG measures.

The SEC's proposal, if adopted, will require funds to make certain disclosures of varying substance based on their categorization into one of the following three categories of Advisers or Funds:

- **Integration Funds** - Funds that consider and integrate ESG factors in their respective investment decisions. The SEC's proposed rules require these Funds to describe how ESG factors are incorporated into their investment process.
- **ESG-Focused Funds** - Funds that focus on ESG factors as a significant or main consideration. The SEC's proposed rules require these Funds to provide more comprehensive disclosures, including a standardized ESG strategy overview table.
- **Impact Funds** - ESG-Focused Funds that seek to achieve a particular ESG impact. The SEC's proposed rules require these Funds to disclose what impact(s) the funds seek to achieve, how the funds will achieve the impact(s), how the funds measure progress, what key performance indicators are analyzed, what time horizon is used to analyze progress, and the relationship between the impact and financial returns.

The SEC proposal requires a "layered" disclosure framework. Specifically, Funds will be required to provide a concise overview of all ESG considerations in the investment selection process within the Fund's prospectus summary, followed by a more detailed disclosure within the body of the prospectus. Funds would also be required to provide such detail in other disclosure documents. Advisers that consider ESG factors in the investment selection process would also be required to make similar disclosures in their brochures and to report certain ESG information in their ADVs and annual SEC filings. ESG-Focused and Impact funds will have even greater disclosure and reporting responsibilities, including detailed information about their objectives, desired impacts, and key metrics.

Finally, the SEC's proposal requires ESG-Focused Funds to disclose additional information regarding the GHG emissions associated with their investments, including the 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. Integration funds that consider GHG emissions would be required to disclose additional information about how the fund considers GHG emissions, including the methodology and data sources the fund may use in the process.

Countervailing Arguments for Industry Consideration

The SEC's proposal seeks to impose greater reporting and disclosure responsibilities on Advisers and Funds that market services or products under the "Green" umbrella in order to attract environmentally conscious and socially responsible investors. While increased transparency to investors has appeal and keeps Advisers and Funds honest with regard to their marketing efforts, we raise the following countervailing policy considerations for industry debate and consideration.

- 1. Are the increased ESG disclosure requirements material enough to justify the additional costs which will ultimately be borne by investors?** The SEC acknowledges that Advisers and Funds will incur additional costs to comply with the proposed rule, *e.g.*, attorney and compliance costs for preparing disclosures and supervisory costs related to ensuring the accuracy of disclosures. Throughout the proposal, the SEC also readily acknowledges that "any increase in compliance costs" will ultimately be "passed on to investors as funds are pass-through vehicles." The real question is whether investors are willing to bear the additional costs and the SEC seems to be betting that the answer to that question is a resounding "yes."
- 2. Are the increased ESG disclosure requirements material enough to justify additional length to prospectuses and other risk disclosure documents?** Whenever Advisers and Funds increase the length of prospectuses and risk disclosure documents for compliance purposes, the industry often debates whether adding additional disclosure to already lengthy disclosure documents is practical for investor consumption. Prospectus and risk disclosure documents - which can be dozens, if not hundreds of pages in length - are intended to provide customers with adequate material information so that they can make informed investment decisions. As Winston Churchill once famously said, "This report, by its very length, defends itself against the risk of being read." Thus, a question arises as to whether the additional information being disclosed tips the scale towards adding material value to aid an investor in making an investment decision or, alternatively, does it tip the scale towards distracting investors away from more material risk disclosures, and/or decreasing the likelihood that investors will read and consider other, arguably more important disclosures. It is hard to say at this time that there is an outweighed benefit in making these specific ESG-related disclosures to investors given the SEC's acknowledgment that it lacks sufficient data in this regard.
- 3. Are Advisers and Funds appropriately trained and/or qualified to quantify and publish the ESG metrics proposed by the SEC, including calculations of GHG emissions, carbon footprints and weighted average carbon intensity levels?** It seems logical that, as a threshold matter, any interpretation of ESG metrics an Adviser or Fund would need to disclose to investors must first be verified or validated by the very company with which the Adviser or Fund invests. Thus, before an Adviser or Fund makes certain disclosures to investors, must the Adviser or Fund validate the information being disclosed? If that is the expectation, there will be a significant increase in costs to ensure the representations made by the companies with which the Adviser or Fund invests hold true. Also, if the SEC truly desires uniformity, consistency and accuracy in reporting, we are doubtful that the proposed rules will achieve such a profound result without Advisers and

Funds having to employ specialists in the ESG field to routinely interpret the data provided by companies and ensure the accuracy of the disclosures made by ESG-oriented companies before making the required disclosures. This increased process will also add costs to investors.

4. **Will the ESG disclosure requirements have a ripple effect throughout the broader retail distribution of ESG-related products?** It is not a stretch to foresee the SEC and other regulators later looking to broker/dealers to exercise a reasonable amount of due diligence to ensure that certain investment products are in fact “green” before onboarding and advertising the products as such. If the current proposal is adopted, rest assured this will be the next shoe to drop.
5. **Will the increased obligations placed on Advisers and Funds considering ESG factors while selecting investments dissuade them from doing so altogether?** If public policy weighs heavily in favor of promoting ESG considerations and environmental awareness, protections and sustainability, it is foreseeable that the SEC’s proposed rule may have counterintuitive results because additional regulation may impede rather than encourage this form of investing. Indeed, the SEC acknowledges the proposed rule may change Advisers or Funds’ willingness to continue with or venture into ESG-focused investment strategies and investment implementation practices.

Conclusion

Climate control and ESG-related investment issues have been a hot topic with the SEC and, in particular, a strong focus of Gary Gensler, the Commission’s Chair, since he took office. Over the last year, the SEC proposed rules which would require companies to report how their operations affect the climate. The proposed rules also impose requirements for companies to quantify and report carbon omissions and to provide risk disclosures as to how changes in the climate could adversely affect their business operations and net value. Such proposals have been met with stark industry critique and opposition with many arguing that the SEC does not have authority to regulate on these issues. Despite the opposition, Mr. Gensler continues to press forward with his climate control initiatives and the latest proposal is yet another attempt for the SEC to gain traction in this space. While the proposed rules presented in this alert are arguably more within the SEC’s regulatory purview than the first proposal (because they focus on Advisers and Funds’ disclosure requirements to investors), they still present some obvious areas for critique and continue to raise eyebrows within the industry. We expect that the SEC’s push into climate control and ESG initiatives will continue to spill into all facets of the securities industry, eventually making its way into the broker/dealer space through broad interpretations and the enforcement of Regulation BI.

Our team at BCLP stands ready to provide additional insight and answer any questions that you may have on this topic or any other securities, regulatory or litigation matters.

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