



WASHINGTON INSIGHTS

SEC Proposes ESG Disclosures in Form ADV

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Welcome to the August issue of the Investments & Wealth Institute’s Washington Insights. This month’s column reviews a proposed rule by the Securities & Exchange Commission (SEC or Commission) requiring specific disclosures by registered investment advisers (RIAs) and investment companies if they offer environmental, social, and governance (ESG) strategies as part of their investment management services. Washington Insights also provides a brief wrap-up of other public policy topics of interest to wealth and institutional asset managers.

SEC Proposes Specific ESG Disclosures by Advisory Firms and Investment Companies

On May 25, 2022, the SEC [released for public comment](#) a rule proposal that, for the first time, would require specific disclosures of ESG investment strategies used by SEC-registered investment advisers. The proposed amendments also would require detailed disclosures by investment companies offering ESG-focused mutual funds and exchange-traded funds including, in environmentally focused funds, the greenhouse gas emissions associated with the portfolio’s investments.

SEC Chairman [Gary Gensler said he was “pleased to support this proposal](#) because, if adopted, it would establish disclosure requirements for funds and advisers that market themselves as having an ESG focus.” He added, “I think investors should be able to drill down to see what’s under the hood of these strategies.” Left unstated in his brief remarks are the SEC’s and European regulators’ concerns with greenwashing—mentioned 23 times in the rule proposal—in which firms make inflated or misleading claims about the use of ESG factors in their products or services.

Under existing disclosure regulations, there are no specific requirements for what an advisor following an ESG strategy must include. In regard to RIAs, the proposed rule would use amendments to Form ADV, Parts 1A and 2A, to require advisors to explain what it means to incorporate ESG factors into their investment recommendations, including a description of how a strategy employs those factors. For example, Item 8 of Part 2A currently requires advisors to describe their methods of analysis and investment strategies used to formulate investment recommendations or manage client portfolios. A new sub-Item 8.D. would be added to require the advisor to flesh out in greater detail a discussion of its use of ESG factors.

An SEC-registered investment adviser not employing ESG strategies would not be required to make any specific disclosures except checking “no” to the new Form ADV questions regarding the offer of ESG advice. State-registered investment advisers also would be exempt from the SEC disclosure requirements—even if they offered ESG-related investment advice.

Noticeably absent from the 362-page rule proposal is an SEC definition of ESG. According to the release, “Instead we are proposing to require advisers to provide a description of the ESG factor or factors they consider, and disclose to clients how they incorporate these factors when providing investment advice, including when recommending or selecting other investment advisers.”

In lieu of an umbrella-type ESG definition, the SEC has proposed definitions for ESG integration, focused, and impact strategies. These definitions are similar to the ones that would be required for describing those same investment approaches by fund managers, and are summarized below:

- ESG integration strategies consider one or more ESG factors alongside other, non-ESG factors
- ESG-focused strategies focus on one or more ESG factors by using them as a significant or main consideration in selecting investments
- ESG-impact strategies have a stated goal that seeks to achieve a specific ESG impact that generates specific ESG-related benefits

The SEC release provided one example of an advisor pursuing an integration strategy that involves consideration of carbon emissions generated by those investments alongside other, non-ESG factors. When explaining this ESG integration strategy, the advisor would have to explain that carbon emissions were no more significant than other factors it considers. But if the advisor employs an ESG-focused strategy, the advisor would have to disclose that ESG factors are a significant or primary consideration in the strategy, and how the advisor incorporates those factors into investment recommendations. If an ESG-impact strategy is adopted because the advisor seeks to achieve a specific ESG impact, additional disclosures would be required.

An advisor’s fiduciary obligation to carefully review ESG products and investment managers used by clients apparently allows for disclaimers. The proposed rule requires advisors to disclose whether they review the portfolio manager’s application of relevant ESG factors or, alternatively, an explanation (i.e., disclaimer) that the advisor or third-party manager does not assess the ESG portfolio manager’s use of ESG factors.

Most of the discussion of the ESG disclosures required by RIAs [can be found on pages 127–148](#) of the release. The text of the proposed rule covering RIAs begins on page 353.

The comment period on the rule proposal ends August 16, 2022. As of mid-June not many comments had been filed, but many large trade groups can be expected to weigh in by the deadline. A smattering of commenters questioned the need for the rule. One individual identified only as “Blake” warned that implementation “will no doubt continue to stoke the flames of inflation.” A retired securities law attorney, Billy Dogwhistle, supported the proposal but said that while “greenwashing may be troubling, I have yet to see clear evidence that it exists.”

THE WRAP-UP

Private Certification

FPA Wants Legal Protection of Professionals Using the Term ‘Financial Planner’

The Financial Planning Association (FPA) announced July 21, 2022, that [it would lead a multi-year lobbying effort](#) to seek legal recognition of the term “financial planner.”

“The legal recognition of the term ‘financial planner’ through title protection is an acknowledgment that anyone proclaiming to be a financial planner meets minimum standards that protect consumers and advance the financial planning profession,” said FPA President Dennis J. Moore, MBA, CFP®.

FPA’s news release offered few details about how it would accomplish this goal, noting only that regulation of financial planners has been the subject of debate within the industry for years. In 2002, FPA published a white paper, “Regulation of Financial Planners,” that laid out various regulatory options ranging from a financial planner self-regulatory organization (SRO) with oversight by the SEC to state regulation of financial planners. As examples, the paper cited a 1985 proposal by the International Association for Financial Planning to establish an SRO and a 1992 Colorado bill to regulate financial planners. Neither initiative was successful.

Following the 2009 financial crisis, as part of reform legislation considered by Congress, FPA and a coalition of financial planning organizations lobbied for an SRO option, but the concept failed to gain traction. Instead, the U.S. Government Accountability Office (GAO) was tasked with [studying regulatory gaps in the regulation of financial planners](#) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In [a report released in 2011](#) titled, “Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain,” the GAO concluded that while there was no direct regulation of financial planners “various laws and regulations apply to most of the services they provide.”

It is likely that other industry trade groups would object to the FPA’s initiative because functional regulation of the services provided by financial planners would overlap with existing regulatory coverage. Opponents likely would try to kill any legislative proposals or seek broad exemptions. It also is likely that state securities regulators would oppose state regulation that diluted their oversight authority over financial planners, who typically are registered as investment advisers. Depending on whether a title protection law also included persons offering financial planning services, advisors using other titles such as “wealth manager” could be subject to registration if a functional definition was overly broad.

Editor’s Note: The Investments & Wealth Institute government relations committee, the Committee for Protection and Advancement of Certification Excellence (or PACE committee) will meet to discuss whether to support or oppose the FPA initiative. A recent independent survey from Cerulli Associates indicated that more than two-thirds of Institute advisor members offer financial planning. The Certified Private Wealth Advisor® (CPWA®) certification objectively and consistently qualifies certificants to deliver advanced financial planning techniques and services to high-net-worth clients. The CPWA® certification program recently became the first financial planning certification in the United States to meet an [international standard for personnel certification](#).

SEC Regulation

Asset Managers: New Electronic 13F Filing Requirement on Tap

New [SEC amendments to Form 13F filings](#) were approved June 23, 2022, by the SEC with a six-month transition period to provide sufficient time for firms to switch from paper to electronic filing of Form 13F and related documents. The new amendments are effective January 3, 2023, for SEC-registered investment advisers in addition to banks, insurance companies, pension plans, and broker–dealers with discretionary trading authority of more than \$100 million in client securities.

In [an accompanying news release](#), SEC Chairman Gensler said the new electronic filing requirements will make submissions “more efficient, transparent, and operationally resilient.” The amendments will affect three types of filings previously submitted on paper—confidential treatment requests for Form 13F filings, applications for orders under the Investment Advisers Act of 1940, and Form ADV-NR. The confidential treatment requests and RIA applications must be submitted through the SEC’s EDGAR system with Form ADV-NR filed through the IARD system.

SEC Enforcement

Pennsylvania Jury Finds Advisory Firm Guilty of Selling Unsuitable, Higher-Cost UITs to Clients

After a six-day trial, a Pennsylvania jury found Dean McDermott and his advisory firm, McDermott Investment Advisers, LLC, in violation of fiduciary duties owed to clients by selling them high-cost unit investment trusts (UITs) through a wholly owned broker–dealer during a two-year period. According to the SEC’s complaint, a no-load version of the investment was available, resulting in “double dipping” through receipt of both advisory and brokerage fees. According to [a statement by the SEC](#) following the verdict, the firm failed to seek best execution and to clearly disclose the firm’s conflicts of interest “in order to line their own pockets.”

Life Insurance Company Equitable Financial to Settle SEC Charges Alleging Misleading Account Statements to School Teachers, Staff

On July 18, 2022, [the SEC announced](#) that Equitable Financial Life Insurance Company agreed to settle fraud charges for allegedly misleading some 1.4-million variable annuity investors by failing to disclose all of the fees charged to their accounts. According to the SEC order, since at least 2016, Equitable listed only certain types of fees and “more often than not the statements had \$0.00 listed for fees” in the quarterly statements. Most of the investors were K–12 public school teachers and other school employees, according to the SEC news release.

The Commission said Equitable had agreed to pay a \$50-million fine with the proceeds to be distributed to those investors. It said Equitable also agreed to revise its fee disclosures in the investors’ account statements.

Reg BI Enforcements, Arbitrations

The Financial Industry Regulatory Authority (FINRA) is stepping up its scrutiny of Regulation Best Interest (Reg BI) compliance. *Financial Advisor IQ* [reported in late June](#) that during an 18-month period ending in December 2021, FINRA had conducted more than 570 exams focused on Reg BI compliance and that it plans on taking “deeper dives” this year into Reg BI’s care obligation, including excessive trading activity and comparison of brokers’ recommendations to their clients’ investment profiles.

[In related news](#), dozens of Reg BI cases have been filed in FINRA’s arbitration forum this year while, interestingly, “breach of fiduciary duty” remains one of the most common claims filed. In adopting Reg BI, the SEC chose “not to apply the existing fiduciary standard” although the agency acknowledged that Reg BI was drawn from key fiduciary principles. As such, the SEC said it believed that investors filing arbitration claims could not allege violations of Reg BI, notwithstanding the “best interest” standard that appears to imply fiduciary obligations. Although fiduciary breach claims in FINRA’s tracking system have dropped year-over-year from 661 cases in May 2021 compared to 485 cases in May 2022, nonetheless 37 cases were filed this year alleging violations of Reg BI. FINRA did not track this claim in 2021.

Gamification

Although the SEC continues to be concerned about gamification—a term used to describe digital engagement practices in which brokerage firms create a playful-like environment complete with confetti showers to celebrate securities transactions—it’s possible that Reg BI could be employed in the agency’s crackdown. The SEC’s top enforcement cop, Enforcement Director Gurbir Grewal, [told a House committee hearing](#) on July 19 that his concern was “when gamification crosses the line into a recommendation.” He went on to say, “If it does, those folks have to comply with Reg BI. I see that as an avenue for us to get involved in that space.”

DOL Regulation

Final Phase-in of PTE 2020-02 Rollover Advice Regulation Effective July 1

On July 1, the final phase-in of Prohibited Transaction Exemption 2020-02 went into effect requiring a written explanation by the financial advisor providing the rollover advice to include the specific reasons why the rollover is in that individual investor’s best interest. A [good overview of PTE 2020-02](#), “The ERISA Fiduciary Advice Exemption,” by the Groom Law Group, can be found on the Investment Adviser Association website. In recent years, the SEC and FINRA also have made rollover advice activity an examination priority.

Cybersecurity

Colgate-Palmolive Sued by Worker Over Cybertheft

A former Colgate-Palmolive worker has sued the company and its plan recordkeeper, alleging a hacker swiped the entire contents of her retirement plan due to their failure to have reasonable procedures in place to avert the theft.

According to the lawsuit, filed July 7 in a New York federal court, a person claiming to be the retirement account holder, Paula Disberry, changed the contact information from South Africa to the United States, and then requested an immediate cash distribution of the \$750,000 retirement account. This “should have been a red flag that triggered some further action to confirm the legitimacy of the request,” Disberry said in her complaint.

Colgate-Palmolive didn’t immediately respond to a request for comment [from Bloomberg Law \(subscription-only\)](#), which reported the lawsuit.

ERISA Litigation

Class-Action Complaints Up in 2022

Thirty-nine lawsuits—most of them alleging unreasonable investment and recordkeeping fees—were filed by the end of Q2 2022 against 401(k)-type plan fiduciaries, or about 20 percent more than during the same period last year.

In addition to excessive fee claims, 11 of the 39 complaints alleged failure to follow the plan’s governing documents (typically the investment policy statement), and 10 of the 39 suits alleged selection of imprudent qualified default investment alternatives (typically target-date funds, some of which were actively managed). Twenty-two of the complaints, or just more than half, alleged use of higher-cost share classes when more reasonably priced share classes were available for the same investment.

Plaintiffs’ law firms still mostly are targeting billion-dollar plans—27 this year through June. Only one defendant (99 Cents Only Stores’ plan) held less than \$100 million in plan assets, or \$70 million.

IRS

IRS Launches Pre-Examination Compliance Program for Plan Sponsors

The Internal Revenue Service (IRS) has [announced a pilot program](#) for plan sponsors that gives selected plans a 90-day review window in which the agency will review the plan’s documents and operations to determine whether they meet current tax law requirements. If the agency review turns up deficiencies, the plan sponsor may be able to self-correct any mistakes under current correction rules.

At the end of the pilot program the IRS said it will determine whether to continue the program as part of the agency’s overall compliance strategy.

ABOUT WASHINGTON INSIGHTS

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If you have questions after reading this update, please contact the Institute's general counsel, Robert (Rob) Frankel at rfrankel@i-w.org.