WASHINGTON INSIGHTS

SEC Cracks Down on ESG 'Greenwashing'

Vol. 7, No. 6, June 2022

Welcome to the June issue of the Investments & Wealth Institute's Washington Insights (*formerly* Legislative Intelligence)*. This month's column examines the recently proposed rules by the Securities and Exchange Commission (SEC or Commission) that would tighten the rules requiring disclosure of environmental, social, and governance (ESG) factors used in mutual fund names and in Form ADV disclosures by registered investment advisers (RIAs).* Washington Insights *also provides a brief wrap-up on other recent public policy topics of interest to wealth and institutional managers.*

WHAT'S IN A NAME? SEC WANTS MUTUAL FUNDS, RIAs TO INCLUDE ENHANCED DISCLOSURES EXPLAINING THEIR USE OF ESG

The SEC on May 25 proposed new rules governing mutual fund names that promote ESG investing and enhanced disclosures by investment advisers who do not accurately disclose in Form ADV their use of ESG factors in managing client portfolios.

SEC Chair Gary Gensler said if adopted, the rules "would establish disclosure requirements for funds and advisers that market themselves as having an ESG focus," adding that "I think investors should be able to drill down to see what's under the hood of these strategies." The SEC commissioners voted 3–1 to release the rules for a 60-day comment period.

Mutual Fund 'Names Rule' to be Updated. Under the so-called "names rule" adopted by the SEC for mutual funds in 2001, if a mutual fund uses a name suggesting a focus on a particular type of investment, industry sector, or with a geographic focus, the fund must adopt a policy to invest at least 80 percent of its assets in that type of investment (examples include ABC Large Cap Fund, JKL Utilities Fund, or XYZ Latin America Fund).

With the increased popularity of ESG investing and triple the amount of assets invested in mutual funds and exchange-traded funds (ETFs) during the past two decades ($22.8 trillion as of March 2020), the SEC believes that funds using ESG and related terms such as "green," "socially responsible," or "sustainable" may result in misleading and deceptive fund names that result in "greenwashing."[1] By defining certain uses of ESG terminology (although the Commission has declined to define the term "ESG"), the SEC believes it will help investors and money managers avoid style drift and ambiguity in the 80-percent basket restrictions.

However, the proposed rule draws a distinction between fund names that connote an investment objective, strategy, or policy, such as “growth” or “value” and therefore are not subject to the 80-percent investment policy requirement. According to a Morningstar analyst, Ben Johnson, 1,211 fund names include “value” or “growth” while just 307 funds are using “ESG” or “sustainable” in their names. The updated names rule also will tackle the issue of how to factor in the increasing use of derivatives in the funds’ 80-percent policy requirement.

New ESG Disclosure Requirements for Funds and RIAs. In addition to the names rule, RIAs also will need to modify certain disclosure items in Part 2A of their ADV brochures. According to the proposing release, SEC staff asserts “that requiring advisers to disclose with specificity their ESG investing approach would help clients understand the investing approach the adviser uses, as well as compare the variety of emerging approaches, such as employment of [a screen], focus on a specific impact, or engagement with issuers to achieve ESG goals.”

The proposal identifies three types of ESG funds subject to the new disclosure requirements. RIAs utilizing an ESG strategy would be required to make similar disclosures in Form ADV regarding the use of ESG factors in their investment strategies and methods of analysis:

- Integration funds, or investment strategies that integrate ESG factors with non-ESG factors. Advisors and fund managers would have to describe how ESG factors are incorporated into the decision-making process.

- ESG-focused funds. Advisors and fund managers would be required to provide detailed disclosure in funds or strategies in which ESG factors play a significant or primary role.

- Impact funds. A subset of ESG-focused funds or strategies. Advisors and fund managers would be required to disclose how their investment strategies or methods of analysis seek to achieve a particular ESG impact and how the fund/advisor measures progress to its objective.

Investment advisors employing ESG investment strategies would be required to make changes to Items 8, 10, and 17 of Form ADV Part 2A.

The Investment Company Institute (ICI), a mutual fund trade group representing nearly all the major U.S. fund companies, pushed back on the new disclosure package as “unworkable.”

As reported by *Bloomberg News*, “The proposal for some funds to disclose emissions related to their holdings seems to be unworkable,” said Eric Pan, ICI’s chief executive officer, adding “some of the information may not even be publicly available.”

Meanwhile, the SEC already is cracking down on alleged greenwashing by asset managers. According to a May 23 news release, an asset manager unit of BNY Mellon has agreed to pay a $1.5-million penalty for allegedly making misleading statements about ESG considerations for certain proprietary funds between July 2018 and September 2021. According to the SEC order, BNY Mellon’s investment policy for those funds required an “ESG quality review score” from one to 10 (with 10 considered “world-leading”) but in one example failed to score 67 of 185 equities in one mutual fund within the specified time period for review.

THE WRAP-UP

SEC Staff to Brokers and Advisors: Be Careful on Rollover and Other Account Recommendations. In a March 30 staff bulletin to broker–dealers (BDs) and investment advisory firms, SEC staff offered some frequently asked questions (and answers**) on how to comply with Regulation Best Interest (Reg BI) and the related fiduciary guidance for RIAs**. Among other things, when it is not clear what "hat" a dually registered broker–advisor is wearing when discussing account recommendations, SEC staff said broker–advisors should disclose to the investor "**that you are acting in both capacities.**" SEC staff also said that whether acting as a broker, advisor, or both, they should document the basis for their account recommendations.

SEC Chair: More Reg BI Guidance Coming. At a recent conference of state securities regulators, SEC Chair **Gary Gensler touched briefly on Reg BI** and fiduciary obligations of investment advisors, telling the audience that in addition to the above guidance on account recommendations, SEC staff "is considering additional guidance" regarding avoiding or managing conflicts of interest, considering reasonable alternatives before making a recommendation in the best interest of the client, and the need to consider costs and risks to investors. "**While it is true that they don't always have to recommend the lowest-cost option**, [brokers and advisers] must have a reasonable basis to believe a higher-cost recommendation nonetheless is in the investor's best interest," Gensler said.

Federal Thrift Savings Plan (TSP) Opens Brokerage Window. Beginning on June 1**, federal workers and military personnel will have access to some 5,000 mutual funds** as well as a limited selection of stocks, bonds, and commodities, according to the Federal News Network and other news reports. However, unlike brokerage windows found in 401(k) plans, **the TSP window comes at a direct cost and with certain restrictions for federal participants**. The initial investment through the TSP window is **a minimum $10,000** and the overall investments **cannot exceed one-quarter of the individual's total account balance**. In addition, because the 2009 federal law allowing the TSP window must be paid by its users, federal workers will have to pay annual fees of $150 plus **an eye-opening $28.75 per-trade fee**.

Independent BD Warns of a 'Barrage of Regulation' Coming From the SEC Soon. According to trade press reports, Raymond James Chief Executive Officer and Chair Paul Reilly warned reps at a May 19 conference that the SEC is coming out soon with 12 regulatory proposals and has 26 more on its agenda. **The new regulations will take up a lot of financial advisors' time** because "they all have some impact and they're all proposed in the same relatively short time frame," Reilly said.

RIAs Still on the Sidelines of SEC's New Client Testimonial/Marketing Rule. According to an analysis of Form ADV filings by IndyFin, **nearly two-thirds of advisors are not yet taking advantage of the SEC's marketing rule** that goes into effect November 4. In an interview with WealthManagement.com, IndyFin President and Chief Executive Officer Akshay Singh said **only 2.3 percent of some advisors amending their ADVs reported using client testimonials** but he believes that number eventually will grow to somewhere between 25 and 40 percent over time. However, some observers think most advisors already are set with their marketing programs and are not inclined to make big changes—at least for now.

Department of Labor (DOL) Backs Off From Crypto Plan Audits—For Now. Private sector 401(k)-type plans that incorporate cryptocurrency options in their menus shouldn't expect an automatic investigation by the DOL, a top DOL official said at a recent industry conference. Ali Khawar, acting assistant secretary of employee benefits, in responding to **a recent announcement by Fidelity Investments that it will offer a crypto product** to plan sponsors said, "That's not really the way our enforcement program works." Khawar said his agency doesn't have the resources and in any event will be focused on "aggressive marketing" directed at encouraging plan fiduciaries to approve risky cryptocurrency investments in their plan lineup.

No Surprise: Retirement Planning Still Top of Mind for Investors. According to [a recent survey by the American College](), "**Understanding how much I can safely spend in retirement**" (also known as retirement income planning), **is by far the number one service of financial advisors sought by consumers** (31.3 percent). "Improving the performance of my investments" ranked second (16.3 percent) followed by "creating a saving and investing plan for retirement" (about 13 percent). In a related survey of qualities investors seek in an advisor, "Looking at the data, **we see a clear need for further education and specialized knowledge in retirement income planning**—it is what consumers want, and it is what advisors in the RIA community think is valuable," Michael Finke, PhD, professor of wealth management and a director at the American College, said in a statement.

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.

ENDNOTE

1. *Investopedia* defines ESG greenwashing as: "the process of conveying a false impression or providing misleading information about how a company's products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company's products are environmentally friendly."