Regulatory Update

What's happening?

The SEC has markedly reversed course since President Biden took office, putting ESG and climate change front and center this year. There have been a series of announcements from the SEC this year related to ESG and climate risks in financial markets. In March the Division of Examinations issued a risk alert, and then proceeded to name these topics as priorities for 2021, creating a Climate and ESG Taskforce to oversee these efforts. We see these moves as positive developments for the industry, to provide clarity and transparency to investors, and to increase accountability for managers and corporations.

The Asset Management Advisory Committee ("AMAC") established an ESG subcommittee in March and subsequently drafted recommendations to the SEC in July.

There are two areas that the SEC is focused on:

1. Investment product disclosures

In March the SEC issued a risk alert after discovering instances of ESG labelled products that were investing and voting in ways that appeared to be inconsistent with their marketing. Since then, the agency has been reviewing fund managers and their processes to see whether they match their disclosures and advertisements. This can get complicated because there are a wide range of approaches to ESG integration that fund managers pursue, and a different definition of what encompasses ESG. SEC Chair Gary Gensler has asked his SEC staff to assess what information fund managers should have to disclose to provide clarity to investors.

By April 2022, the SEC plans to propose requirements for investment companies and investment advisers related to ESG factors, including ESG claims and related disclosures; propose rule amendments regarding shareholder proposals under Rule 14a-8; and propose rule amendments governing proxy voting advice. The AMAC has recommended that the SEC align with the taxonomy developed by the Investment Company Institute ("ICI") ESG Working Group, to provide a clear description of each product's strategy and investment priorities, including description of non-financial objectives such as environmental impact or adherence to religious requirements.

On September 21, Brent Fields, acting deputy director and chief counsel to the SEC Division of Investment Management, said that the SEC plans to update the Names Rule with a provision that will divide ESG funds into two categories based on the level of ESG integration in the investment process: integration funds and focus funds. Funds would be categorized as integration funds if ESG is simply a consideration in the strategy, and those funds would not be allowed to use "ESG" or related terms in their names or in their fund objective statements. Funds would be categorized as focus funds if ESG is fully integrated as a core component of the investment process, and can use terms like "sustainable" or "ESG" in their name or fund objective.[1]

Europe is ahead of the US on guidance and regulation in this area. The European Commission's Sustainable Finance Action Plan is intended to help direct capital toward sustainable activities and prevent misleading information. The EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR) requires asset managers to expand disclosure and reporting requirements, and came into effect this year. The implementation of SFDR is likely to have significant effects for both companies domiciled in the EU as well as companies operating within the EU. The European Commission has not clarified its position on whether it applies to non-EU companies who operate in the EU or who market funds into the EU, although there has been a widespread assumption that it will. Article 6, 8 and 9 funds are the three classifications of investment strategy under SFDR. Articles 8 and 9 are subject to higher standards of disclosure.

1 Ignites, Not All ESG Funds Will Be Treated the Same: SEC Director, David Isenburg, September 22, 2021.

- Article 6 covers funds which do not integrate any kind of sustainability into the investment process and could include stocks currently excluded by ESG funds such as tobacco companies or thermal coal producers. While these will be allowed to continue to be sold in the EU, provided they are clearly labelled as non-sustainable, they may face considerable marketing difficulties when matched against more sustainable funds.
- Article 8, also known as 'environmental and socially promoting', applies "... where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices."
- Article 9, also known as 'products targeting sustainable investments', covers products targeting bespoke sustainable investments and applies "... where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark."

The CFA Institute has also, in parallel, created draft ESG disclosure standards for investment products, which was released in May and is supposed to be finalized by November. Meant to be disclosure focused rather than prescriptive, the purpose of the Standards is to provide greater transparency and consistency in ESG-related disclosures, resulting in clearer communication regarding the ESG-related features of investment products. CFA's proposed standards would ask managers to report information on product objectives, benchmarks, exclusions, how ESG information is used in financial analysis and valuation, portfolio-level ESG criteria, the process to achieve an impact objective, and stewardship practices. When creating the draft, the CFA took into consideration feedback from 111 letters with more than 3,000 comments from 30 countries, all from investment providers, consultants, and asset owners.

The CFAI has stated that the Standards will not conflict or overlap with naming rules, labeling and certification programs, classification systems, and assessment methodologies because the following decisions have been made: The Standards will neither require nor prohibit the use of particular terms in investment product names, descriptions, or presentations. The Standards are not intended to be a naming or labeling standard, nor are they intended to be a universal glossary of terms. Rather than try to define these terms, the Standards use plain language and encourage investment managers to do so as well in their disclosures. Furthermore, a growing number of regulators are establishing rules for particular terms that can or cannot be used for certain types of investment products. Such rules do not conflict with the Standards' provisions to disclose information about an investment product. If the Standards were to require or prohibit the use of particular terms, the Standards would inevitably conflict with local regulations and would not be globally applicable as intended. It appears that these Standards will be like the GIPS for ESG, although one key difference is that compliance is claimed at the product level, not the firm level.

2. Corporate disclosures

Investors have a very difficult time comparing company disclosures on sustainability related information. Company reporting is not standardized and can be confusing to interpret as a result. The SEC opened a public comment period for market participants to comment on how the SEC should approach climate risk disclosures. The request elicited more than 550 unique comment letters, and 3 out of 4 of those letters supported mandatory climate disclosure rules for public companies. Many participants called for alignment with the TCFD guidance. Gensler has asked the agency's staff to consider whether public companies should be required to disclose a variety of quantitative and qualitative climate-related information in their annual financial reports.[2]

They're also reviewing current guidance. In 2010 the SEC provided guidance to public companies on existing disclosure requirements on climate change – now they want staff to review the extent to which companies are addressing topics in the 2010 guidance. As the SEC continues to formulate a climate disclosure rule, many have anticipated such a rule would either require uniform disclosures by all public companies across industries or go sector by sector attempting to create standards based on the industry's climate risks. Commissioner Lee suggested the SEC could bless a standard setting body, such as SASB (now the Value Reporting Foundation), and require companies to comply with their framework. This would expand the scope of reporting beyond climate to other ESG issues, which Gensler has already signaled is on the agenda. However, senate Republicans are already raising objections.

2 https://www.sec.gov/news/speech/gensler-pri-2021-07-28

Commissioner Lee also recently called for the SEC to consider drafting disclosure regulations regarding corporate political spending and diversity. The SEC will propose rule amendments by October 2021 on both Climate Change disclosure and Board Diversity disclosure. Within the SEC, opinions are divided. Five Commissioners have already made more than 10 speeches on ESG disclosure this year, expressing differing positions on what these rules should look like.

Gensler noted in his prepared remarks during the Principles for Responsible Investment Climate and Global Financial Markets webinar in July, "Together, I think updates to public company disclosures and to fund disclosures could bring needed transparency to our capital markets. This gets to the heart of the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[3]

What does it mean for advisors?

Regulation will create standardization in disclosures from corporates and asset managers. This will inherently make it easier for investors to make more informed investment decisions. With common standards comes a common language where financial market participants can compare apples to apples. It will also reduce the chances of asset managers misrepresenting their products or overstating their approach to sustainable investing. This clarity will ultimately help advisors select the best investment for their clients depending on their sustainability goals and interests.

Where do we go from here?

ESG regulation is inevitable. We don't know when the SEC will have a definitive timeline to develop, implement and then enforce regulatory standards for ESG disclosures. But we do know that investors are demanding this. They're asking regulators for more ESG and climate risk disclosures. When investors have the information they need, they can more adequately decide what risks they are willing to take.

What's happening here is not new. Investors have asked for more information many times over the last several decades as our economy has transformed and financial systems have advanced. Capital markets have been and will be shaped by new complex realities of climate change, disasters, natural resource depletion, socio-economic inequalities, and the increasing interconnectedness of these realities. What is considered financially material has evolved and will continue to evolve as we face global sustainability challenges that cannot be ignored. This is an area of focus for the SEC because they know it is important and incredibly relevant to financial markets.

There is still uncertainty with what guidance the SEC will provide, however, Envestnet PMC is here to support advisors in identifying appropriate sustainable investments for clients. We have a quantitative, data driven framework and standards for vetting investment strategies on their ESG approach. You can learn more about that process here.

Check out our website for additional insights, or contact us directly at impact@envestnet.com.

3 https://www.sec.gov/news/speech/gensler-pri-2021-07-28

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