Regulatory Scrutiny of the Sustainable & Impact Investing Industry Is Intensifying

Mark Hays and John McCabe

In fall 2021, we wrote in The Journal of Wealth Management about the significant growth of sustainable and impact investing over the past five years and the remaining challenges holding back would-be allocators — specifically confusion over terminology, perceived greenwashing and a lack of clarity on how this investment discipline aligns with fiduciary duty. (The full article can be found here.) To help address those challenges, we suggested a sustainable and impact investing taxonomy, outlining four distinct approaches to sustainable and impact investing (integrated, mandated, thematic and high impact concessionary) and offered a framework to align various client account types (e.g., revocable and irrevocable trusts, ERISA, etc.) with fiduciary duty.

Additionally, we provided practitioners with a four-step process to guide such a fiduciary framework, which included 1) a focus on rigorous risk-adjusted return analysis, 2) clear documentation, 3) checks and balances on implementation and 4) ongoing monitoring. We closed our piece with the hope that our taxonomy and framework could serve as a precursor to wider industry standardization, and to spur broader adoption and acceptance of sustainable and impact investing in the industry.

In the time since we released our original piece, regulatory scrutiny of the sustainable and impact investing industry has intensified. Thus far in 2022, there has been significant activity by the Securities and Exchange Commission (SEC), while the Department of Labor (DOL) has issued new proposed regulations that could open the door for ERISA plan sponsors to use environmental, social and governance (ESG) investment strategies. We consider three potential takeaways from this activity:

- 2022's regulatory scrutiny of asset managers offering ESG-related strategies will continue to intensify, and may ultimately provide asset owners with more direction in sifting out greenwashing in their portfolios.
- A new proposed regulation from the DOL may open the door for ERISA plan sponsors to offer mandated and thematic strategies, potentially leading to increased inflows from 401(k) plan participants.
- Over the long term, this collective regulatory activity may result in a more enduring, standardized industry fit for a larger proportion of institutional investors and foster the next phase of growth in adoption.

In this article, we provide more detail on the regulatory activity in place today and what is likely coming next, delineated by the group affected most by each activity.

Proposals from the Department of Labor affecting ERISA plan sponsors

Under ERISA, a fiduciary has a duty to act for the exclusive purpose of providing benefits to participants in the plan. In the past several years, the DOL has placed additional scrutiny on plan sponsors considering ESG strategies, such as ESG Mandated or Thematic strategies. For example, the DOL's October 2020 final rule on investment duties stated that "ERISA fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote nonpecuniary benefits or goals."[1] This 2020 rulemaking "reaffirmed the DOL's longstanding position that ERISA requires plan fiduciaries to treat the financial interests of plan participants and beneficiaries as paramount when making investment decisions."[2]

Notably, however, the 2020 regulation provided that an ERISA fiduciary must focus solely on "pecuniary factors" in making investment decisions. In announcing the rule, the DOL noted that it is "concerned … that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance."[3] Although the rule did not prohibit the use of ESG factors in making investment decisions, it imposed documentation requirements for certain decisions and also prohibited fiduciaries from selecting ESG funds as qualified default investment alternatives for plans.[4]

That approach potentially changed when the DOL proposed a rule in October 2021 to clarify that the duties of prudence and loyalty include the ability to consider climate change and other ESG factors when selecting investments and exercising shareholder rights.[5] The proposal moves closer to a principles-based approach that does not target (positively or negatively) ESG compared to any other investment strategies, asset classes or investment styles. If finalized, the proposed rules could provide ERISA fiduciaries "with some comfort that they will not be penalized for appropriately considering ESG-type factors when weighing investment alternatives, where those factors are material to the risk-return analysis."[6]

Enhanced ESG disclosure requirements for corporations

In March 2022, the SEC proposed broad rule changes that would require publicly traded companies 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.[7] The SEC believes these rules, if adopted, would "provide investors with consistent, comparable and decision-useful information for making their investment decisions, and it would provide consistent and clear reporting obligations for issuers."[8] Going forward, SEC Chair Gary Gensler has stated that the SEC will next seek to focus on human capital-related disclosures, including pay equity and diversity, equity, and inclusion data.[9]

[1] *Hays, M., and J. McCabe. "Sustainable and Impact Investing: A Taxonomy of Approaches and Considerations for Fiduciaries." The Journal of Wealth Management (Fall 2021).*

[2] *Bogner, I.G., et al. "DOL Issues Final 'ESG' Rule Restricting ERISA Fiduciary Consideration of Non-Pecuniary Investment Factors." Employee Benefits and Executive Compensation Blog, Proskauer, November 10, 2021.*

[3] *Federal Register, Financial Factors in Selecting Plan Investments, November 13, 2020.*

[4] *Ibid.*

[5] *Manganaro, J. "DOL Proposes New Rule on ESG Investing in Retirement Plans." October 13, 2021.* https://www.plansponsor.com/dol-proposes-new-rule-esg-investing-retirement-plans/.

[6] *Bogner, et al.*

[7] *"SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors." March 21, 2022.* https://www.sec.gov/news/press-release/2022-46.

[8] *Ibid.*

[9] *"A Mission for Inclusion: In Conversation with Gary Gensler."* https://www.sec.gov/sec-stories/mission-inclusion-conversation-gary-gensler.

Regulation and disclosure requirements for investors

In May 2022, the SEC proposed two rule changes relating to its concerns around ESG investing, including one directed at a concern that certain ESG-sounding fund names might mislead investors about a fund's investment focus or holdings, also known as "greenwashing." Specifically, the SEC is seeking to amend the "Names Rule" adopted in 2001 to address certain broad categories of mutual fund names that seemed likely to mislead investors about risks and holdings by requiring that 80% of the assets of the fund be the type of investment suggested by the name. The proposed amendments would explicitly extend the Names Rule to funds whose names suggest a focus on investments with "particular characteristics," including funds with "ESG" in the name and specifically deem as "materially misleading" any name of an integration fund that included the terms "ESG" or "Sustainable." The rationale for that firm decision is that such funds might use ESG or sustainable factors, but not as a prominent or consistent part of the investment process.

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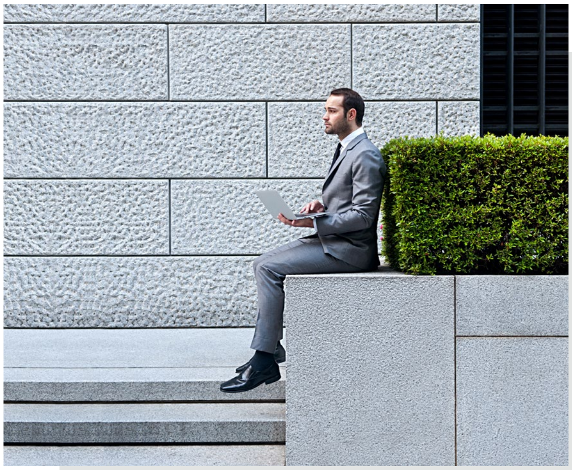
In addition to the Names Rule amendments, the SEC has also proposed rules and form amendments under the Investment Advisers Act of 1940 and the Investment Company Act of 1940, which would require disclosure of specific, detailed information about ESG investment practices. These rules actually differentiate ESG investment strategies into Integration, ESG Focused and ESG Impact, and the extent of the disclosure required varies depending on that taxonomy. In general, the rules would require an overview of the ESG strategy, including whether it uses negative or positive screens, a discussion of how proxy voting figures into the objective, how ESG factors are considered in investment decisions, whether shareholder engagement is used and identification of any critical ESG data or service providers. Notably, the proposals also specify the form of reporting, requiring a table of disclosures in the prospectus so that prospective investors could easily compare one product to another.

REGULATORS ARE ALSO HOMING IN ON GREENWASHING, WHICH IS CONVEYING MISLEADING INFORMATION AROUND AN INVESTMENT PRODUCT'S INTENTION AND/OR ABILITY TO MEET SUSTAINABILITY GOALS.

Conclusion



The regulatory activity summarized here may serve to address key challenges often cited by would-be allocators: confusion over terminology and approaches among sustainable and impact investing disciplines and a lack of clarity on whether and how investors who serve in a fiduciary capacity can incorporate these disciplines. With an expectation for continued regulatory scrutiny, it is critical for fiduciaries to leverage a framework by which they ascribe precision to their ESG approach and its fit with fiduciary duty. We offer such a framework for fiduciary considerations in our original piece (click here to read the article).[10]

***Mark Hays** is Director of Sustainable & Impact Investing at Glenmede.*
***John McCabe** is Glenmede's General Counsel.*

[10] *Note that Glenmede's taxonomy is denoted into four categories and roughly maps to the SEC's three naming rule categories of "Integrated," "Focused" and "Impact," although with more specificity on how Glenmede distinguishes strategies within the "Focused" and "Impact" strategies.*

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