The Investment Lawyer

Covering Legal and Regulatory Issues of Asset Management

VOL. 29, NO. 10 • OCTOBER 2022

TABLE OF CONTENTS

FROM THE EDITOR

3 **Highlights of This Issue**
By Stephanie Darling

9 **The Digital Asset Regulatory Landscape Begins to Take Shape: The Responsible Financial Innovation Act**
By Juan Arciniegas and W. Thomas Conner

19 **SEC Proposes Climate Disclosure Rules—Part 2**
By Athena Eastwood, Archie Fallon, Elizabeth P. Gray, Robert B. Stebbins, William J. Stellmach, and William L. Thomas

REGULATORY MONITOR

26 **SEC Update**
- SEC Settles Enforcement Action Against ESG Fund Adviser

Wolters Kluwer

SEC Solicits Comments on Whether Index Providers, Model Portfolio Providers, and Pricing Services Are Investment Advisors: Seeking a Problem for a "Solution"

By Peter J. Shea, Richard Kerr, Trayne Wheeler, and Nick Ersoy

On June 15, 2022, the Securities and Exchange Commission (SEC) issued a "Request for Comment on Certain Information Providers Acting as Investment Advisers" (Request).[1] The Request addresses three categories of what the SEC refers to as "information providers" or "providers:" *index providers*; *model portfolio providers*; and *pricing services*.[2] The SEC is seeking comment with respect to information providers "whose activities, in whole or in part, may cause them to meet the definition of 'investment adviser' under the Investment Advisers Act of 1940" (Advisers Act)[3] and whether these information providers meet the definition of being an "investment adviser" to an investment company under the Investment Company Act of 1940 (1940 Act).[4] Historically, information providers have not been subject to regulation under the Advisers Act due to the nature of their services and products. The Request suggests that the SEC is reconsidering information provider status under the Advisers Act. The comment period closed on August 16, 2022.

continued on page 4

Editorial Board

EDITOR-IN-CHIEF

Stephanie Darling
Law Office of Stephanie Darling
(410) 920-7329
Stephanie@DarlingLawOffice.com

EDITORIAL BOARD

Edward Baer
Ropes & Gray LLP
San Francisco, CA

Barry P. Barbash
Willkie Farr & Gallagher LLP
Washington, DC

David W. Blass
Simpson Thacher & Bartlett LLP
Washington, DC

Steven Boehm
Eversheds Sutherland (US) LLP
Washington, DC

Gary Cohen
Carlton Fields Jorden Burt, P. A.
Washington, DC

Leslie Cruz
Mayer Brown LLP
Washington, DC

Joshua B. Deringer
Faegre Drinker Biddle & Reath LLP
Philadelphia, PA

Douglas Dick
Dechert LLP
Washington, DC

Nicolas Fermaud
Elvinger SARL PLLC
New York, NY

Ann B. Furman
Carlton Fields Jorden Burt, P.A.
Washington, DC

Benjamin Haskin
Willkie Farr & Gallagher LLP
Washington, DC

David Kaleda
Groom Law Group
Washington, DC

Jennifer Klass
Baker & McKenzie, LLP
New York, NY

Elizabeth Marino
Sidley Austin LLP
Boston, MA

Carolyn McPhillips
Mutual Fund Directors Forum
Washington, DC

Mary C. Moynihan
Perkins Coie LLP
Washington, DC

Amy Pershkow
Vedder Price
Washington, DC

Eric Purple
Stradley Ronon Stevens & Young
Washington, DC

Gwendolyn A. Williamson
Perkins Coie LLP
Washington, DC

George J. Zornada
K&L Gates LLP
Boston, MA

WOLTERS KLUWER

Richard Rubin
Publisher

Jayne Lease
Managing Editor

EDITORIAL OFFICE
28 Liberty Street
New York, NY 10005
(212) 771-0600

The Investment Lawyer

Covering Legal and Regulatory Issues of Asset Management

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

The Investment Lawyer (ISSN 1075-4512) (USPS P0000-062) is published monthly by Wolters Kluwer at 28 Liberty Street, New York, NY 10005. To Subscribe, call 800-638-8437. For Customer Service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

Permission requests: For information on how to obtain permission to reproduce content, please go to *www.WoltersKluwerLR.com/policies/permissions-reprints-and-licensing*. Purchasing reprints: For customized article reprints, please contact *Wright's Media* at 1-877-652-5295 or go to the *Wright's Media* website at *www.wrightsmedia.com.*

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other professional assistance is required, the services of a competent professional person should be sought.—From a *Declaration of Principles* jointly adopted by Committee of the American Bar Association and a Committee of Publishers and Associations.

Visit the Wolters Kluwer website at *www.WoltersKluwerLR.com.*

FROM THE EDITOR

Highlights of This Issue

Stephanie Darling

This first article in our October issue was authored by Peter Shea, Richard Kerr, Trayne Wheeler, and Nick Ersoy of K&L Gates LLP, and discusses the Securities and Exchange Commission's (SEC) Request for Comment on Certain Information Providers Acting as Investment Advisers. The article explains that the SEC uses the term "information providers" to refer to three categories: index providers, model portfolio providers and pricing services, and that the Request posits whether such information providers' activities cause them to meet the definition of an investment adviser under the Investment Advisers Act of 1940. The authors note that although they expect the Request to generate a significant amount of public comment, the Request "does not articulate any specific problems in the industry other than some vague SEC concerns and observation of discretionary activity by providers."

In our next article, Juan Arciniegas and Thomas Conner of Vedder Price P.C. discuss what they believe are three of the most potentially impactful titles of the Responsible Financial Innovation Act (RFIA) on the federal regulation of digital assets: (1) securities laws, (2) commodities laws, and (3) tax laws. The authors explain that while the RFIA "touches a broad array of federal statutes and has implications for a variety of federal agencies," the article focuses squarely on how the RFIA would change current regulation of digital assets in those three areas. The authors also offer their observations as to how these new frameworks may bring some clarity for digital asset companies and practitioners for structuring new digital asset businesses.

Our third article of this issue consists of the second installment of a two-part series authored by Athena Eastwood, Archie Fallon, Elizabeth Gray, Robert Stebbins, William Stellmach, and William Thomas of Willkie Farr & Gallagher LLP. Part 1 appeared in the August issue of *The Investment Lawyer*. The article provides a thorough discussion of the SEC's proposed rules requiring registrants to provide climate-related information in registration statements and annual reports, including in financial statements. This Part 2 discusses greenhouse gas emissions, attestation of Scope 1 and Scope 2 emissions disclosures, targets and goals, and certain important takeaways. Part 2 also discusses the dissenting statement by Commissioner Hester Peirce.

Finally, in our SEC Update column, Gary Cohen of Carlton Fields, P.A. discusses the settlement of an SEC enforcement action against Bank of New York—Mellon Investment Adviser. Mellon advises mutual funds with an environment, social, and governance (ESG) profile, and the SEC charged Mellon with material misstatements and omissions in regard to ESG principles and with failing to adopt policies and procedures designed to prevent untrue statements of fact from being included in prospectuses. Mr. Cohen believes that the SEC's action is an indication of additional enforcement actions to come in the ESG arena.

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

SEC Solicits Comments …
continued from page 1

As discussed further, Advisers Act regulation of information providers would potentially bring a range of new requirements and considerations to the provider industry—from Uniform Application for Investment Adviser Registration (Form ADV) filings and new disclosure obligations, to the adoption of compliance programs and the hiring of chief compliance officers (CCOs), to heightened responsibilities that come along with being considered a fiduciary. The SEC in its Request is giving the information provider industry and other interested parties the opportunity to voice views on the appropriateness of such a change. We expected that the industry would take up this invitation.

Changing Times

The Request notes the role of information providers has grown in size and scope in the asset management industry in recent years and states that the information providers' operations "raise potential concerns about investor protection and market risk", citing front-running trades and conflicts of interest concerns.[5] When discussing each type of provider, the SEC focuses on the amount of discretion each provider has in rendering their products and services.

Index Providers

Index providers generally create, maintain, operate, calculate, and publish financial and securities indices, and license them to third parties for use in managing investment products. The SEC observes that index providers have "significant discretion" in creating and maintaining financial indices, "in some cases without publicly disclosing their index methodologies or rules."[6] The SEC sees this discretion being exercised at index design, reconstitution, rebalancing, and in response to index component corporate events (that is, mergers, reorganizations, etc.). The Request further remarks on the "specialization" of indices, index "customization," and the "bespoke" nature of certain indices.[7] The SEC asserts that index providers are making active decisions with respect to their indices created for the purpose of licensing to sponsors of investment products, and concludes that the inclusion or exclusion of index components "drives" advisers' decision to buy or sell those securities for their clients.[8]

Model Portfolio Providers

Model portfolio providers include "broker-dealers, asset managers, third-party strategists, asset allocators, and advisers."[9] The Request observes that these providers design, rebalance over time, and can customize their models, which can be used on a discretionary or non-discretionary basis. The Request includes "direct indexing" in the model portfolio category.[10]

Pricing Services

Pricing services provide prices, valuations, and additional data about a particular investment. Pricing services are also called "valuation agents or providers of fairness opinions."[11] Pricing services provide pricing services when market quotations are not available or over-the-counter markets render incomplete information necessary for the pricing of a security. The SEC asserts, "pricing services may exercise significant discretion" as to valuation methodology, inputs, further value adjustments, and meeting user-raised challenges.[12] The SEC also notes that different pricing services may produce different values for the same securities and that the same service may also offer different pricing levels for the same security depending on methods and needs.[13]

Significance of the Request

The Request reflects a belief by the SEC that the discretionary aspects of provider products and services alone warrant the application of the Advisers Act regulatory regime to providers. Notably, the Release does not discuss any past or present complaints, abuses, frauds, investor losses, investor

confusion, market manipulations, market disruptions, or other bad or malicious effects attributable to these information providers. The process initiated by the Request is designed to facilitate the SEC's consideration of whether, given the "national presence" that certain information providers are able to have, regulatory action by the SEC is necessary or appropriate.

Any Advisers Act information provider regulatory regime ultimately adopted should be expected to impose new and significant costs and burdens on providers, which may ultimately be passed on to customers and investors that rely on provider products and services. Among other things, a new SEC information provider regulatory regime may subject information providers to the same requirements and responsibilities as registered investment advisors, including:

- New fiduciary or fiduciary-like obligations to customers or investors or other end users;
- SEC registration on, and annual renewal filings of, Form ADV and mandated document deliveries to customers or investors or other end users;
- Mandated contractual provisions governing customer relationships;
- CCO designations and the development and implementation of written compliance manuals and codes of ethics;
- Increased costs of compliance; and
- SEC routine and for-cause inspections.

In addition, the wider investment management and financial services industries may experience costs from SEC regulation of information providers. These costs may be, among other things, the passing through of new compliance expenses to investors, reduced competition in the industry, and declining innovation to meet investor needs.

Information Providers and Fiduciary Duty

The SEC makes clear in the Request that it is considering whether providers have fiduciary obligations to those who use their services. Question 8 asks whether providers view themselves as having fiduciary obligations, their view of the scope of such obligations, whether they have a narrower view of such obligations than "a traditional client-facing adviser," and how providers address conflicts of interest in their business relationships.[14] Presently, providers have a commercial relationship with their customers defined by contract. The federal imposition of fiduciary obligation on a provider may create obligations owed directly to customers, licensees, and buyers, or indirectly to end-users or third-party beneficiaries, such as fund shareholders or advisory clients. In this respect, Adviser Act regulation of providers would represent a fundamental change in nature of the business relationships of providers with their customers. Provider relationships would no longer be governed solely by their contracts but also by federal regulation which, among other things, would establish a fiduciary duty including duties of loyalty and care in all aspects of their operations.

Even if the SEC ultimately does not impose full investment adviser fiduciary duties on providers, it may still attempt to impose regulatory obligations relating to, among other things, suitability standards, conflicts of interest mandates or prohibitions, regulatory anti-fraud liability, recordkeeping standards, and required disclosure or document delivery (that is, a Form ADV brochure) to end-users of their products and services. The SEC's potential fundamental reframing of a provider's relationship with its customer, licensee or buyer to be a fiduciary or fiduciary-like one is expected to generate a significant number of comments on question 8 alone.

Publisher's Exclusion Targeted

The SEC states that historically many information providers have relied on the "publisher's exclusion" from registration as an investment adviser under Section 2(a)(11) of the Advisers Act,[15] and discusses the fact that information providers frequently rely on the "publishers exclusion" from registration provided in Advisers Act section 2(a)(11)(D). The

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

Request describes the elements of the "publisher's exclusion" from registration under the Advisers Act section 2(a)(11)(D), which excludes from being an investment adviser the "publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation."[16] The Request describes the interpretation of the "publisher's exclusion" by the 1985 Supreme Court in the *Lowe* decision, but states that, given the passage of time and the development of new business models since 1985, the Staff of the SEC is considering the extent to which information provider activities raise investment adviser status questions and whether the applicability of the "publishers' exclusion" to information provider activities should be reevaluated.[17] This part of the Request is expected to generate many comments.

The Requests for Comment—a Total Evaluation of Investment Adviser Status

The specific questions of the Request demonstrate that the SEC is considering whether and to what extent that the information providers should register as investment advisors and be subject to all aspects of the Advisers Act.

The Request has two "General" questions concerning defining information providers, their risks and conflicts of interest and their numbers in the United States. Request questions 3 to 16 generally seek information about information providers under the Advisers Act, including whether the SEC should create an exemption for providers (question 15) and the economic benefits and costs of regulating providers as investment advisers (question 16). Questions 17 to 21 target index providers, question 22 model portfolio providers, and questions 23 and 24 pricing services. Questions 25 to 29 deal with Advisers Act registration issues.

Questions 30 to 32 address the applicability of the entirety of the Advisers Act to providers who register under the Act, the impact on providers and investors, and whether any SEC regulatory regime for information providers ought to be aligned with the regime of the European Securities and Market Authority and its EU Benchmarks Regulation. Questions 33 and 34 solicit responses concerning Adviser Act reporting and disclosure obligations for providers.

Finally, the Request discusses 1940 Act issues presented by information providers, including the 1940 Act's separate definition of an investment adviser to a fund, under questions 35 to 40.

Potential Significant Increase in Adviser Regulation

Information providers as well as advisers, funds, and investors relying on information provider products and services all should be aware of the potential consequences, costs, and compliance repercussions of any rulemaking that may ultimately result from the Request. In addition to the consequences highlighted above, such regulation also may be expected to:

- Reduce investment product and advisory service offerings to investors if costs cannot be shifted to investors;
- Result in the closure of some funds or other investment products if the existing, and any replacement, provider refuses or is unable to satisfy the regulatory requirements;
- Impose barriers to entry to new potential information providers or cause existing information providers to consolidate with other providers or shut down entirely;
- Reduce the sophistication and future innovation in investment strategies available to retail investors if financial index or model construction is required to be simplified in order to avoid regulation by the SEC as an investment adviser or otherwise; and
- Impose additional burdens on registered fund boards and product sponsors for the oversight of index providers, model providers, or pricing services who become subject to SEC regulation

(including in the context of registered funds, subjecting information providers that are deemed to be investment advisers to the shareholder and board approval requirements of Section 15 of the 1940 Act).

Conclusion

The Request is far reaching in scope concerning information providers. While the Request seeks comment on the costs and burdens associated with Advisers Act regulation of providers, it does not articulate any specific problems in the industry other than some vague SEC concerns and observation of discretionary activity by providers. The scope of the Request leads us to expect that the Request will generate a significant amount of public comment.

Mr. Shea is a Partner in the New York, NY Office, **Mr. Kerr** and **Mr. Wheeler** are Partners in the Boston, MA Office, and **Mr. Ersoy** is an Associate in the Washington, DC Office, of K&L Gates LLP.

NOTES

1 SEC Release Nos. IA-6050; IC-34618 (File No. S7-18-22), which can be found at *https://www.sec.gov/rules/other/2022/ia-6050.pdf*.

2 As an indication that the SEC may be considering widening the scope of its regulatory jurisdiction, the Request seeks comment on whether any other types of information provider should be regulated by the SEC other than the three types considered in the Request. *See* Request, at 15, (Question 2) (Are there "any other types of information providers whose activities, in whole or in part, may raise investment adviser status issues? If so, which providers, and why?").

3 *Id.* at 1 (Summary).

4 *Id.* at 28-31.

5 *Id.* at 3 and 5.

6 *Id.* at 4-5 and n. 6.

7 *Id.* at 4 and 6.

8 *Id.* at 6.

9 *Id.* at 7. *See id.* at n.13 ("This discussion focuses on third-party model portfolio providers that sell models to wealth managers that apply them to client portfolios . . . versus internal firm models. This discussion includes as third-party model portfolio providers those persons who make available their own portfolios so that others can copy or license those portfolios in exchange for compensation. Portfolios may be made available through the provider's online platform.")

10 *Id.* at 8 and n.15.

11 *Id.* at 9 and n.19.

12 *Id.* at 10.

13 The Request discusses 1940 Act rule 2a-5's adoption, which recognized the role pricing services play in fair valuation determinations by fund boards while noting the risks and conflicts of pricing services. In particular, the Request states, "Staff have also observed compliance issues in connection with registrants' interactions with third-party pricing services, including the risks of misleading disclosure regarding whether those services provide "independent" values and the possibility of stale or otherwise inaccurate valuations." This statement is solely based on an SEC Compliance Alert from July 2008 on deficiencies and weaknesses related to reliance on third-party pricing services for valuing high yield municipal bonds. *Id.* at 11 and n.23. *See* Compliance Alert, SEC Division of Examinations (July 2008), available at *https://www.sec.gov/about/offices/ocie/complialert0708.htm*.

14 *Id.* at 17.

15 Under Section 2(a)(11) an investment adviser is defined to mean: "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;…"

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

[16] *Id.* at 14. The Request also addresses the Supreme Court's interpretation of the publisher's exclusion where a qualifying publication: "(i) provides only impersonal advice; (ii) is 'bona fide,' meaning that it provides genuine and disinterested commentary; and (iii) is of general and regular circulation rather than issued from time to time in response to episodic market activity." *See* Lowe v. SEC, 472 U.S. 181, 208-210 (1985).

[17] *Id.* at 15.

The Digital Asset Regulatory Landscape Begins to Take Shape: The Responsible Financial Innovation Act

By Juan Arciniegas and W. Thomas Conner

In early June 2022, US Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced the long-awaited Responsible Financial Innovation Act (RFIA), an ambitious start toward comprehensive legislation for digital assets.[1] The bipartisan bill is a cohesive framework for digital asset regulation that seeks to encourage "responsible financial innovation, flexibility, transparency and robust consumer protections while integrating digital assets into existing law." Many of the principles articulated in the RFIA were laid out in President Biden's Executive Order on Ensuring Responsible Development of Digital Assets, released March 3, 2022. While the legislative future of the RFIA is murky at best, as a "first effort" the proposals contained therein could provide models for subsequent legislation and/or regulatory action.

Importantly, the RFIA seeks to, among other things:

- Provide a coherent set of defined terms related to digital assets, addressing the lack of standard nomenclature in the industry.
- Introduce several clarifications regarding the tax treatment of digital assets.
- Provide the first comprehensive regulatory framework designed to ensure full and fair disclosure to the general public when digital assets are traded after their initial offering, while treating as commodities the vast majority of digital assets that by their terms lack the basic indicia of a "security." This framework preserves the fundamental registration and disclosure requirements of the federal securities laws for a digital asset *offering,* while providing companies with a readily identifiable "off-ramp" strategy to exit registration and disclosure requirements.
- Resolve jurisdictional ambiguity by expanding the authority of the Commodity Futures Trading Commission (CFTC) to regulate digital asset spot markets while preserving the Securities and Exchange Commission's (SEC) jurisdiction over digital asset offerings.
- Establish a new permissive registration category for digital asset exchanges along with a compliance framework for the offering of digital assets on a margined, leveraged, or financed basis.

This article discusses what we believe are three of the most potentially impactful titles of the RFIA on the federal regulation of digital assets: (1) securities laws, (2) commodities laws, and (3) tax laws. While we recognize the RFIA touches a broad array of federal statutes and has implications for a variety of federal agencies, we focus squarely on how the RFIA would change current regulation of digital assets in the foregoing three areas, and we offer observations as to how these new frameworks may bring new clarity for digital asset companies and practitioners for structuring new digital asset businesses.

New Framework for Regulation of Digital Assets under the Federal Securities Laws

Title III of the RFIA would provide the first comprehensive regulatory framework designed to ensure full and fair disclosure to the general public when digital assets are traded after their initial

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

offering, while treating as commodities the vast majority of digital assets that by their terms lack the basic elements of a "security." This framework retains the fundamental registration and disclosure requirements of the federal securities laws for a digital asset *offering* and imposes new periodic reporting requirements, all while providing companies with a readily identifiable "off-ramp" to exit registration and disclosure requirements.

The following section describes the evolution of Title III, the new regulatory framework and opportunities it may provide, and our observations on key practical implications of the new framework.

Current Regulation of Digital Assets under the Federal Securities Laws[2]

Digital assets such as cryptocurrency, tokens, and stablecoins have been widely used over the past decade to raise capital for innovative digital asset networks.[3] Equally important as the capital raising opportunities digital assets present, though, digital assets are fundamental to the operations of digital asset networks. Digital assets can function in numerous roles in this regard, from acting as currency for network users[4] to representing voting rights in the management of a network.[5]

To date, the SEC has developed what some observers have viewed as a piecemeal approach to regulating digital assets. For example, in 2017, the SEC announced in an investigative report (DAO Report) that a cryptocurrency is a security.[6] Since then, there have been a series of enforcement proceedings against digital asset issuers asserting that the digital assets being offered were securities and that the issuers failed to register their offer and sale.[7] The SEC Staff has issued informal guidance,[8] and Commissioners and Senior SEC Staff members have given speeches regarding whether cryptocurrencies and similar digital assets are securities.[9] The regulatory landscape for digital assets has evolved in response, but there continues to be legal uncertainty for companies seeking to raise money through the sale of digital assets (sometimes referred to as an initial coin offering or ICO).[10]

The SEC Staff also has suggested that while a digital asset may be viewed as a security in an initial capital raise, when a network becomes sufficiently "decentralized" (discussed below), a token can cease to be a security.[11] An important question remains, however, as to how a digital asset such as a virtual currency or token that begins as a security can subsequently be utilized in a network and traded freely, serving a utilitarian purpose in a way that allows the management and operation of the network to become "decentralized."

New Regulatory Framework

There have been a series of efforts by the SEC and Congress to provide additional regulatory certainty regarding the regulation of digital assets under the federal securities. For example, in 2020 SEC Commissioner Hester Peirce proposed a new regulatory framework to address challenges faced by entrepreneurs across the crypto landscape in their attempts to develop "worthwhile and beneficial" products.[12] Commissioner Peirce noted that whether one is issuing tokens to be used in a network, launching an exchange-traded product based on bitcoin, providing custody for crypto assets, operating a broker-dealer that handles crypto transactions, or setting up an alternative trading system where people can trade crypto assets for digital assets, regulatory challenges can stifle innovation.

Commissioner Peirce went on to note that many crypto entrepreneurs seek to build decentralized networks in which a token serves as a means of exchange on, or provides access to, a function of the network, and in the course of building out the network, these entrepreneurs need to get their tokens into the hands of other people. She observed that these efforts, though, are often hampered by concerns that such efforts might be perceived as an offer of unregistered securities that, particularly given the SEC's propensity to bring enforcement actions involving unregistered digital assets, could be disastrous.[13]

Additionally, there have been a series of bills introduced in Congress addressing various aspects of digital asset regulation.[14] Although none have presented regulatory solutions to all aspects of digital asset regulation, the RFIA draws on some of these legislative efforts to build a comprehensive regulatory solution for offerings of digital assets.

By building on these bills and some of the core concepts in Commissioner Peirce's proposal, Title III of the RFIA proposes a fresh new framework for companies considering issuing digital assets to support new digital platforms. In summary, this framework allows a company to raise capital by issuing digital assets, and so long as certain enumerated periodic disclosure requirements are satisfied, the digital asset will be treated as a commodity subject to regulation by the CFTC rather than the SEC. Such assets are treated under the RFIA as "ancillary assets."

Preservation of Registration and Disclosure Requirements under Federal Securities Laws

Importantly, while the RFIA establishes a presumption that a digital asset is a commodity subject to CFTC regulation if periodic disclosure requirements are satisfied, the RFIA does *not* purport to change fundamental registration requirements under Section 5 of the Securities Act for digital asset *offerings*.[15] The RFIA builds upon the longstanding principle that when an investor invests in a public offering with an expectation of profit through the "entrepreneurial or managerial efforts of others," an "investment contract" is formed between the digital asset issuer and the buyer. It is this investment contract that might constitute a security rather than the related digital asset that the SEC has historically viewed as the security.[16] Issuers and their counsel will remain tasked with evaluating the different options for registering a digital asset offering or relying on applicable registration exemptions.

Digital Assets No Longer Viewed As Securities

Beginning in 2017, the SEC has applied the *Howey* test in a series of cases alleging that companies conducted unregistered (and therefore, absent an exemption, illegal) securities offerings of digital assets. Importantly, these cases generally treated the *digital asset* being sold as the security.[17] As discussed above, the RFIA draws an important distinction between the *investment contract* that may be created between a digital asset issuer and asset purchasers, and the digital asset itself. This distinction is a key feature of the RFIA. The RFIA recognizes that even if buyers in digital asset offerings do in fact expect future profits to flow from the entrepreneurial and managerial efforts of the issuing company, most digital assets nonetheless do not incorporate the hallmarks of a security.

Under Title III, a digital asset would only be viewed as a security if it presents one or more of such hallmarks. The RFIA defines such hallmarks as including a debt or equity interest in the company, liquidation rights with respect to that entity, entitlement to an interest or dividend payment from the company, a profit or revenue share in the company derived from the entrepreneurial or managerial efforts of the entity, or any other specific financial interest in the company.[18] We believe that few "ancillary assets" will fall within one or more of these categories (and therefore be treated as a security) because very few of these assets provide the holder with financial rights in a separate "business entity." Instead, digital assets generally give the holder the right to purchase and sell that asset or use it in accordance with the platform protocol provided by the issuer of the asset, but do not represent a clear legal connection to an identifiable legal entity. Under this framework, where a digital asset is sold alongside an investment-like opportunity that helps to finance a crypto project, the token itself may be presumed to be a commodity while the offering of the asset would constitute a "security."

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

New Periodic Disclosure Requirements

The RFIA is intended to strengthen existing laws by requiring tailored disclosures relating to ancillary assets to provide investors with the information necessary to make informed financial decisions. Even though the ancillary assets themselves are presumed to be commodities under the RFIA and thus regulated by the CFTC, the periodic disclosure requirements that the RFIA imposes on issuers of ancillary assets are subject to the SEC's jurisdiction. These periodic disclosures must be filed with the SEC.[19]

To address information asymmetries that might exist between these persons and the company that issued the digital assets, the SEC Staff has to date focused on whether the management and further development of the platform to which a digital asset relates has become sufficiently "decentralized." Until this decentralization occurs, digital assets, according to the Staff, should be considered securities.[20] This construct, of course, raises a question not heretofore addressed by the SEC or federal courts: When does a platform protocol become "sufficiently decentralized"?

The RFIA, on the other hand, addresses potential information asymmetries and subjectivity concerns inherent in the "sufficient decentralization" test by imposing periodic disclosure obligations on companies that have issued digital assets in offerings through investment contracts. Required disclosures include information both as to the issuer itself and to the ancillary asset. As to the *issuer*, disclosure required includes not only basic corporate information but also includes some detail regarding the issuer's activities in support of the ancillary asset. As to the ancillary asset, disclosure required relates to the asset's design, use, offering and market considerations.

Periodic disclosure requirements are initially triggered if (1) the average daily aggregate value of all ancillary assets offered, sold or provided by the issuer is greater than $5 million for the 180-day period immediately succeeding the date of the first offer, sale or provision of the ancillary asset; and (2) the issuer has engaged in entrepreneurial or managerial efforts that primarily determine the value of the ancillary asset. Issuers will be subject to the periodic disclosure requirements for the one-year period beginning on the date that is 180 days after the first date on which ancillary assets were issued through an arrangement or scheme constituting an investment contract.

On an ongoing basis, periodic disclosure requirements are triggered for a given fiscal year if in the immediately preceding fiscal year of the issuer (or any portion thereof) the average daily aggregate value of all trading in a related ancillary asset in all spot markets open to the public in the United States was greater than $5,000,000 (the "trading volume test"), based on the knowledge of the issuer after due inquiry, and the issuer engaged in entrepreneurial or managerial efforts that primarily determined the value of the ancillary asset.

Constructing Exit Strategies

Finally, the RFIA provides a means for companies to exit from their disclosure requirements. Under the RFIA, the obligation to provide disclosure generally terminates on the date that is 90 days after the date on which the company files a required certification with the SEC that includes reasonable evidence, based on the knowledge of the issuer filing the certification, after due inquiry, that either (i) the trading volume test is not met in the 12-month period preceding the date on which the certification is filed, and (ii) during such 12-month period the company has not engaged in entrepreneurial or managerial efforts that primarily determine the value of the related digital asset.

Observations: By providing the first comprehensive framework for regulating digital assets, the RFIA will permit companies and practitioners to begin to conceptualize how one might plan and control each of the three phases of a digital asset capital raise. Of course, the RFIA likely will undergo major revisions before any final adoption. However, digital asset issuers and practitioners now have a conceptual roadmap to begin thinking about

how to determine respective responsibilities under the federal securities laws (and their counterpart the federal commodities laws), for developing and implementing a comprehensive, actionable plan for digital asset offerings.

- Phase 1—Capital raise through a public or private offering under the federal securities laws.
- Phase 2—Develop and implement periodic reporting procedures.
- Phase 3—Plan exit strategy with identifiable metrics known ahead of time.

Expanded CFTC Jurisdiction Over Digital Assets

The CFTC has asserted jurisdiction over digital asset transactions on several occasions, beginning with a CFTC settlement order with Coinflip, Inc. in 2015.[21] Jurisdiction was based on the CFTC's position that digital assets are "commodities" under the US Commodity Exchange Act, as amended (CEA).[22] The CFTC's position regarding its statutory authority over transactions involving digital assets has remained consistent in public statements made by former CFTC commissioners, a CFTC interpretation of the "actual delivery" exception to regulation of leveraged retail commodity transactions,[23] CFTC Staff guidance and enforcement actions in both administrative and civil cases.

Even though the CFTC has determined that certain digital assets are commodities, the CFTC's jurisdiction over these assets (as with all physical commodities) is limited to policing fraud and manipulative activities in interstate commerce. Beyond this type of enforcement authority, the CFTC does not generally oversee digital asset transactions or exchanges and cannot, for example, require a spot cryptocurrency exchange to register with the CFTC. However, despite the CFTC's lack of registration jurisdiction over spot markets, to the extent that a digital asset product in a spot market provides for margin or leverage and is offered to retail customers, the product generally would be considered a futures contract subject to CFTC jurisdiction.

Under Title IV of the RFIA, the expansive definition of "digital assets" is nestled directly into the CEA as an enumerated commodity. Doing so eliminates any ambiguity associated with the type or classification of a commodity under the CEA and resolves potentially conflicting assertions of jurisdiction between the SEC and the CFTC over transactions in digital assets.[24] The RFIA grants *exclusive* jurisdiction to the CFTC with respect to transactions in digital assets, including the newly created category of ancillary assets, subject to exclusions for (i) digital asset transactions offered to retail customers on a leveraged, financed, or margined basis that (a) settle within two business days, or (b) are executed on a registered digital asset exchange or with a registered futures commission merchant (FCM); and (ii) *non-fungible* digital assets and those that represent digital collectibles or other unique assets.

Implications for Non-Fungible Tokens

The grant of exclusive jurisdiction to the CFTC over *fungible* digital assets would seem to be a conspicuous effort to limit the CFTC's regulatory authority over non-fungible tokens (NFTs), which are most often associated with digital images, songs, videos, art and also can be used to give an NFT owner access to exclusive merchandise, tickets to live or digital events, or be linked to physical assets.[25] The gap created by this exclusion is likely to raise a number of issues for NFT creators. The RFIA does not elaborate on aspects of "fungibility," which means that many may be left to wonder how certain NFTs with a limited degree of fungibility might be characterized and regulated. This is especially problematic in cases where NFTs are "fractionalized," where multiple investors can purchase a subdivided portion of an NFT or a fraction of a large NFT collection. Where such an NFT generates income streams or conveys profit rights to owners, it may have the potential to meet the definition of an "investment contract" under the *Howey* test, which

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

would then qualify the asset as a security. Needless to say, many consumers and businesses may be under the misguided impression that an NFT they hold or produce complies with federal securities laws if additional guidance is not provided.

Digital Asset Exchanges

The RFIA creates a pathway for digital asset exchanges to register with the CFTC to conduct trading and clearing activities, providing the CFTC with authority to establish governing "core principles" but leaving room for the digital asset exchanges to exercise discretion in determining the manner in which it complies. Any such registered digital asset exchange would be limited to offering digital assets (including those on a margined, leveraged, or financed basis), which means that it would *not* be authorized to offer futures contracts, options, or swaps unless it is also registered as a designated contract market (DCM) or a swap execution facility (SEF) under the CEA. In contrast, registered DCMs and SEFs that satisfy the relevant requirements under the RFIA could elect to be considered a registered digital asset exchange through a deemed registration concept.

Unlike other regulatory categories for trading platforms, registration as a digital asset exchange would be voluntary, intimating that registration would come with certain regulatory benefits. Among those benefits, the ability to offer leveraged, margined, or financed transactions to retail customers would seem to be at the top of that list given the number of enforcement actions in this area.[26] Thus far, several existing digital asset exchanges have been forced to withdraw certain margined products from their listings in the United States (or have bypassed dealing in US markets altogether) in order to avoid registration as an FCM.[27] Uniquely, Title IV of the RFIA expressly permits digital asset exchanges to accept and hold customer assets directly (without an FCM) which would seem to address recent proposals by digital asset exchanges to offer "non-intermediated" or direct trading and clearing of margined products to retail customers.

Title IV of the RFIA also provides that a digital asset exchange must also register as a "money services business" with the Secretary of the Treasury's Financial Industry Crimes Enforcement Network (FinCen), which comes along with certain anti-money laundering (AML) and know your customer (KYC) requirements. The RFIA also establishes digital asset exchanges as "financial institutions" under the Bank Secrecy Act.

FCMs and Treatment of Customer Assets

Title IV of the RFIA also expands the ability of FCMs to provide services to digital asset customers. Accordingly, the RFIA defines a "digital asset customer" as a customer involved in a cash or spot, leveraged, margined, or financed digital asset transaction in which the FCM is acting as the counterparty. When read alongside the limitation under Title IV prohibiting an FCM from acting as a counterparty in any agreement, contract, or transaction involving a digital asset that has not been listed on a digital asset exchange, this will have commercial implications for those digital asset exchanges that choose not to register with the CFTC.

Requirements regarding the custody and segregation of customer funds would continue to apply, where FCMs have an explicit obligation to treat and deal with all money, assets, and property of any digital asset customer received as belonging to such customer. As such, FCMs would be prohibited from commingling customer assets with the assets of the FCM or another customer, although the RFIA provides for the ability of customers to opt out of these segregation and commingling protections by an affirmative written election to the FCM. The FCM would be subject to a general obligation to hold customer money, assets, and property in a manner that minimizes the customer's risk of loss of, or unreasonable delay in the access to, such money, assets, and property. Lastly, an FCM would be obligated to hold customer property with a licensed, chartered, or registered custodian subject to regulation by the CFTC, SEC, an appropriate state or federal banking agency,

or an appropriate foreign governmental authority in the home country of the custodian.

Observations. Additional regulatory guidance addressing "fungibility" of certain digital assets may be necessary as the rapid development of NFT offerings has created a wave of new (and sometimes fraudulent) entrants into the NFT ecosystem looking to cash in on these novel products.

Digital asset exchanges would appear to wield a fair amount of initial control over the regulation of digital assets through established core principles and the attendant power and authority to detect, investigate and enforce violation of these rules. There is no intermediate self-regulatory organization to help supervise compliance with the RFIA in the way that FINRA, for example, helps the SEC police securities exchanges. Will these new compliance requirements lead to the creation of a new digital asset self-regulatory organization (SRO)?

Demand for, and availability of, digital asset products for retail consumers may hinge on the number of registered digital asset exchanges in the market. Given the ability of digital asset exchanges to now hold customer property directly, what will this mean for the intermediated market and the potential for this construct to extend to other asset classes?

Taxation of Digital Assets

Title II of the RFIA addresses several pressing questions relating to the taxation of digital assets and their use. Four of Title II's most important provisions are discussed below together with our observations.

First, the RFIA addresses certain concerns raised by the arguably overbroad definition of "broker" added to the Internal Revenue Code by the Infrastructure Investment and Jobs Act enacted in 2021 (Infrastructure Act).[28] Under the definition contained in the Infrastructure Act, any person that regularly provided any service effectuating the transfer of digital assets on behalf of another person for consideration would be considered a broker. This broad definition could subject collateral digital asset industry players such as cryptocurrency "miners" or software developers to the broker information reporting requirements that are more appropriate for digital asset exchanges. Title II recognizes that cryptocurrency exchanges are better equipped to develop reporting procedures than such collateral non-exchange cryptocurrency players and limits the Infrastructure Act's definition of broker to persons who (for consideration) stand ready in the ordinary course of a trade or business to effect sales of digital assets at the direction of their customers. Importantly, the digital asset reporting requirement under the Infrastructure Act would have applied to transactions occurring during 2023, but the RFIA delays this reporting requirement. The new reporting requirement would first apply to transactions occurring during 2025.

Second, the RFIA provides that certain activities involving digital assets will be nontaxable. Section 201 of the RFIA provides such relief for ordinary retail transactions by providing for a *de minimis* exclusion of up to $200 per transaction from a taxpayer's gross income for use of virtual currency for payments for goods and services under specified conditions. Sections 205 and 208 provide relief for two other notable activities involving digital assets: (1) digital asset lending agreements, and (2) digital assets obtained from mining or staking activities. Digital assets used in a qualified lending transaction would avoid the recognition of gain or loss in a manner similar to how securities used in a qualified securities lending transaction are currently treated and income from mining and staking activities would not be recognized until the taxable year of the disposition of the assets produced or received in the mining or staking activity.

Third, the RFIA addresses the current uncertainty regarding how decentralized autonomous organizations (DAO) are treated for federal income tax purposes. Specifically, under the RFIA the default classification of a DAO will now be as a "business entity which is not a disregarded entity." To be considered a DAO, the organization must be, among other things, "properly incorporated or organized

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

under the laws of a State or foreign jurisdiction as a decentralized autonomous organization, cooperative, foundation or any similar entity."

Finally, the RFIA provides an exclusion from a foreign person being considered to be engaged in a US trade or business if that foreign person is trading in digital assets through a broker, commission agent, custodian, digital asset exchange, or other independent agent who is resident in the United States or is trading in digital assets for the person's own account. This provision is similar to the current law exclusions for securities and commodities trading and provides additional certainty with respect to foreign persons being subject to US federal income tax on their digital asset trading activity.

Observations. As noted, the RFIA provides much needed clarity to questions involving the taxation of digital assets and their use. Unfortunately, the RFIA does not contain express provisions clarifying the treatment of cryptocurrencies under the publicly traded partnership (PTP) rules, which is an important tax issue for ETFs and other funds that provide exposure to cryptocurrencies or futures contracts on cryptocurrencies. If cryptocurrencies and related futures contracts are deemed to create "qualifying income" under the PTP rules, these funds that would otherwise be treated as partnerships for federal income tax purposes will avoid double taxation as corporations. Currently, there is limited guidance on this issue, and while Title II does not expressly address the issue, the RFIA may provide additional comfort to funds and their counsel by classifying most digital assets as commodities subject to CFTC jurisdiction.

Additional guidance regarding the taxation and use of digital assets may be forthcoming as a result of studies and additional guidance mandated by Title II. First, Title II requires the Secretary of the Treasury to adopt guidance within one year regarding the federal income tax treatment of forks, airdrops and similar activities, merchant acceptance of digital assets as payments, digital asset mining and staking, payment stablecoins, and charitable contributions of digital assets greater than $5,000. Second, Title II requires the Comptroller General to study and provide a report regarding certain issues relating to retirement investing in digital assets.

What to Expect Going Forward

Moving forward, the RFIA likely will be used to frame the ongoing legislative and regulatory debate around digital assets within the United States. While the RFIA marks a significant step forward for the US Senate in outlining a legal framework for digital assets, the RFIA is unlikely to pass the Senate this year. In fact, several reports suggest that in a briefing with reporters before the RFIA was released, the staff of both Senator Lummis and Senator Gillibrand suggested that the RFIA likely would be advanced in piecemeal fashion through various committees in an effort to make it ready to pass the Senate sometime next year. That said, the lead sponsors of the RFIA sit on key committees with jurisdiction over its proposed provisions—Senator Lummis serves on the Senate Banking Committee that oversees the SEC and Senator Gillibrand sits on the Senate Agriculture Committee that oversees the CFTC—that may help its chances of moving quickly in the Senate. Then any final Senate legislation would need to be reconciled with a companion bill passed by the House of Representatives, if any. With this in mind, the digital asset community and interested participants should expect significant revisions to the RFIA as it meanders through the legislative process.

Mr. Arciniegas and **Mr. Conner** are Shareholders with Vedder Price. The authors would like to express their deep gratitude to Bruce Rosenblum, Dan Sherlock, Jeremy Senderowicz, Wayne Aaron, John Sanders, Mary Donohue and other Vedder Price colleagues who contributed to this article.

NOTES

1 As discussed below, RFIA includes a specific definition for "digital assets." From a practical standpoint,

the term "digital assets" includes virtual currencies such as bitcoin or ether, tokens and stablecoins offered in initial coin offerings (ICOs).

2 RFIA defines "digital assets" as a natively electronic asset that confers economic, proprietary, or access rights or powers, and is recorded using cryptographically secured distributed ledger technology or a similar analogue. The term includes virtual currency, tokens and stablecoins.

3 This article uses the term "network" to refer to cryptocurrency platforms and networks and other types of protocols that employ digital assets.

4 *See*, *e.g.,* Decentraland Foundation (*https://decentraland.org/*).

5 *See*, *e.g.*, Maker Foundation (*https://makerdao.com/en/*).

6 Report of Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934: the DAO, SEC Report, Release No. 81207(July 25, 2017).

7 *See* SEC v. Wahi, No. 2:22-cv-01009 (W.D. Wash. Jul. 21, 2022); SEC v. Ripple Labs, Inc. No. 1:20-cv-10832, Dkt. No. 331 at 13 (S.D.N.Y. Mar. 11, 2022).

8 *See, e.g.,* Framework for "Investment Contract" Analysis of Digital Assets, SEC Framework (Apr. 3, 2019).

9 Commissioner Hester M. Pierce, On the Spot: Remarks at "Regulatory Transparency Project Conference on Regulating the New Crypto Ecosystem: Necessary Regulation or Crippling Future Innovation" (June 14, 2022) (transcript available at *https://www.sec.gov/news/speech/peirce-remarks-regulatory-transparency-project-conference*); Director William Hinman, Digital Asset Transactions: When Howey Met Gary (Plastic) (June 14, 2018) (transcript available at *https://www.sec.gov/news/speech/speech-hinman-061418*).

10 The term "company" is used in this article to refer to any type of formal or informal entity formed for the purpose of issuing digital assets.

11 A platform becomes "decentralized" when there is no longer a core group of developers and managers to which network users look for profit and the network functions on its own. *See* Press Release, "SEC Charges Decentralized Finance Lender and Top Executives for Raising $30 Million Through Fraudulent Offerings" (Aug. 6, 2021), *https://www.sec.gov/news/press-release/2021-145.*

12 Commissioner Hester M. Pierce, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020) (transcript available at *https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06*).

13 Press Release, SEC, "SEC Charges Poloniex for Operating Unregistered Digital Asset Exchange" (Aug. 9, 2021), *https://www.sec.gov/news/press-release/2021-147*.

14 *See, e.g.*, Virtual Currency Tax Fairness Act of 2022 (H.R. 6582); Securities Clarity Act (H.R. 4451); Blockchain Regulatory Certainty Act (H.R. 5045); and Eliminate Barriers to Innovation Act of 2021 (H.R. 1602).

15 Framework for "Investment Contract" Analysis of Digital Assets, SEC Framework (Apr. 3, 2019).

16 The basis for this conclusion is a 1946 Supreme Court case, *Securities and Exchange Commission v. W.J. Howey Co.* The *Howey* case requires an analysis of the "economic realities" of such a transaction. Where there is an (i) investment of money. (ii) in a common enterprise, (iii) the purchaser has a reasonable expectation of profit, (iv) resulting primarily from the efforts of others, the offering will be characterized and treated as a securities transaction.

17 Framework for "Investment Contract" Analysis of Digital Assets, SEC Framework (Apr. 3, 2019).

18 Where a crypto token does grant its holder financial rights in a business, the token would also be viewed as a security.

19 As a technical matter, these periodic reports would be "furnished" rather than "filed," which imparts a lower level of liability under applicable federal securities laws.

20 According to a 2018 speech (Hinman Speech) given by William Hinman, the then-Director of the Division of Corporation Finance of the SEC, if the network on which the token or coin is to function is

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

sufficiently decentralized—where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts—the assets might not represent an investment contract. Moreover, when the efforts of the third-party manager or entrepreneur are no longer a key factor for determining an enterprise's success, all users will have the same access to information and information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes challenging and less meaningful.

[21] In the Matter of Coinflip, Inc., CFTC No. 15-29, Comm. Fut. L. Rep. (CCH) (Sept. 17, 2015).

[22] *Id.* at 77,855.

[23] *See* Retail Commodity Transactions Involving Certain Digital Assets, 85 *Fed. Reg*. 37,734 (June 24, 2020) (final interpretative guidance).

[24] The CEA makes distinctions based on the type or classification of a commodity. It refers in various provisions to securities, foreign currencies, non-financial commodities, agricultural commodities, excluded commodities, and exempt commodities, and includes definitions of the latter two classifications. Classification of digital assets as securities or non-securities is relevant, as the CEA and federal securities laws allocate jurisdiction over securities-related derivatives between (or jointly to) the CFTC and SEC (*e.g.*, an instrument can be a CFTC-regulated "swap," an SEC-regulated "security-based swap," or both, otherwise known as a "mixed swap").

[25] Non-fungible tokens (NFTs) are unique and non-interchangeable units of data that can signify ownership of associated digital items since each token typically has unique attributes. However, multiple NFTs could represent the same digital or physical item, although each NFT's data would be unique. Congressional Research Service Report on Non-Fungible Tokens, R47189 (*https://crsreports.congress.gov*).

[26] *https://www.cftc.gov/PressRoom/PressReleases/8433-21; https://www.cftc.gov/PressRoom/PressReleases/8450-21; https://www.cftc.gov/PressRoom/PressReleases/8434-21*.

[27] To the extent that a digital asset product in a spot market provides for margin or leverage and is offered to retail customers, the product would generally be considered a futures contract under the CEA, which limits the persons permitted to engage in such trading to certain CFTC registrants such as an FCM (among others).

[28] Public Law No. 117-58.

SEC Proposes Climate Disclosure Rules—Part 2

By Athena Eastwood, Archie Fallon, Elizabeth P. Gray, Robert B. Stebbins, William J. Stellmach, and William L. Thomas

On March 22, 2022, the Securities and Exchange Commission (SEC or Commission) voted 3-1 to propose rules requiring registrants to provide additional climate-related information in their registration statements and annual reports, including in their financial statements.[1]

Proposed Amendments

The Proposing Release sets forth proposed rules dealing with (1) Climate-Related Disclosure, (2) Climate-Related Impacts, (3) Governance, (4) Risk Management, and (5) Financial Statement Metrics, each of which was discussed in Part 1 of this article, which appeared in the August 2022 issue of *The Investment Lawyer*. This current installment discusses the following additional items set forth in the Proposing Release: (1) Green House Gas (GHG) Emissions; (2) Attestation of Scope 1 and Scope 2 Emissions Disclosures; and (3) Targets and Goals. In addition, this Part 2 discusses the dissenting statement by Commissioner Hester Peirce, certain important takeaways, and certain recent developments.

GHG Emissions

Disclosure Requirement

The proposed rules would require a registrant to disclose its GHG emissions for its most recently completed fiscal year, which rules are based on the concepts of scopes. Scopes are based on the concepts of direct and indirect emissions.[2] The proposed definitions of Scope 1, Scope 2 and Scope 3 are substantially similar to the definitions provided by the GHG Protocol.

The Proposing Release defines (1) Scope 1 emissions as direct GHG emissions from operations that are owned or controlled by the registrant; (2) Scope 2 emissions as indirect GHG emissions from the generation of purchased electricity, steam, heat, or cooling that is consumed by operations owned or controlled by the registrant; and (3) Scope 3 emissions as all indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream and downstream activities of a registrant's value chain. The proposed rules would require a registrant to disclose its total Scope 1 emissions and its total Scope 2 emissions (regardless of materiality) after calculating them from all sources that are included in the registrant's organizational and operational boundaries (as described below). A registrant would also be required to disclose separately its total Scope 3 emissions for the fiscal year if those emissions are material, or if it has set a GHG emissions reduction target or goal that includes its Scope 3 emissions.[3]

When assessing the materiality of Scope 3 emissions, registrants should consider whether Scope 3 emissions make up a relatively significant portion of their overall GHG emissions.[4] However, even when Scope 3 emissions do not represent a relatively significant portion of overall GHG emissions, a quantitative analysis alone would not be sufficient for purposes of determining whether Scope 3 emissions are material and a registrant would also need to consider qualitative factors. Accordingly, Scope 3 emissions may make up a relatively small portion of a registrant's GHG emissions but still be material where Scope 3 represents "a significant risk," Scope 3 is "subject to significant regulatory focus," or if there is a substantial likelihood that a reasonable investor

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

would consider it important in making an investment decision.[5] This is an extremely broad articulation of materiality.

For each scope of emissions, the proposed rules would require a registrant to disclose (1) the emissions disaggregated by each constituent GHG, and (2) GHG emissions data in the aggregate, excluding any offsets. The proposed rules would require a registrant to express each scope of its GHG emissions in terms of carbon dioxide equivalent (CO2e), which is the unit of measurement used by the GHG Protocol to indicate the global warming potential of each GHG.[6]

If required to disclose Scope 3 emissions, a registrant would need to identify the categories of upstream and downstream activities that have been included in the calculation of its Scope 3 emissions and describe the data sources used to calculate these emissions. If any upstream or downstream activities were significant to the registrant when it calculated its Scope 3 emissions, the proposed rules would require the registrant to identify such categories and separately disclose Scope 3 emissions data for each of those categories, together with a total of all Scope 3 emissions.[7]

The proposed rules would also require a registrant to disclose the sum of its Scopes 1 and 2 emissions as to GHG intensity. Also, if required to disclose Scope 3 emissions, a registrant would be required to separately disclose its Scope 3 emissions as to GHG intensity. The proposed rules would define "GHG intensity" to mean a ratio that expresses the metric tons of CO2e per unit of total revenues or per unit of production.[8]

The proposed rules would require disclosure to be provided for the registrant's most recently completed fiscal year and for the historical fiscal years included in the registrant's financial statements in the applicable filing, to the extent such historical GHG emissions data is reasonably available; provided that if the registrant is a smaller reporting company, only two years of Scope 1 and Scope 2 emissions metrics would be required.[9]

Methodology

As proposed, a registrant would be required to describe the methodology, significant inputs, and significant assumptions used to calculate its GHG emissions metrics. The description of the registrant's methodology would be required to include the registrant's organizational boundaries, operational boundaries, calculation approach, and any calculation tools used to calculate the registrant's GHG emissions. "Organizational boundaries" would mean the boundaries that determine the operations owned or controlled by a registrant for the purpose of calculating its GHG emissions. "Operational boundaries" would mean the boundaries that determine the direct and indirect emissions associated with the business operations owned or controlled by a registrant.[10]

A registrant's organizational boundaries determine the business operations owned or controlled by a registrant. The proposed rules require a registrant to set the organizational boundaries for its GHG emissions disclosure using the same set of accounting principles applicable to its consolidated financial statements.[11] Also, the scope of consolidation and reporting is required to be consistent for financial data and GHG emissions data, and a registrant would be required to apply existing GAAP when preparing its required GHG emissions disclosures.

Describing a registrant's operational boundaries involves identifying emissions sources within its plants, offices, and other operational facilities that fall within its organizational boundaries, and then categorizing the emissions as either direct or indirect emissions. The proposed rules would require a registrant to include its approach to categorizing its emissions and emissions sources when describing its methodology to determine its operational boundaries. For most registrants, purchased electricity would likely constitute a large percentage of their Scope 2 emissions.[12]

A registrant also needs to select a GHG emissions calculation approach. While direct measurement of GHG emissions is likely to yield the most accurate

calculations, given the expense of direct monitoring, the Proposing Release provides that an acceptable method for calculating emissions involves the application of published emission factors. Emission factors are ratios that typically relate GHG emissions to a proxy measure of activity at an emissions source.[13]

After a registrant has selected a calculation approach (that is, direct measurement or application of emissions factors), the registrant would determine what data needs be collected and how to conduct the relevant calculations, including whether to use any publicly available calculation tools.[14]

The following rules would also apply to the methodology for calculating GHG emissions: (1) a registrant may use reasonable estimates when disclosing such emissions as long it describes the assumptions underlying, and its reasons for using, the estimates; (2) a registrant is required to disclose, to the extent material, any use of third-party data when calculating its GHG emissions (including the source of the data), regardless of the particular scope of emissions; (3) a registrant is required to disclose any material change to the methodology or assumptions underlying its GHG emissions disclosure from the previous fiscal year; (4) a registrant is required to disclose, to the extent material and as applicable, any data gaps in connection with the calculation of its GHG emissions, and how it addressed these gaps and how this has affected the accuracy or completeness of its disclosure; (5) when determining whether its Scope 3 emissions are material, and when disclosing those emissions, in addition to emissions from activities in its value chain, a registrant must include GHG emissions from outsourced activities that it previously conducted as part of its own operations; (6) if a registrant is required to disclose Scope 3 emissions, and if there was any significant overlap in the categories of activities producing the Scope 3 emissions, the registrant must describe the overlap, how it accounted for the overlap, and its disclosed total Scope 3 emissions; and (7) a registrant may present its estimated Scope 3 emissions in the form of a range, so long as it discloses its reasons for using the range and the underlying assumptions.[15]

Scope 3 Safe Harbor

The Proposing Release sets forth the following accommodations for Scope 3 emissions disclosure: (i) a safe harbor for Scope 3 emissions disclosure from certain forms of liability under the Federal securities laws, (ii) an exemption for smaller reporting companies from the Scope 3 emissions disclosure requirements, and (iii) a delayed compliance date for Scope 3 emissions disclosure. As to the safe harbor, disclosure of Scope 3 emissions by a registrant would not be deemed to be a fraudulent statement, unless it is shown that such statement was made without a reasonable basis or was disclosed other than in good faith. As to the compliance date, all registrants would have an additional year to comply initially with the Scope 3 emissions disclosure requirement beyond the compliance date for the other proposed rules.[16] The Proposing Release also notes that Securities Act Rule 409 and Exchange Act Rule 12b-21, which provide accommodations for information that is unknown and not reasonably available, would be available for the proposed Scope 3 emissions disclosures.

Attestation of Scope 1 and Scope 2 Emissions Disclosure

The proposed rules would require a registrant that is an accelerated filer or large accelerated filer to include in the relevant filing an attestation report covering the disclosure of its Scope 1 and Scope 2 emissions.[17] The attestation engagement must, at a minimum, be at the "limited assurance" level as to the required GHG emissions disclosure for fiscal years two and three after the disclosure compliance date and at the "reasonable assurance" level for fiscal years four and beyond.[18]

The proposed rules also set forth minimum qualifications and independence requirements for the attestation service providers. A GHG emissions attestation provider is defined as a person or firm that (1) is an expert in GHG emissions by virtue

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

of having significant experience in measuring, analyzing, reporting, or attesting to GHG emissions, and (2) is independent (based on factors similar to those used to determine whether an accountant is independent) with respect to a registrant and its affiliates.[19] The attestation provider would be subject to liability under the federal securities laws for the attestation conclusion.

The proposed rules also set forth certain requirements for the attestation report, which report is to be included in the separately captioned "Climate-Related Disclosure" section in the relevant filing.[20]

Each registrant, other than a large accelerated filer or accelerated filer that is required to include a GHG emissions attestation report in its filings, must include certain information in its filings if such registrant's GHG emissions disclosures were subject to third-party attestation or verification, including the name of the service provider, the level or scope of assurance or verification, and the results of the assurance or verification.[21]

Targets and Goals

If a registrant has set any climate-related targets or goals, then the proposed rules would require the registrant to provide certain information about those targets or goals, including a description of (if applicable): (1) the scope of activities and emissions included in the target; (2) the unit of measurement; (3) the time horizon by which the target is intended to be achieved, and whether the time horizon is consistent with one or more goals established by a climate-related treaty, law, regulation, policy, or organization; (4) the defined baseline time period and baseline emissions against which progress will be tracked with a consistent base year set for multiple targets; (5) any interim targets; and (6) how the registrant intends to meet its climate-related targets or goals.[22]

If a registrant has used carbon offsets or renewable energy certificates (RECs) in its plan to achieve climate-related targets or goals, it would be required to disclose (1) the amount of carbon reduction represented by the offsets or the amount of generated renewable energy represented by the RECs, (2) the source of the offsets or RECs, (3) a description and location of the underlying projects, (4) any registries or other authentication of the offsets or RECs, and (5) the cost of the offsets or RECs.[23]

Miscellaneous

Compliance Date

Assuming the proposed rules are adopted with an effective date in December 2022 and that the registrant has a December 31 fiscal year-end, (1) the compliance date for a large accelerated filer for all proposed disclosure (other than Scope 3) is fiscal year 2023 (filed in 2024) and the compliance date for Scope 3 is fiscal year 2024 (filed in 2025), (2) the compliance date for an accelerated filer for all proposed disclosure (other than Scope 3) is fiscal year 2024 (filed in 2025) and the compliance date for Scope 3 is fiscal year 2025 (filed in 2026), and (3) the compliance date for a smaller reporting company for all proposed disclosures (other than Scope 3) is fiscal year 2025 (filed in 2026) and the smaller reporting company would be exempted from Scope 3 reporting.[24]

The proposed compliance dates above would apply to both annual reports and registration statements.

Inline XBRL

The proposed rules would require registrants to tag the proposed climate-related disclosures in a structured, machine-readable data language.[25]

Comments

The comment period for the proposed rules was originally scheduled to close on May 20, 2022 but was subsequently extended to June 17, 2022. The Proposing Release contains 201 specific requests for comments, and the SEC received over 14,000 letters commenting on the proposed rules.

Dissenting Statement

Commissioner Hester Peirce issued a long statement in dissent.[26] Her main arguments are that:

- Public companies are already required to disclose material client risks by existing SEC rules.
- The proposed materiality analysis for Scope 3 disclosures departs from the "reasonable investor" standard set forth by the Supreme Court.
- The justification for the SEC's disclosure mandate provided at page 9 of the Proposing Release ("we understand investors often employ diversified strategies, and therefore do not necessarily consider risk and return of a particular security in isolation but also in terms of the security's effect on the portfolio as a whole, which requires comparable data across registrants") departs from the SEC's traditional company-specific approach to disclosure and suggests it is appropriate for shareholders of the disclosing company to subsidize other investors' portfolio analysis.
- The proposal exceeds the SEC's statutory limits by using the disclosure rules to achieve objectives that are outside of the SEC's statutory mission (protecting investors, facilitating capital formation and fostering fair, orderly and efficient markets) and by pursuing those objectives by disclosure mandates that may violate First Amendment limitations on compelled speech.
- The economic analysis underestimates the cost of the proposal, including the costs of the Scope 3 disclosure framework, compliance with the attestation requirements, and audit costs.
- The proposal will not lead to comparable, consistent and reliable disclosure because the underlying data (including data obtained from suppliers, customers and employees) is unlikely to be reliable.
- The proposal will hurt investors, the economy, and the SEC by pushing capital allocation toward politically and socially favored ends, especially when the SEC has no expertise in capital allocation or the applicable science.[27]

Takeaways

While there almost certainly will be litigation over the proposed rules (see Commissioner Peirce's dissent as to the SEC exceeding its statutory limits and acting outside its area of expertise), registrants nevertheless need to begin preparing to comply with the proposed rules. This will involve, among other things, setting up internal reporting systems, reviewing their risk management practices as to climate-related disclosures and climate risk assessment, reviewing disclosures in current public filings as per the proposed requirements, possibly hiring additional staff, reviewing board practices and the backgrounds of board members as per the disclosure requirements in the Proposing Release and amending governance documents accordingly, briefing the board on the contents of the Proposing Release, working with outside auditors in preparation for the new financial statement requirements, and beginning the process of obtaining an attestation provider.

There has been significant pushback by companies as to the inclusion of the Scope 3 requirements; if these requirements are still included in the adopting release, thousands of private entities that do business with registrants will need to set up reporting systems that will allow such entities to provide information to registrants as to their GHG emissions, and registrants will need to start working with these private entities so that such entities can become prepared to provide this information.

The proposed rules are extremely detailed and complex, and compliance will require a great deal of money, time and effort from registrants. The Proposing Release estimates $640,000 of increased compliance costs in year one for a large company resulting from the proposed rules, excluding third-party assurance costs; we would not be surprised if the actual number was much higher.

Scope 1 and Scope 2 disclosures are required without regard to materiality. The language in the Proposing Release as to determining materiality for purposes of Scope 3 disclosures will make it far

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

from easy to conclude that these disclosures are not material.

Companies that already compile and disclose information on climate risk and related performance will need to align and, in some cases, significantly refine such efforts to ensure compliance with the proposed rules.

Companies will be subject to increased litigation risk with respect to their climate disclosures. Companies should use forward-looking statement legends with respect to these disclosures.

The disclosure requirements around targets and goals and the increased possibility of litigation may serve to greatly reduce the number of companies publishing such targets and goals in the future.

The rules can be expected to drive corporate behavior through the required disclosures. As the SEC lacks expertise in environmental standard setting, it relied on the Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol in drafting the Proposing Release. Based on this, the likely ensuing litigation could have negative ramification for the doctrine of "Chevron deference" for Federal administrative agencies, as certain members of the Supreme Court have already expressed serious discomfort with the doctrine.

Recent Developments

On June 23, 2022, the Supreme Court issued its opinion in *West Virginia et al. v. Environmental Protection Agency et al.*[28] In this 6-3 decision, the Supreme Court struck down the Clean Power Plan rule promulgated by the Environmental Protection Agency (EPA) in 2015, which rule addressed carbon dioxide emissions from existing coal- and natural-gas-fired power plants.[29] For authority, the EPA cited Section 111(d) of the Clean Air Act, which had previously been only used by the EPA a handful of times since its enactment in 1970. The Supreme Court found that Congress did not grant the EPA in Section 111(d) the authority to devise emissions caps based on the approach the EPA took in the Clean Power Plan.[30]

The Supreme Court noted that there are extraordinary cases, such as the case at hand, in which the history and breadth of the authority asserted, and the economic and political significance of such assertion, require an agency to point to clear congressional authorization for the authority it claims. This is known as the major questions doctrine.[31]

The Supreme Court found that the EPA claimed to discover an unheralded power representing a transformative expansion of its authority in the "vague language of a long-extant, but rarely used, statute designed as a gap filler."[32] This allowed the EPA to adopt a regulatory program that Congress had declined to enact. Given these circumstances, the Supreme Court held that there is every reason to hesitate before concluding that Congress intended to confer on the EPA the authority it claims under Section 111(d) of the Clean Air Act. Thus, the EPA was required to point to clear congressional authorization for its regulatory program, which it failed to do.[33]

In the dissent, Justice Kagan takes issues with the majority's view of Section 111(d) as an "ancillary provision."[34] Justice Kagan also takes issue with the caselaw the majority claims supports the majority questions doctrine; she instead found that the relevant decisions do normal statutory interpretation and using that method, struck down agency actions for two principal reasons. First, when an agency was operating far outside its traditional lane so that it had no viable claim of expertise or experience and second, when the action, if allowed, would have conflicted with Congress's broader design, which she found was not the case here.[35] Justice Kagan thus concluded that the Supreme Court was substituting its own ideas about policymaking for Congress's and that the Supreme Court, rather than Congress, is deciding how much regulation is too much.[36]

This case could have major implications for the SEC's proposed climate disclosure rules. The major questions doctrine will likely be used to challenge these proposed rules, and under such doctrine the SEC would be required to point to clear

congressional authorization to enact the proposed rules. In addition, the proposed rules may also be attacked under the test set forth in Justice Kagan's dissent, by a claim that the SEC is operating outside its traditional lane where it has no viable experience. In response, the Commission will argue that the proposed rules relate to disclosures, and regulation of disclosure is well within its area of expertise.

Ms. Eastwood is a partner in the Corporate & Financial Services Department at Willkie Farr & Gallagher LLP in Washington, DC. **Mr. Fallon** is a partner in Willkie Farr & Gallagher LLP's Corporate & Financial Services Department and Co-Chair of the firm's Power & Renewable Energy, Environmental, Social & Governance and Project Finance practice groups in Houston, TX. **Ms. Gray** is a partner in the Litigation Department and Co-Chair of the Securities Enforcement Practice Group in Washington, DC. **Mr. Stebbins** is a partner in the Corporate & Financial Services Department and Co-Chair of Willkie Farr & Gallagher LLP's Corporate Governance practice in New York, NY. **Mr. Stellmach** is a Litigation partner and Co-Chair of Willkie Farr & Gallagher LLP's global White-Collar Defense Group in Washington, DC. **Mr. Thomas** is counsel and head of the Willkie Farr & Gallagher LLP's Environment, Health & Safety Practice in Washington, DC.

NOTES

1 *See The Enhancement and Standardization of Climate-Related Disclosures for Investors* (Mar. 22, 2022) (the Proposing Release).

2 *Id.* at p. 153.

3 *Id.* at pp. 156-157.

4 The Proposing Release provides that no quantitative materiality threshold is being proposed but does make reference to a threshold of 40 percent used by some companies. *Id.* at p. 173.

5 *Id.* at p. 173.

6 *Id.* at pp. 158-159.

7 *Id.* at pp. 178-180.

8 *Id.* at p. 187.

9 *Id.* at pp. 191-192.

10 *Id.* at p. 193.

11 *Id.* at pp. 194-195.

12 *Id.* at pp. 198-199.

13 *Id.* at p. 200.

14 *Id.* at pp. 201-204.

15 *Id.* at pp. 206-210.

16 *Id.* at pp. 218-222.

17 The SEC notes in the Proposing Release that its rules typically do not require registrants to obtain assurance over disclosure provided outside of the financial statements. *Id.* at p. 229.

18 *Id.* at p. 224.

19 *Id.* at pp. 257-267.

20 *Id.* at pp. 248-249.

21 *Id.* at pp. 273-274.

22 *Id.* at pp. 276-278. A registrant would be required to update the disclosure in clause (6) each fiscal year by describing the actions taken during the year to achieve its targets or goal. *Id.* at p. 280.

23 *Id.* at p. 281.

24 *Id.* at p. 300.

25 *Id.* at p. 293.

26 *See* We are Not the Securities and Environmental Commission—At Least Not Yet, Commissioner Hester M. Peirce (Mar. 21, 2022).

27 *Id.* at pp. 2-9.

28 West Virginia *et al.* v. Environmental Protection Agency *et al.*, 597 U.S. __ (2022).

29 *Id.* at pp. 1-6.

30 *Id.* at p. 4.

31 *Id.* at pp. 4-5.

32 *Id.* at pp. 4-5.

33 West Virginia *et al.* v. Environmental Protection Agency *et al.*, 597 U.S. __ (2022) (Kagan, E. dissenting).

34 *Id.* at pp. 2-9.

35 *Id.* at p. 13

36 *Id.* at p. 32.

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

REGULATORY MONITOR

SEC Update

By Gary O. Cohen

SEC Settles Enforcement Action Against ESG Fund Adviser

The US Securities and Exchange Commission (SEC) has settled[1] an enforcement action against Bank of New York—Mellon Investment Adviser (Mellon), an investment adviser to mutual funds with an environment, social, and governance profile (Mellon Funds). This seems to be the first such SEC action in many years.[2]

The SEC charged Mellon with using "material misstatements and omissions . . . concerning the consideration of Environmental, Social, and Governance (ESG) principles to make investment decisions for certain mutual funds [it] advised."[3]

More specifically, the SEC found that Mellon had represented or implied, through fund prospectuses and statements to Mellon Fund boards of directors, that it "implemented ESG principles by conducting proprietary ESG quality reviews as part of the [affiliated] Sub-Adviser's investment research process for all investments made by the [Mellon] Funds."[4] However, the SEC found that the Mellon Funds "made investments that had not always received ESG quality reviews."[5] Therefore, the SEC concluded that the Mellon Fund "prospectuses, prepared and filed by [Mellon] . . . made . . . representations [that] were incomplete because they did not also state that the Sub-Adviser could and did select portfolio investments that were not necessarily subject to that aspect of the research process."[6]

The SEC also found that Mellon "failed to adopt and implement policies and procedures reasonably designed to prevent the inclusion of untrue statements of fact in prospectuses or the inclusion of misleading statements . . . to the [Mellon] Funds' boards."[7]

The SEC determined[8] that Mellon violated:

- Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act), which prohibits an investment adviser, directly or indirectly, from engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client";
- Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which provides in relevant part that it is unlawful for an investment adviser to a pooled investment vehicle to make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle;
- Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require investment advisers registered with the SEC to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder; and
- Section 34(b) of the Investment Company Act of 1940 (1940 Act), which makes it unlawful for any person to make any untrue statement of a material fact in any registration statement, or other document filed or transmitted pursuant to that Act, or for any person so filing or transmitting to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

Mellon, without admitting or denying the SEC's findings, agreed[9] to a cease-and-desist order and a censure and to pay a $1.5 million penalty.

Say What You Do; Do What You Say

The SEC's enforcement action against Mellon bears out what SEC personnel have been urging the mutual fund industry to do for some time: "say what you do and do what you say."[10] Here, the fund adviser did not do what it said it would do.

Commissioner Hester Peirce, who has often dissented from Commission actions, did not dissent from the settlement of this enforcement action. Indeed, she issued a statement declaring that the "concern [about advisers saying one thing and doing another] is real because advisers can mint money by calling their products and services 'green' without doing anything special to justify that label."[11]

SEC Proposes Rules

The SEC announced the settlement of the Mellon enforcement action just a couple of days before proposing two rules[12] that would impose ESG regulation. So, the SEC timed the announcement of the settlement as an introduction to, and tacit justification of, the proposals.

Commissioner Peirce has not been enthusiastic about the SEC's proposed ESG disclosure and name rules. She said that

> while enforcement proceedings of this sort illustrate the problem, they also show that we already have a solution when we see advisers that do not accurately characterize their ESG practices, we can enforce the laws and rules that already apply. A new rule to address greenwashing, therefore, should not be a high priority.[13]

SEC Task Force

The SEC's enforcement action against Mellon was spearheaded by an office in the SEC's Division of Enforcement titled the "Climate and ESG Task Force" (Task Force).[14] The Task Force was formed in March 2021 and "analyzes disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[15] The Task Force is headed by the SEC Staff person who is Deputy Director of the Enforcement Division.[16]

The SEC dedicates a page[17] on its website to describing the Task Force. The page lists 13 examples of SEC enforcement actions related to ESG issues or statements beginning in 2008.

SEC watchers may question whether 13 enforcement actions over 14 years justify a special task force with such a high-ranking official as the Deputy Director of the Division of Enforcement. However, the Task Force may be currently working on a number of cases that will be made public in the near future.[18]

SEC Precedent

The SEC lists[19] its first enforcement action related to ESG issues as being against Pax World Management Corp. (Pax World) in 2008. The Pax World enforcement action is similar to the Mellon enforcement action.

According to the SEC,[20] Pax World represented to investors and to the boards of directors of the mutual funds (Pax Funds) it advised that it complied with various "socially responsible investing" (SRI) restrictions. These restrictions included, among others, that it would not purchase for the Pax Funds securities issued by companies that derived revenue from the manufacture of weapons, alcohol, tobacco or gambling products.

The SEC charged[21] that Pax World acted contrary to these representations and violated the Pax Funds' SRI restrictions for a multi-year period when Pax World purchased ten securities that the restrictions prohibited it from buying. The prohibited securities included securities of companies that: (1) derived revenue from the manufacture of alcohol and/or gambling products; (2) derived more than 5 percent of their revenue from contracts with the US Department of Defense; and (3) failed to satisfy the Pax Funds' environmental or labor standards.

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

The SEC also charged[22] that Pax World failed to consistently follow its own SRI-related policies and procedures regarding the Pax Funds. The policies and procedures required all securities to be screened by Pax World's Social Research Department prior to purchase to ensure compliance with the SRI disclosures. The SEC further charged[23] that Pax World did not consistently adhere to other SRI-related policies and procedures, including continuously monitoring Pax Funds' holdings.

The SEC determined[24] that Pax World violated:

- Section 206(2) of the Advisers Act in that it engaged in transactions, practices or courses of business that operated or would operate as a fraud or deceit upon clients or prospective clients;
- Section 13(a)(3) of the 1940 Act by the Pax World Funds in that it caused the Funds' deviation from the Funds' SRI investment policy that was changeable only if authorized by shareholder vote and their deviation from policies recited in their respective registration statements pursuant to Section 8(b)(3) of the 1940 Act; and
- Section 34(b) of the 1940 Act in that it made untrue statements of material fact in a registration statement, application, report, account, record, or other document filed or transmitted pursuant to that Act, or omitted to state therein, any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

Pax World, without admitting or denying the SEC's findings, agreed[25] to a cease-and-desist order and a censure and to pay a $500,000 penalty.

Compliance and Director Oversight

The SEC did not fault either Mellon's or the Mellon Funds' compliance personnel or the Mellon Funds directors.

The SEC stated that Mellon "lacked written policies and procedures reasonably designed to prevent inaccurate or materially incomplete statements in prospectuses . . . or to the [Mellon] Funds' boards about the Sub-Adviser's use of ESG quality reviews when selecting investments for [the Mellon] Funds" and that Mellon's "compliance personnel were unaware . . . that quality reviews were not prepared for all [Mellon] Fund investments, and thus lacked pertinent facts when determining whether [Mellon's] prospectuses . . . complied with federal securities laws."[26]

Conclusion

The SEC, after extended jawboning, has taken enforcement action against what it deemed to be a bad actor in the ESG space. There are indications that the SEC is working on additional enforcement actions in the ESG space.

Mr. Cohen is of counsel at Carlton Fields, P.A., in Washington, DC. Mr. Cohen spent five years on the Staff of the SEC's IM Division, ultimately serving as assistant chief counsel, and has dealt with the Division as a private practitioner for more than 50 years. Mr. Cohen has served on *The Investment Lawyer*'s Editorial Board since the outset of the publication and has published numerous articles in this publication over many years. He thanks his colleague Robert B. Shapiro and his firm's librarian, Nicole Warren, for reviewing and contributing to this article. The views expressed are those of Mr. Cohen and do not necessarily reflect the views of his firm, its lawyers or its clients.

NOTES

1 *BNY Mellon Investment Adviser, Inc.,* Investment Advisers Act Release No. 6032, Investment Company Act Release No. 34591 (May 23, 2022) [hereinafter SEC Mellon Order], available at *https://www.sec.gov/litigation/admin/2022/ia-6032.pdf*. The SEC

announced the SEC Mellon Order in Press Release, SEC, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022) [hereinafter SEC Mellon Press Release], available at *https://www.sec.gov/news/press-release/2022-86.*

2 The SEC lists 13 "Examples of Enforcement Actions Related to ESG Issues or Statements" dating back to 2018 on its website. Spotlight on Enforcement Task Force Focused on Climate and ESG Issues [hereinafter Spotlight on SEC Task Force], available at *https://www.sec.gov/spotlight/enforcement-task-force-focused-climate-esg-issues*. One of the examples is the settlement of an enforcement action, similar to the SEC Mellon Order, *supra* n.1, against a "socially responsible" fund adviser. *Pax World Management Corp.*, Investment Advisers Act Release No. 2761, Investment Company Act Release No. 28344 (July 30, 2008) [hereinafter Pax World Order], available at *https://www.sec.gov/litigation/admin/2008/ia-2761.pdf.,* discussed *infra* nn.20-25 and accompanying text. Compare Thomas Cain and Katherine McCurry, Kilpatrick Townsend & Stockton LLP, "SEC Settles First Major Enforcement Action Related to ESG Investment Disclosures," available at *https://www.jdsupra.com/legalnews/sec-settles-first-major-enforcement-2937244/.*

3 SEC Mellon Order, *supra* n.1, at 2.

4 *Id*. at 2. The SEC specified other aspects of Mellon's "material misstatements and omissions" that this article does not summarize relating, for example, to other mutual funds that Mellon advised and to investment firms interested in making investments in the Mellon Funds for their clients.

5 *Id.* The SEC provided the following specifics:

> Numerous equity and/or corporate bond investments held by certain [Mellon] Funds did not have an ESG quality review score as of the time of investment. For example, out of 185 investments made by one [Mellon] Fund between January 1, 2019 and March 31, 2021, 67 did not have an ESG quality review score as of the time of investment (or, in the case of corporate bonds, within 30 days after purchase, consistent with the Sub-Adviser's policy), amounting to nearly 25 percent of the fund's net assets as of March 31, 2021. *Id*. at 4.

6 *Id*. at 3.

7 *Id.* at 6.

8 *Id.* at 6-7.

9 *Id.* at 7.

10 Staff members of the SEC's Division of Investment Management have so stated in oral remarks at legal conferences sponsored by the Investment Company Institute and Independent Directors Council. *See*, Hestor P. Peirce, Commissioner, SEC, Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies (May 25, 2022) ("we settled an enforcement proceeding in which we alleged that an adviser said one thing about ESG and did another") (footnote omitted) [hereinaftert Peirce Statement], available at *https://www.sec.gov/news/statement/peirce-statement-esg-052522#_ftn2*; Caroline A. Crenshaw, Commissioner, SEC, Virtual Remarks at the Center for American Progress and Sierra Club: Down the Rabbit Hole of Climate Pledges (Dec. 14, 2021) ("metrics calculated using reliable and comparable methodologies that enable investors to decide whether the companies mean what they say"), available at *https://www.sec.gov/news/speech/crenshaw-cap-sierra-club-20211214*; Linda Chatman Thomsen, Director of Division of Enforcement, SEC, quoted in Press Release, SEC, SEC Charges Mutual Fund Manager for Violating Socially Responsible Investing Restrictions (July 30, 2008) ("Advisers simply cannot tell investors they are going to do one thing with their funds and then not follow through on those promises"), available at *https://www.sec.gov/news/press/2008/2008-157.htm.*

11 Peirce Statement, *supra* n.10, first paragraph.

12 *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, Investment Advisers Act Release No. 6034, Investment Company Act Release No. 34594 (May 25, 2022) (proposing to

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

amend rules and forms under both the Advisers Act and 1940 Act to "require registered investment advisers . . . registered investment companies [and others] to provide additional information regarding their environmental, social, and governance (ESG) investment practices), available at *https://www.sec.gov/rules/proposed/2022/ia-6034.pdf,* and *Investment Company Names*, Investment Company Act Release No. 34593 (May 25, 2022) (proposing to amend Rule 35d-1 under the 1940 Act that "addresses certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks"), available at *https://www.sec.gov/rules/proposed/2022/ic-34593.pdf*. The SEC described the proposed disclosure requirements as follows:

> The proposed amendments seek to categorize certain types of ESG strategies broadly and require funds and advisers to provide more specific disclosures in fund prospectuses, annual reports, and adviser brochures based on the ESG strategies they pursue. Funds focused on the consideration of environmental factors generally would be required to disclose the greenhouse gas emissions associated with their portfolio investments. Funds claiming to achieve a specific ESG impact would be required to describe the specific impact(s) they seek to achieve and summarize their progress on achieving those impacts. Funds that use proxy voting or other engagement with issuers as a significant means of implementing their ESG strategy would be required to disclose information regarding their voting of proxies on particular ESG-related voting matters and information concerning their ESG engagement meetings.

Press Release, SEC, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices (May 25, 2022) [hereinafter SEC Press Release on Proposed Disclosure Requirements], available at *https://www.sec.gov/news/press-release/2022-92*. The SEC described the proposed name requirements as follows:

> The Names Rule currently requires registered investment companies whose names suggest a focus in a particular type of investment (among other areas) to adopt a policy to invest at least 80 percent of the value of their assets in those investments (80 percent investment policy). The proposed amendments would enhance the rule's protections by requiring more funds to adopt an 80 percent investment policy. Specifically, the proposed amendments would extend the requirement to any fund name with terms suggesting that the fund focuses in investments that have (or whose issuers have) particular characteristics. This would include fund names with terms such as "growth" or "value" or terms indicating that the fund's investment decisions incorporate one or more environmental, social, or governance factors. The amendments also would limit temporary departures from the 80 percent investment requirement and clarify the rule's treatment of derivative investments.

Press Release, SEC, SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names (May 25, 2022), available at *https://www.sec.gov/news/press-release/2022-91*.

13 Peirce Statement, *supra* n.10, first paragraph (footnote omitted).

14 SEC Mellon Press Release, *supra* n.1.

15 Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (March 4, 2021), available at *https://www.sec.gov/news/press-release/2021-4.*

16 *See,* SEC Press Release on Proposed Disclosure Requirements, *supra* n.12, and Spotlight on SEC Task Force, *supra* n.2.

17 Spotlight on SEC Task Force, *supra* n.2., stating:

> The Climate and ESG Task Force is coordinating the effective use of Division resources, including through the use of sophisticated

data analysis to mine and assess information across registrants, to identify potential violations including material gaps or misstatements in issuers' disclosure of climate risks under existing rules, and disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

18 This article speaks as of July 8, 2022.

19 Spotlight on SEC Task Force, *supra* n.2.

20 SEC Pax World Order, *supra* n.2, at 2.

21 *Id.*

22 *Id.*

23 *Id.*

24 *Id*. at 7-8.

25 *Id.* at 8-9.

26 SEC Mellon Order, *supra* n.1, at 6.

Copyright © 2022 by CCH Incorporated. All Rights Reserved.

October/10041525-0700