

MEMO# 35889

October 22, 2024

SEC Charges Investment Adviser with Failing to Adhere to Its Own Investment Criteria For ESG-Marketed Funds

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TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
ESG Advisory Group
SEC Rules Committee SUBJECTS: Compliance
Disclosure
ESG
Litigation & Enforcement RE: SEC Charges Investment Adviser with Failing to Adhere to Its Own Investment Criteria For ESG-Marketed Funds

On October 21, 2024, the SEC instituted public administrative and cease-and-desist proceedings against an asset manager arising from statements made regarding three exchange-traded funds (the "ESG Funds") that it marketed as incorporating environmental, social, and governance ("ESG") factors.[\[1\]](#) To settle the charges, the asset manager has agreed to pay a penalty of \$4 million.

The SEC's order found that from March 2020 until November 2022, the asset manager "misstated" to the ESG Funds' board of trustees ("Board") and investors that the ESG Funds would not invest in companies that were "involved in certain controversial products or activities," including fossil fuels and tobacco. Instead, the order noted that "the ESG Funds invested in the securities of companies ... that were involved in such activities, including coal mining and the transportation of coal, natural gas extraction and distribution, and the retail sale of tobacco products." The order found that the asset manager "represented to the Board that the model it was developing would have the capability to screen out the securities of companies that had 'any involvement' in fossil fuels and tobacco" and that the ESG Fund's registration statement stated that the asset manager's model "excluded the securities of such companies." However, the order alleges that the asset manager "was aware ... that its investment process was ... not removing all securities of companies involved in fossil fuels," and that the model "also failed to exclude all securities of companies involved in tobacco-related activity."

The order found that the asset manager "did not adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act in connection with the investment process for the ESG Funds, including concerning the manner in which [the] model excluded the securities of certain companies from the portfolios of the ESG Funds as described in its statements to the Board and the ESG Funds' disclosures."

Representations to the Board and Prospectus Disclosures for the ESG Funds

According to the order, in discussions with the Board the asset manager stated that, as part of the investment process, "[s]ecurities of companies involved in certain controversial products or activities," such as fossil fuels and tobacco, would be "excluded." The order stated that "[n]either during any of these presentations to the Board nor in any other Board meetings did [asset manager] describe any limitations on its ability to conduct this exclusionary screening or otherwise describe its interpretation of terms such as 'fossil fuels' or 'tobacco.'"

The SEC's order noted that the prospectuses for the ESG Funds stated that "[s]ecurities of companies involved in certain controversial products or activities," including "fossil fuels" and "tobacco," "are excluded regardless of revenue measures."

Investment Practices Regarding Fossil Fuels

The order indicated that the asset manager "[i]n order to exclude the securities of certain companies from the ESG Funds' portfolios ... contracted with Vendor A, a third-party ratings, research, and analytics firm, which offered research that identified companies' involvement in providing certain products or services." It further noted that Vendor A "offered several data sets that addressed different aspects of fossil fuels activities that were described as: 'Arctic Oil and Gas Exploration,' 'Thermal Coal,' 'Oil Sands,' 'Shale Energy,' and 'Oil and Gas,'" and that the asset manager "did not subscribe to the latter two data sets." Thus, according to the SEC's order, "these data sets did not purport to identify all companies involved in fossil fuels-related businesses."

The order noted that prior to the inception of the ESG Funds, the asset manager "became aware that the three fossil fuels-related data sets that it ordered from Vendor A had failed to capture certain companies involved in fossil fuels," and that in response, it "incorporated data from an additional vendor, Vendor B, another ratings, research, and analytics firm, in an attempt to further exclude the securities of certain companies involved in fossil fuels from the ESG Funds' portfolios." The order noted that "[l]ike the data from Vendor A, the data from Vendor B had certain limitations, as it did not offer data for an industry sector that encompassed all fossil fuels-related businesses." According to the order, the asset manager "only used Vendor B's 'Energy Sector' data to exclude the securities of companies from the portfolios of the ESG Funds, even though other Vendor B industry-sector classifications included companies involved in fossil fuels." As an example, the order notes that "the 'Utilities Sector' included utility companies that distributed natural gas to residential and industrial customers that were not identified in Vendor B's 'Energy Sector' data." The order asserted that "[i]n its representations to the Board and in the ESG Funds' Prospectuses, [asset manager] did not describe the limitations of the data sets it used from Vendor A and Vendor B in its screening process or otherwise define the term 'fossil fuel,'" instead, the asset manager "stated that it would screen out the securities of companies 'involved in' fossil fuels regardless of revenue measures." As a result, the order noted that the "limitations regarding the data sets [asset manager] used in its screening process led to the ESG Funds regularly holding the securities of certain companies involved in fossil fuel

related activities, including companies involved in the transport of coal or the extraction, distribution, or sale of natural gas."

The order asserted that the asset manager "learned ... that data from an investment research firm that owned Vendor A identified that the ESG Funds held positions in companies involved in activities related to fossil fuels."

Investment Practices Regarding Tobacco

The SEC's order noted that the prospectuses for the ESG Funds stated that the securities of companies "involved in . . . tobacco . . . are [also] excluded regardless of revenue measures," and that the asset manager's disclosures to the Board "similarly conveyed that [asset manager] would exclude companies with 'any' tobacco involvement." It further noted that documentation regarding Vendor A's methodology "stated that Vendor A would not capture a company's tobacco retail sales if those sales comprised less than 10% of such company's revenues," and alleged that the asset manager "did not disclose to the Board or in the ESG Funds' Prospectuses the information it received from Vendor A concerning these limitations." The order noted that three months after the ESG Funds' inception, Vendor A informed the asset manager that it was "changing its methodology for its Tobacco data set ... which resulted in the data set identifying companies with retail tobacco sales of less than 10% of their revenue that had not been flagged previously," but that the asset manager "continued to invest in companies that Vendor A identified as being involved in retail tobacco sales" during the relevant period.

Compliance Deficiencies, Violation and Sanctions

The SEC's order found that the asset manager "did not adopt and implement any written policies and procedures concerning the process for excluding the securities of certain companies from the ESG Funds' portfolios and, more broadly, for its ESG investment process."

The asset manager consented to the entry of the order, which stated that, as a result of the conduct, the asset manager willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rules 206(4)-7 and 206(4)-8 under the Advisers Act and Section 34(b) of the Investment Company Act of 1940. The asset manager was ordered to cease and desist from committing or causing future violations of these provisions, censured, and ordered to pay a civil money penalty of \$4 million.

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Notes

[1] See In the matter of WisdomTree Asset Management, Inc., IA Rel. No. 6753, IC Rel. No. 35364, File No. 3-22268 (Oct. 19, 2024), available at: <https://www.sec.gov/files/litigation/admin/2024/ia-6753.pdf>.

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