Blogs

In the first half of 2022, we saw significant U.S. Securities and Exchange Commission (SEC) enforcement and rulemaking activity around ESG investing, and the SEC's intense focus in this area shows no signs of abating as we move through the third quarter. In this four-post series we:

- Summarize the 2019-2021 ESG-related initiatives at the SEC;
- Review the SEC's ESG-related enforcement activity in the asset management industry;
- Outline the SEC's May 2022 ESG-related rule proposals for funds and advisers; and
- Suggest factors that mutual fund boards should consider in their oversight of ESG funds and adviser ESG initiatives.

Regulatory Background: 2019-2021

At a high level, in its regulation of ESG investing, the SEC is primarily concerned with the problem of "greenwashing," or misrepresenting a firm's ESG story to attract sustainability-focused investors. The anti-fraud provisions of the Investment Company Act of 1940 (1940 Act) and the Investment Advisers Act of 1940 prohibit greenwashing by registered funds and advisers as a basic matter, and registered funds and advisers are required to have compliance policies and procedures designed ?to prevent fraud. In 2019, the staff of the SEC Office of Compliance, Inspections, and Examinations, now known as the Division of Examinations (Exams), began seeking information on topics that have remained at the center of the SEC's ESG focus, including:

- The firm's definition of "ESG,"
- Factors used in selecting ESG portfolio investments,
- Use of ESG ratings/scores,
- ESG proxy voting record,
- Achievement of stated ESG goals,
- Adherence to United Nations Principles for Responsible Investment (UNPRI) and/or other ESG frameworks,
- Top/bottom ESG investments and ESG performance record,
- ESG awards, and
- Results of any ESG audit.

In 2020, Exams priorities included the accuracy and adequacy of disclosures by advisers with ESG strategies. And, in seeking to eliminate misleading fund names by requesting comments on Rule 35d-1 under the 1940 Act, the SEC asked whether the restrictions of the Names Rule should be applied to registered funds with ESG strategies. In March 2021, the SEC announced a dedicated website titled "SEC Response to Climate and ESG Risks and Opportunities" and named a Senior Policy Advisor on Climate Change and ESG. The SEC also announced a new Enforcement Task Force Focused on Climate and ESG Issues that began, among other things, analyzing disclosure and compliance issues around ESG investment strategies. Later that year, the SEC named a new Climate Counsel to SEC Chair Gary Gensler. The SEC's 2021 annual regulatory agenda included ESG investment fund rules, and the 2021 Exams priorities included the compliance programs of firms managing mutual funds, exchange-traded funds (ETFs), or private funds with ESG strategies, with a focus that included:

- Alignment of ESG messaging and firm operations, investment activities, and proxy voting.
- Performance marketing, regulatory disclosures, and representations to global ESG framework sponsors.
- The veracity of ESG advertising, and the consistency and adequacy of disclosures regarding ESG strategies and practices.
- Business continuity plans "in light of intensifying physical risks associated with climate change."

In April 2021, the Exams staff released a risk alert (the Risk Alert) that remains the most concrete guidance on the SEC's ESG-related expectations of registered funds and advisers. These include that:

- Controls be in place to ensure the accuracy of ESG-related messaging.
- The CCO develop a holistic control framework to test and document adherence to ESG commitments.
- ESG policies, codes, and standards be appropriately tailored and part of the compliance program.
- Investment professionals with ESG expertise be engaged on ESG strategies unless otherwise disclosed.
- Proxy voting be consistent with ESG investment strategies and representations.
- Internal ESG scoring and ESG performance measurement methodologies be documented in a testable manner.

- Any third-party ESG score/ranking be verified before use in advertising.
- An independent ESG audit be conducted if appropriate given extent and complexity of ESG commitment.
- As appropriate for enterprise risk management, ESG whistleblower procedures and/or an ESG oversight committee be established.

2022: ESG Enforcement Activity Involving Funds and Advisers

In our second post in this series, we'll delve into the SEC's ESG-related enforcement activities this year, including a settlement with a mutual fund complex.

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