ESG Asset Managers and Investment Funds—Near-Term SEC Enforcement Risk

AUGUST 3, 2021

The Securities and Exchange Commission (SEC) threw down the gauntlet after President Biden's election and asserted its interest in greater regulation and policing of environmental, social, and governance (ESG) issues. One aspect of this initiative—the possibility of mandatory disclosure rules for all issuers—has reignited significant debate about the SEC's role and the nature of the potential disclosures, including whether the SEC has the authority to mandate such disclosures if ESG issues are not material to a specific issuer.[1] These debates have received significant attention and will likely take time to resolve.

This client alert addresses the SEC's focus on the burgeoning sector of investment products focused specifically on their ESG attributes—a sector estimated to include 800 registered investment companies with more than $3 trillion in assets. Simply put, this is an area where we expect enforcement attention from the SEC in the near term. Policing ESG investment products is likely to be an SEC priority under the umbrella of its mandate to police disclosure, given the sector's substantial growth and the priority the SEC has announced it will place on ESG issues generally.

In July alone, multiple top SEC officials sent messages that they are focused on ESG disclosures made by investment advisers and funds. For example, on July 28, 2021, SEC Chairman Gary Gensler stated that he had instructed the SEC staff to consider recommendations on whether fund managers should disclose the ESG criteria and related data that are used to determine what investments qualify, noting that "[l]abels like 'green' or 'sustainable' say a lot to investors."[2] And on

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[1] *Compare* Letter from Senator Toomey et al. to Chair Gary Gensler and Commissioner Allison Herren Lee (June 13, 2021), *with* Commissioner Lee's May 24, 2021, Speech, *Living in a Material World: Myths and Misconceptions about "Materiality"*; *see also* Hester Peirce, Commissioner, *Speech by Commissioner Peirce on ESG Disclosure* (July 21, 2021).

[2] Gary Gensler, Chairman, *Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar* (July 28, 2021).

July 13, 2021, then Acting SEC Director of Enforcement Melissa Hodgman stated that funds advertising ESG investments will be subject to increased scrutiny and should anticipate potential disclosure-related enforcement actions.[3] These are only the most recent statements warning the industry of the SEC's increased focus on these issues; for example:

- In March 2021, the SEC established a Climate and ESG Task Force in the Division of Enforcement (ESG Task Force). The announcement cited disclosure and compliance related to ESG strategies of investment advisers and funds as an area of focus for the ESG Task Force.

- Soon after, in April 2021, the Head of the ESG Task Force publicly emphasized that existing legal provisions can be applied to enforcement actions for fraudulent marketing of ESG products and insufficient controls around those products.

- In April 2021, the SEC's Division of Examinations published a Risk Alert based on its examination of investment advisers, registered investment companies and private funds offering ESG products and services and highlighted six areas of weakness.

- Earlier in July 2021, SEC Chairman Gensler explained that he was concerned about truth in advertising with ESG products, and he explained that he had asked the SEC staff to consider both mandatory disclosure obligations for ESG funds and possible revisions to the "Names Rule" applicable to ESG funds.[4]

- The SEC's Asset Management Advisory Committee (AMAC), made up of outside experts and industry participants, established a subcommittee at the beginning of 2020 to review ESG issues and to make related recommendations to the SEC. On July 7, 2021, AMAC recommended, in part, that the SEC suggest best practices for ESG investment product disclosures.

This client alert reviews the SEC's statements on these issues, the application of the SEC's potential legal theories to ESG investment products, and the questions asset managers and fund advisers should ask to best protect themselves. Whatever views asset managers and fund advisers may have concerning this SEC initiative, those who are participating in this growing sector should take steps to ensure that ESG-related investment products are accurately described to investors,

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[3] Al Barbarino, *Top SEC Official Suggests More ESG Enforcement Is Coming*, Law360 (July 13, 2021).

[4] Gary Gensler, Chairman, *Prepared Remarks Before the Asset Management Advisory Committee* (July 7, 2021). As currently framed, Rule 35d-1 under the Investment Company Act of 1940 (the Names Rule) requires a registered investment company with a name suggesting that it focuses on a particular type of investment to invest at least 80% of its assets in the type of investment suggested by its name.

that reasonable policies and procedures have been established to adhere to funds' ESG-related criteria, and that those policies and procedures are applied as intended.

SEC's Demonstrable Focus on ESG-Related Investments

ESG products have become a clear focus of the SEC's attention. This is not surprising given the growth of the investment sector, the SEC's investor protection mandate, and the opportunity to support the SEC's other ESG initiatives through enforcement actions.

Both the Division of Examinations' 2020 and 2021 Priorities specifically referred to ESG products.[5] The 2021 Examination Priorities, published in March 2021, explained:

> The Division will review the consistency and adequacy of the disclosures [registered investment advisers] and fund complexes provide to clients regarding [ESG] strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.[6]

In April 2021, the Division of Examinations issued a Risk Alert, which identified the issues that it observed during its examination of asset managers and fund advisers. We discuss the Division of Examinations' findings below.

On March 4, 2021, the SEC announced the formation of the ESG Task Force. The press release explained that the ESG Task Force will, among other items, "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[7] The Task Force will develop its

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[5] SEC, Division of Examinations, 2021 Examination Priorities at 17 (Mar. 3, 2021); SEC, Division of Examinations, 2020 Examination Priorities at 15 (Jan. 7, 2020).

[6] SEC, Division of Examinations, 2021 Examination Priorities at 28 (Mar. 3, 2021). "Due to investor demand, RIAs are increasingly offering investment strategies that focus on sustainability. These strategies may include products and services that are referred to by a variety of terms such as sustainable, socially responsible, impact, and ESG conscious. The Division will focus on products in these areas that are widely available to investors such as open-end funds and ETFs, as well as those offered to accredited investors such as qualified opportunity funds. The Division will review the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies." *Id. See also* Press Release, SEC, *SEC Division of Examinations Announces 2021 Examination Priorities: Enhanced Focus on Climate-Related Risks* (Mar. 3, 2021).

[7] Press Release, SEC, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (Mar. 4, 2021).

own investigations but will also work closely with the Divisions of Examinations, Corporate Finance, and Investment Management, including taking referrals from the Division of Examinations.[8]

There also appears to be bipartisan support among commissioners for evaluating whether the claims of asset managers and fund advisers about ESG products match their investment activities, policies, and practices. For example, Commissioner Hester Peirce, who has expressed significant concerns about potential ESG disclosure rulemaking,[9] issued a public statement in response to the Division of Examinations' Risk Alert that affirmed the obligation of asset managers and investment managers to accurately define what they are doing under the banner of ESG. Commissioner Peirce stated that she viewed the underlying legal obligations on asset managers as neither new nor specific to ESG-related products.

> Therefore, as I have noted previously, asset manager accountability in the ESG space is important. Firms claiming to be conducting ESG investing need to explain to investors what they mean by ESG and they need to do what they say they are doing. This same rule applies no matter what label an adviser puts on its products and services.[10]

Of course, there may be differences in commissioners' respective views regarding when the facts or law support charges. Commissioner Peirce has also explained that the SEC staff must not apply its own view of what an ESG product is or should be, but rather look at whether the asset manager or fund set forth the relevant criteria and failed to meet those standards.[11]

Warnings from the Division of Examinations' Risk Alert

The Division of Examinations' April 2021 Risk Alert identified issues with disclosure and compliance procedures from its review of investment advisers, registered investment companies, and private funds offering ESG products and services.[12] The Risk Alert sends a clear warning to the industry. The concerns identified by the Division of Examinations are a roadmap for the types of issues that the ESG Task Force will likely pursue as enforcement matters. In total, the Division of

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[8] *Id*.

[9] *See generally Speech by Commissioner Peirce on ESG Disclosure*, *supra*, note 1.

[10] Hester Peirce, Commissioner, *Statement on the Staff ESG Risk Alert* (Apr. 12, 2021).

[11] *Id.* ("Some readers of the risk alert might ask whether the SEC will make its own assessments of whether an investment is consistent with an ESG investment approach. The staff's role is not to second-guess investment decisions through an SEC-created ESG scoring system; rather, it is to understand whether firms are adhering to their own ESG claims.").

[12] SEC, Division of Examinations, *Risk Alert: The Division of Examinations' Review of ESG Investing* (Apr. 9, 2021).

Examinations identified six areas of concern related to disclosure, controls, marketing, and compliance:

- *Portfolio management practices that are inconsistent with disclosures about ESG approaches.* This included a lack of adherence to global ESG frameworks where firms claimed adherence.

- *Controls that are inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.* This included inadequate controls around negative screens and implementing client preferences.

- *Claims regarding ESG approaches that are unsubstantiated or otherwise potentially misleading.* This included marketing materials that relied on metrics that appeared to inflate returns and unsubstantiated claims by advisers regarding their contributions to the development of specific ESG products.

- *Controls that are inadequate to ensure ESG-related disclosures and marketing are consistent with the firm's practices.* This included touting adherence to global ESG frameworks that were not followed, unsubstantiated claims about investment practices, a lack of documentation of ESG investment decisions, and the failure to update marketing materials in a timely manner.

- *Investment firm compliance programs that do not adequately address relevant ESG issues.* For example, the Division of Examinations found compliance programs that did not ensure that ESG-related marketing claims were reasonably supported or provide for sufficient oversight of sub-advisers. The Division of Examinations also found that firms had difficulty substantiating that they followed their stated ESG investment processes.

- *Proxy voting that is inconsistent with advisers' stated approaches.* This includes unfulfilled promises to allow clients to direct voting and to evaluate proxy votes on a case-by-case basis.[13]

The Risk Alert acknowledges that various firms approach ESG investing in different ways. However, unlike the debate over mandatory issuer disclosure, where the differences among companies may create substantial challenges for the SEC to define regulatory obligations, asset

[13] SEC Chairman Gary Gensler has stated that the agency will consider revising guidance for oversight of proxy voting and other related corporate governance topics promulgated during the Trump Administration. *See* Katanga Johnson, *U.S. SEC Chief to Review Trump-era Proxy Rules, May Draft Replacement*, Reuters (June 1, 2021).

managers and fund advisers set their own definitions and approaches. The primary questions for asset managers and fund advisers are (1) whether the ESG disclosures and performance claims, if applicable, in their disclosure documents (e.g., Form ADV Part 2A) and other client/investor-facing documents (e.g., advisory agreements, offering materials, responses to requests for proposals, marketing decks, and due diligence questionnaires) are clear, accurate, and not exaggerated, and (2) whether their investment practices (e.g., ESG screening and evaluation of specific ESG factors, and compliance with investor-imposed ESG guidelines) are consistent with their disclosures. Indeed, many of the specific issues identified in the Risk Alert arose from disconnects between stated practices and actual practices.

There will also be keen focus by examiners on any projected performance claims associated with ESG screens. Unsubstantiated claims of superior investment performance associated with the application of ESG metrics are likely to be questioned. Given the limited history of these products, some advisors have attempted to substantiate these claims through the use of back-tested performance, applying ESG screens to a portfolio of stocks and then comparing performance to a broad-based benchmark index. Given that these metrics are (1) subjective, making historical claims difficult to verify; and (2) difficult to measure or evaluate historically due to the limited information provided on these metrics by most issuers over prior years, all such advertising and associated disclosures should be carefully reviewed.

It is important for asset managers and funds to remember that the particular facts concerning their ESG policies, procedures, and investments, along with the representations being made about those funds/strategies (and any performance claims in marketing materials), should be examined with an eye to what arguments or defenses to a possible enforcement action are available. Careful review of the Risk Alert and a critical internal review may help avoid issues in the future.

SEC Enforcement Intends to Use Existing Standards to Charge Violations

Head of the ESG Task Force Kelly L. Gibson has asserted that the questions the task force is asking about ESG investment products—regarding the accuracy of disclosures and the adequacy of compliance policies and procedures—are not new, and the Division of Enforcement would be applying existing legal standards to any enforcement actions involving ESG products. This approach will likely avoid some of the more pointed political concerns endemic to some other ESG initiatives.

In an April 2021 interview, Gibson indicated that the SEC staff will look for gaps between ESG-related marketing statements and the actual character of the product, as well as whether advisers and funds have appropriate policies and controls around these products and their marketing representations.[14] Gibson cited Section 10(b) of the Securities Exchange Act of 1934 and Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), including breaches of fiduciary duties, as possible legal provisions that could be applied to ESG-related enforcement actions.[15] The SEC has pursued and settled cases involving asset managers and investment funds in other contexts based on these statutory provisions as well as Section 17 of the Securities Act of 1933 and Advisers Act Rule 206(4)-7, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules promulged under the act. Other provisions are also available to the SEC, including the Advisers Act advertising rule, Rule 206(4)-1; Section 34(b) of the Investment Company Act of 1940, which generally prohibits material misstatements or omissions in fund registration statements and annual reports; and Investment Company Act Rule 38a-1, the fund compliance rule, in the event that funds fail to adopt or implement appropriate policies and procedures relating to prospectus and annual report disclosures, or fail to monitor consistency between such disclosures and portfolio management.

Some of these provisions make it relatively easy for the SEC to establish violations. Negligence is sufficient under certain of these proscriptions and, given an investment manager's heightened obligations to clients, this can be a low standard for the SEC to meet.[16] Furthermore, the SEC can demand various forms of relief—including injunctions, civil monetary penalties, internal compliance consultants,[17] and potentially disgorgement[18]—without establishing investor harm (or even investor

[14] *See* Al Barbarino, *SEC's ESG Unit Chief Says Existing Regs Key To Enforcement*, Law360 (Apr. 9, 2021).

[15] *Id*. Gibson explained that "[w]e're also focusing on disclosure and compliance issues relating to investment advisers, funds and ESG strategies. For example, if an asset manager is marketing an ESG fund in a certain way that's materially false or misleading, or it's not adhering to its client mandates or restrictions, that's an area that we would potentially investigate, as we have many times in the past."

[16] Courts have found asset managers to have acted negligently based on little more than the knowledge of the duty to disclose and the failure to do so. *See, e.g.*, *Robare Grp., Ltd v. Sec. & Exch. Comm'n*, 922 F.3d 468, 473 (D.C. Cir. 2019) (upholding SEC's decision that defendant violated Section 206(2) through negligent conduct.); *Sec. & Exch. Comm'n v. Westport Capital Mkts., LLC*, 408 F. Supp. 3d 93, 106 (D. Conn. 2019) (granting SEC summary judgment under Section 206(2) on the basis that defendants were professionals who knew the rules and their failure to disclose was therefore at least negligent).

[17] In *BlackRock Advisors LLC*, Investment Advisers Act Release No. 4065 (Apr. 20, 2015), BlackRock agreed to a cease-and-desist order and to pay a civil money penalty of $12 million for violations of Sections 206(2) of the Investment Advisers Act, Rule 206(4)-7, and Rule 38a-1 under the Investment Company Act related to undisclosed conflict of interest. The order includes no allegation or analysis of any harm caused to investors who were not informed of the conflict of interest.

[18] In 2020, the Supreme Court articulated parameters for when disgorgement is available as a remedy in federal court cases. Disgorgement must be tied to a wrongdoer's net profits and be awarded for victims in order to constitute equitable relief permissible under 15 U.S.C. § 78u(d)(5). *See* WilmerHale, *Liu v. SEC: The U.S. Supreme Court Upholds the SEC's Power To Obtain Disgorgement in Civil Actions, But With Important Limitations* (June 24, 2020); *Liu v. Sec. & Exch. Comm'n*, 591 U.S. ___; 140 S. Ct. 1936 (2020).

reliance); this may be significant as the failure to follow ESG disclosures or failure to have sufficient internal policies will not necessarily lead to any demonstrable financial detriment.

Of course, there will be legal defenses and arguments surrounding complicated factual issues raised in any enforcement action. In a false statement case, for example, the SEC staff must prove that the statement or omission was material. This may present a challenge in certain instances depending on the facts and the nature of the alleged misstatement. By the Supreme Court's time-honored definition of materiality, a misstatement or omission is material if there is a "substantial likelihood" that it would be viewed by the "reasonable investor" as having altered the "total mix" of information made available.[19] This broad definition has typically allowed the Division of Enforcement to take the position that materiality is satisfied if a reasonable investor would have cared about the disclosure in making an investment decision. In the hypothetical ESG case, the Division of Enforcement would likely frame the question in terms of whether the false or misleading ESG statement may have influenced investors' interest in the relevant fund or the allocation of assets to the asset manager or account. This analysis will be highly fact-dependent, but the more directly any ESG statements are tethered to the stated purpose of the investment product, the more challenging it may be to rebut materiality.

The SEC may also view ESG-related facts and disclosures as being material even where those factors are not financial drivers for the investment, especially where asset managers and fund families marketed products as being particularly ESG-focused.[20] This is a position supported by some members of Congress[21] and by some indicators of what investors see as important.[22] Generally, however, investors are presumed to be investing in financial products to receive performance returns, usually measured in profitability. Investment advisers and funds might argue

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[19] *Basic, Inc. v. Levinson*, 485 U.S. 224, 249 (1988); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[20] There is nothing in the Supreme Court's definition of materiality that would require a relationship to financial or economic factors. *See id*. As such, there is reason to believe that courts could find conscientious ESG factors to be material even without a connection to financial metrics. *See Nat. Res. Def. Council, Inc. v. Sec. & Exch. Comm'n*, 389 F. Supp. 689 (D.D.C. 1974) (holding, where plaintiffs were public interest groups seeking information to make socially responsible investment decisions, among other purposes, that such considerations could be material regardless of whether or not there is or could be a financial impact). The opinion stated, "There are many so-called 'ethical investors' in this country who want to invest their assets in firms which are concerned about and acting on environmental problems of the nation. This attitude may be based purely upon a concern for the environment. . . . Whatever their motive, this Court is not prepared to say that they are not rational investors and that the information they seek is not material information within the meaning of the securities laws." *Id*. at 700.

[21] *See* Corporate Governance Improvement and Investor Protection Act, H.R. 1187, 117th Cong. § 103(b)(3) (2021). The bill, which has passed in the House of Representatives, would render ESG disclosures "de facto" material, although it would still be the SEC's responsibility to define "ESG metrics" under the law.

[22] Virginia Harper Ho, *Nonfinancial Risk Disclosure and the Costs of Private Ordering*, 55 Am. Bus. L. J. 407, 420-422 (2018) (collecting studies supporting increased investor demand for ESG and other nonfinancial disclosure information); SEC, Business and Financial Disclosure Required by Regulation S-K, 81 Fed. Reg. 23,916, 23,970 (Apr. 22, 2016) ("Many commenters noted a growing interest in ESG disclosure among investors and many recommended increased sustainability disclosure requirements.") (citations omitted).

that a reasonable investor's interest is to make money, and that any advancement or promotion of ESG objectives, however significant, is most likely incidental to the primary objective of performance and financial return. For example, if an ESG-focused fund is not providing sufficient returns, and the fund manager moves to investments in companies less ESG-focused to boost performance, would a reasonable investor consider that deviation from the fund's stated investment focus to be material?

Nonetheless, because it would be both rare and a challenge for a fund or an asset manager to litigate with the SEC over an issue of materiality, they should be prepared for an uphill battle in connection with any challenges that arise with the SEC staff over the definition of materiality in the ESG context. There is a strong likelihood that, even where good arguments are advanced, the staff and the Commission's approach to the concept of materiality will continue to expand and become more aggressive once ESG investment product cases begin to settle.

The SEC May Rely on Enforcement Actions to Set Standards for and Define ESG-Related Securities Law Concepts and to Support Regulatory Changes

The SEC may use its enforcement weapons to establish the standards generally for disclosure in this space. Cases premised on misleading disclosures or marketing could be cited in other contexts to bolster the argument. For example, to mandate certain disclosure practices and standards, enforcement actions might also highlight the value of broader Exchange Act disclosure rules for public companies on the basis that such rules may permit better-informed investment decisions and more transparent criteria for the marketing of ESG investment products. Settlements premised on a fund adviser's failure to adhere to internal policies regarding the selection of an investment could also be cited to define the amount of due diligence required of a fund or an adviser when selecting an asset under ESG criteria. Put simply, investigations of asset managers and investment advisers—indeed, any successful ESG Task Force investigation—may have lasting implications for the regulatory environment. When the SEC has used enforcement activity to flesh out an area of law, the practical impact has often been more de facto disciplined disclosure practices and more enforcement activity, even if corresponding formal rules are not adopted.

Steps Asset Managers and Fund Advisers Should Take to Limit Enforcement Risk

Asset managers and fund advisers can take steps to limit the risk that they will be the subject of enforcement actions. The Risk Alert and the recent AMAC recommendations include best practices.[23] The following are key questions to ask:

- Are disclosures clear, precise, and tailored to specific approaches to ESG investing?

- Are disclosures consistent among fund offering documents, marketing documents, investor/client communications, and the adviser's Form ADV, and are all of these documents updated promptly and uniformly?

- Do the disclosures clearly describe how the product carries out its strategy? Do they describe what its objectives are and how it selects investments in line with its strategy and objectives?

- Do the disclosures describe what objectives are based on risk/return characteristics versus characteristics that do not directly (or do not even indirectly) relate to the financial success or failure of the product?

- Are there policies and procedures that address ESG investing and cover the key aspects of the relevant practices?

- If applicable, are there internal mechanisms to communicate the relevant policies and procedures requiring that fund investments be consistent with client objectives and restrictions?

- Are actual practices consistent with the disclosures and policies, including, for example, the types of investments, the investment decision-making process, the control environment, and the approach to proxy voting?

- Are records relating to important stages of the ESG investing process documented and maintained?

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[23] *See* SEC, Asset Management Advisory Committee, Draft Report, Recommendations for ESG at 9 (July 7, 2021).

– Are compliance professionals knowledgeable about relevant ESG practices and integrated into those processes?

– If there are exceptions to the ESG investing policies, are the bases for those exceptions fully disclosed and explained?

Conclusion

The issues surrounding ESG disclosure generally, as well as the SEC's current focus in this area, raise complicated questions. There will no doubt be enhanced scrutiny of investment policies and guidelines, which may make drafting disclosure documents for products with ESG-related strategies more challenging. As it stands, investment advisers and funds with ESG-related strategies establish their own standards and definitions for what ESG investments mean to each; but then they must comply, conforming their disclosures and policies and procedures accordingly. Marketing materials, particularly performance claims, should be carefully reviewed for appropriate disclosure. The SEC has made it clear that the Division of Enforcement will be investigating asset managers and investment funds with ESG-related strategies. Those entities should carefully consider whether their ESG practices will survive intense scrutiny. WilmerHale is experienced in this area and prepared to work with clients to evaluate the current disclosures and controls and to respond to SEC examinations and investigations.

Contributors

Lorraine B. Echavarria

PARTNER

lori.echavarria@wilmerhale.com

+ 1 213 443 5325

Timothy F. Silva

PARTNER

timothy.silva@wilmerhale.com

+ 1 617 526 6502

Amy R. Doberman

PARTNER

amy.doberman@wilmerhale.com

+ 1 212 295 6270

Matthew B. Holmwood

PARTNER

matthew.holmwood@wilmerhale.com

+ 1 202 663 6449

Andrew Miller

ASSOCIATE

andrew.miller@wilmerhale.com

+ 1 202 663 6691