Professional Perspective

Growth of ESG-Related Investments & Regulatory Action

Kirsten Lapham, Josh Newville, and Jonathan Weiss, Proskauer Rose

Bloomberg Law

Growth of ESG-Related Investments & Regulatory Action

Contributed by Kirsten Lapham, Josh Newville, and Jonathan Weiss, Proskauer Rose

The Biden administration's climate-change priorities and the Securities and Exchange Commission's increased emphasis on environmental, social, and corporate governance (ESG) have come into focus. The global impact of ESG investing continues to grow, with key implications for the asset management industry.

In the U.S., where there is no dedicated ESG-related regulatory structure, investor demand for ESG-focused strategies is driving fund managers to provide additional resources in the area. To better understand the future of ESG regulation, particularly in less-monitored areas of social and corporate governance, investors can look for guidance in past regulation of environmental-related investments—particularly concerning greenwashing—and the EU's new regime on sustainability-related disclosures in the financial sector.

This article discusses ESG regulatory trends in the U.S. and the EU, regulatory focus on the environmental aspect of ESG as opposed to the social and corporate governance components, key considerations in ESG-related private litigation, and practical tips for fund managers to comply with increased regulatory scrutiny.

Past SEC Regulation

As interest in ESG-related funds grows and investors have an increased appetite for investing in ESG as an asset class, the U.S. and the EU have heightened regulatory scrutiny. The Biden administration has strongly emphasized the environmentalism aspect of ESG.

In a July 28, 2021 speech, SEC Chair Gary Gensler announced he instructed his staff to consider recommendations about whether fund managers should disclose the criteria and underlying data they use for sustainability-related investing. Gensler later noted concerns relating to the range of meaning that asset managers ascribe to green or sustainable labels, stating, "… investors should be able to drill down to see what's under the hood of these funds."

This follows the SEC's creation of a Climate and ESG Task Force within the Division of Enforcement in March 2021. The task force proactively identifies misconduct related to ESG investing. With respect to fund managers, the task force is focused on concerns that asset managers may be misleading investors by marketing certain funds as environmentally friendly but not fully complying with the marketed strategy—known as greenwashing.

On April 9, 2021, the SEC's Division of Examinations released a Risk Alert on ESG investing, identifying instances where fund managers that touted socially responsible investing were potentially misleading investors, as part of an enhanced review of ESG-focused funds.

The SEC's Enforcement Division focuses its efforts on whether asset managers have overstated their sustainable investing efforts or inaccurately disclosed ESG-related metrics to fund investors. The Division of Examinations will likely refer cases to Enforcement in this space, which will allow Enforcement to look at bringing ESG-related disclosure cases. The SEC will likely view greenwashing as implicating anti-fraud rules. To ensure compliance, fund managers should continue to build robust ESG-focused internal policies and procedures that support disclosures to investors regarding the firm's environmental strategies and processes.

Environmental disclosures are actionable if they are found to be materially false or misleading. Litigation centering on ESG disclosures generally has arisen in two contexts: securities fraud claims under federal law and consumer protection or consumer fraud claims under federal or state law. Key trends in private securities litigation relating to ESG-related disclosures include:

- Whether disclosures related to ESG issues are sufficiently concrete and quantifiable. See *In re BP plc, Sec. Litig.*, MDL NO. 10-md-2185, Civil Action No. 4:10-md-2185, 2013 BL 336825 (S.D. Tex. Dec. 6, 2013).

- Whether they are instead vague and subjective. See *In re Yum! Brands, Inc. Sec. Litig.*, 73 F. Supp. 3d 846 (W.D. Ky. 2014).

- Whether CEOs and CFOs may be liable as "control" persons for any false or misleading statements in ESG disclosures. See *Ramirez v. Exxon Mobil Corp.*, 334 F. Supp. 3d 832 (N.D. Tex. 2018).

- How to treat ESG statements made in response to investors' concerns, especially when those statements are made "amidst contemporaneous questions regarding the company's ethics or investigations of the company's illicit activities." See *In re Eletrobas Sec. Litig.*, 245 F. Supp. 3d 450 (S.D.N.Y. 2017).

Over the past two years, the SEC telegraphed its focus on ESG matters. Before the change in administration, SEC Commissioner Elad Roisman commented that in the ESG space more disclosure from asset managers could be warranted. Commissioner Roisman noted that more managers are asserting that ESG metrics are driving their decisions but that there are no universal definitions for green or sustainable funds and strategies can differ across the ESG spectrum. Roisman asserted that fund managers should explain to investors what ESG means in the context of their fund strategies and how they are taken into account.

The SEC's Division of Examinations identified ESG investment strategies as a focus area in its 2021 Exam Priorities, including "the consistency and adequacy of the disclosures for … sustainable, socially responsible, impact, and ESG conscious" investments.

EU Regime on Sustainability-Related Disclosures

In the EU, there has been significant momentum focused on environmentalism and increasing ESG-related regulation of the private fund industry. In the UK, managers have a regulatory obligation to ensure that any financial promotion made is fair, clear, and not misleading. This concept therefore broadly includes any greenwashing of products or environmental statements about a product that have the potential to be misleading. The UK's financial conduct authority has proposed new rules that look to create a three-tiered approach to sustainability disclosures and product labelling that incorporate product labels, consumer-facing disclosures for investment products, and detailed disclosures for asset managers and certain asset owners. These UK proposals come after the recent July 2021 proposals to align disclosure procedures with those set forth by the Task Force on Climate-Related Financial Disclosures.

Both U.S.-focused and international fund managers are advised to consider the EU regulations as a guide. As the SEC continues to engage in this space, it may look to the EU for guidance. The EU has developed a comprehensive taxonomy regulation and disclosure regulation that promotes clearer transparency between investors and managers on ESG metrics. The rules provide a harmonized taxonomy to clarify what should be considered green or sustainable to avoid managers greenwashing products.

The Taxonomy Regulation—effective January 1, 2022—aims to establish an EU-wide classification system to provide firms and investors with a framework to identify the point that their economic activities are environmentally sustainable. The regulation establishes a common language and a classification tool to help investors and companies make informed ESG investment decisions and guard against greenwashing.

The Disclosure Regulation—effective in the EU as of March 10, 2021—introduces obligations on investors and asset managers to expand their duties toward investors and beneficiaries to include the disclosure how they integrate ESG factors into their risk and investment decision making processes. Firms and advisers will be subject to additional disclosure obligations when the financial product promotes environmental and social characteristics, or structures objectives to include sustainable investment or has a reduction in carbon emissions.

Future of ESG Regulation

The SEC and EU provided clear guidance on the environmental element of ESG, but the social and corporate governance elements have proven to be more amorphous and less subject to clear regulation. With the increased popularity of impact investment we expect to see similar regulatory scrutiny for social and governance elements as on the environmental side.

According to an industry report, the impact investing market grew 42.4% from $502 billion to $715 billion in just the year 2020. With a litany of funds increasingly investing in social impact businesses, asset managers should be conscious of the disclosure issues that may come up as ESG-related investing continues to grow.

The SEC staff is working on potential disclosure enhancements for green fund managers. The Division of Examinations' 2021 Exam Priorities identified ESG and provided some insight into one way exam staff will be overseeing ESG-related investments—through detailed document requests during examinations. In part, these requests serve as an information gathering tool for data on the state of ESG investing across the industry.

The requests can also aid the exam staff in determining whether to issue deficiencies or refer the matter to the SEC's Enforcement Division. Deficiencies have typically fallen into one of two categories: issues with disclosures to investors about the investment process and issues with insufficient internal procedures.

Previous exam requests concerning ESG-related investments typically fall into one of the following five categories:

- **Scoring/Benchmarks**. Requests may seek to understand whether a fund uses a proprietary scoring system or a third-party system, how the system was selected, and how ESG-related investments are scored. Requests may ask about formal written procedures for the propriety scoring system and how often updates occur.

- **Lists of Specific ESG-Related Investments**. Requests for ESG scores for specific investments and supplemental follow-up questions on specific investments, including explanations related to investment positions in portfolios and why investments were sold or retained.

- **Internal Process/Compliance**. Requests may concern compliance evaluations or internal audits that cover the implementation of the ESG-related investment process, including whether specific service providers make ESG-related recommendations.

- **Returns on ESG-Related Investments**. Requests may seek lists of the fund's most and least profitable ESG-related investments and both financial and non-financial performance metrics.

- **ESG-Related Marking Materials**. Requests may include information on all marketing related materials that describe a fund's ESG program.

Taking insights from the environmental side—just as fund managers should seek to avoid greenwashing—funds should be conscious of using diverse labeling as a marketing tool without adequate process or taking credit for a social impact that may not be warranted. Asset managers should make sure their funds have adequate policies in place to support disclosures regarding corporate governance strategies, investment priorities, and performance.

Fund managers should strive to create and foster a robust investment disclosure system that provides adequate information to all investors. What constitutes a salutary social impact for one investor may not for another. The best way to ensure mission alignment between funds and investors is increased transparency and fulsome disclosure.

Fund managers should aim to track appropriate data toward meeting their social and environmental impact goals. Currently, there is no precise definition of exactly what constitutes ESG (particularly the social and governance aspects), and ESG data lacks consistency. The more fund managers can quantify benchmarks for social and governance impact investing through data and concrete metrics, the more they can ensure investor alignment and meet regulatory expectations.