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ESG-Focused Fund Strategies Face SEC Scrutiny on Disclosures and Internal Procedures

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As investors drive demand for investment products focused on environmental, social and governance (ESG) factors, fund managers have increasingly offered ESG-focused or “sustainable investing” funds. However, a recent speech by SEC Commissioner Elad Roisman has highlighted regulatory concerns for fund managers in the ESG space, particularly with respect to disclosures and internal compliance.

Commissioner Roisman’s speech raised two particular issues: When a fund manager claims that green or sustainability metrics are driving their metrics, how are these metrics measured? And is the manager fully disclosing whether an ESG focus improves or perhaps is a trade-off limiting returns?

Earlier this year, the SEC’s Office of Compliance Inspections and Examinations (OCIE) identified ESG investment strategies as a stated focus area in its 2020 Exam Priorities. These priorities publicly stated that OCIE would examine the accuracy and adequacy of disclosures for new or emerging investment strategies, in particular those that incorporate ESG criteria.

How has the SEC exam staff been monitoring the space? In recent years OCIE has sent a number of ESG-focused fund managers detailed document requests relating to ESG strategies. Our sense is that OCIE has been gathering information on practices in ESG investing across the industry. The OCIE document requests seek information in five general categories:

1. What kind of scoring and benchmarks are being used, particularly whether the firm uses a third-party system or a proprietary one, and applicable written procedures.
2. Lists of particular ESG investments made or recommended, and the ESG scoring for each.

3. Internal processes and policies, including compliance evaluations or internal audits related to ESG investments and information on applicable service providers.
4. Returns on ESG investments (*e.g.*, most and least profitable investments, as well as financial performance metrics and non-financial ESG performance metrics).
5. All marketing materials that describe the ESG program to current or prospective investors.

OCIE's requests have been fairly detailed, but the particular focus appears to be on whether disclosures adequately reflect the firm's practices, and whether there are sufficient internal procedures in place to monitor and measure ESG-related investments in light of those disclosures. For registered investment advisers, these inquiries reflect the SEC's regulatory mandate. First, under Section 206 of the Advisers Act, the general antifraud provisions prohibit fraudulent or deceptive conduct, in light of advisers' fiduciary obligations to clients. Second, the Compliance Rule (Advisers Act Rule 206(4)-7) requires SEC-registered advisers to implement policies and procedures reasonably designed to prevent violations of the securities laws.

The SEC's focus is also reflected in Commissioner Roisman's recent speech, asserting his personal view that the ESG space was one where more disclosure from asset managers could be warranted. He 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. Furthermore, there are questions about "greenwashing", or using labeling as a marketing tool without adequate process or taking credit for more of an environmental impact than is warranted. In sum, Roisman asserted that fund managers should explain to investors what "E" "S" or "G" mean in the context of their fund strategies and how they are taken into account.

Looking outward, there has been significant momentum in the area of ESG disclosure in other jurisdictions, which the SEC may take into account as it further engages on these issues. The European Union, for example, has developed a comprehensive "Taxonomy Regulation" and "Disclosure Regulation" which will start to apply from March 2021, and which promotes clearer transparency between investors and managers on ESG metrics. The rules also provide a harmonized taxonomy to clarify what should be considered "green" or "sustainable" to avoid managers' greenwashing products. See here for Proskauer's Podcasts which explore the EU ESG developments in more detail.

As the SEC continues to focus on this space, definitions used by managers, managers' internal process to analyze ESG investments and the corresponding disclosures to investors will be of particular concern.

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