ESG: Practical Points For Where Market Practice and Legal Trends Collide

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If 2021 was the year in which regulators and investors enthusiastically embraced environmental, social and governance ("**ESG**") considerations, by creating new legal and regulatory frameworks, then 2022 will be the year for asset managers to identify and confront the practical challenges of integrating legal requirements and stakeholder expectations into investment policy and performance.

In particular, managers with an ESG focus need to prepare for challenges that arise when their investment mandate intersects with other market or legal trends. In the United States, with concerns mounting regarding potential "greenwashing," it is only a matter of time before the SEC brings an enforcement case against one or more asset managers managing ESG-focused products. The SEC's focus is on whether representations to investors are accurate, and, specifically, whether the manager's practices match their sustainability representations. Managers should anticipate the SEC will expect firms' compliance and legal arms to play more meaningful roles in confirming that such disclosures are accurate. The Financial Conduct Authority ("**FCA**") in the UK is developing its own ESG legislative framework, which will be generally aligned with the EU's recent Sustainable Finance Disclosure Regulation, and Taxonomy Regulation (the "**EU ESG Rules**"). These legislative frameworks give regulators authority to analyze disclosures for potential greenwashing and use applicable enforcement tools where necessary. Once the FCA finalizes its framework, it is expected to review marketing and promotional materials by fund managers, and identified weaknesses may give rise to further review and potentially enforcement actions in extreme scenarios.

In market terms, funds are being held accountable for ensuring that their ESG classifications are integrated into their investment making decisions. As an example, Morningstar recently removed the ESG classification for over 1,200 funds in its rankings, accounting for over $1 trillion in assets, citing managers' failure to integrate ESG factors in a determinative way for their investment selections.

As another example, the increased interest in cryptocurrencies and related investments raises a question of the environmental impact of certain cryptocurrencies and is a fitting example of where asset managers need to clearly delineate exactly which investments are suitably “green”. High energy consumption is a designed feature of Bitcoin and other “proof of work” cryptocurrencies, where miners use computing power to solve equations verifying the relevant blockchain. Combined with the public ledger, this mechanism creates trust in the currency, by preventing a small group from taking control. The majority of mining takes place (following China’s recent ban) in the US and Kazakhstan—with both remaining heavily dependent on fossil fuels for energy needs. As specialized hardware rapidly becomes obsolete, crypto-mining also generates electronic waste. Miners can of course seek to use renewable energy, or rely on newer cryptocurrencies using a less energy-intensive “proof of stake” model, where verifiers pledge a certain amount of their own cryptocurrency. Some proponents also tout mining as a means of allowing a store of value for electricity that would otherwise be wasted, such as renewable energy during off peak demand.

Given increasing activism around crypto as a “dirty” currency, funds seeking to burnish their ESG credentials are therefore advised to tread cautiously as it seems that not all crypto is equal(ly green).

In legal trends, shareholders, investors, governments, and other advocates are increasingly focusing on environmental wrongs and, in search of perceived deep pockets and favorable legal regimes, on parent companies. Claimants in such actions rely on company-wide ESG policies, sustainability assessments and reports to argue that parent companies have assumed responsibility and so a duty of care for the policies of, and implementation by, their subsidiaries. Such positions have been endorsed as arguable by the UK Supreme Court. Class action and other investor lawsuits are also possible in the U.S., focused on materially inaccurate representations regarding sustainable investment choices or environmentally-friendly policies. Plaintiffs have had some success pursuing these theories against mining and energy companies.

In addition, claimants are increasingly asserting claims based on ‘supply chain’ misconduct. For example, in a current English Court claim, it has been held arguable that international tobacco companies could be liable for human rights violations by their third party suppliers.

While a typical private equity structure will be further removed from the operational business than most parent companies, plaintiffs are getting more aggressive in attacking affiliates and an aggressive plaintiff may argue that a manager's commitments to ESG somehow is a basis to assert liability against the manager's affiliates (including their funds).

Notwithstanding that claimants may seek to use a manager's ESG policies as a route to a claim, the solution is not to avoid having such policies, but rather to have effective and appropriate ones, and to ensure compliance. Managers that lack adequate procedures and policies also risk SEC enforcement action for failure to adequately implement and maintain their procedures under the Compliance Rule of the Advisers Act (Rule 206(4)-7)—even in the absence of material misrepresentations to clients. While it may not be necessary for all firms to implement a specific "ESG Policy," this is a must for managers that are highly focused on sustainability. Given other global developments such as the EU ESG Rules, investors have increased expectations for some form of ESG or responsible investment policy as part of their diligence process, which is another reason why firms should consider implementing such policies.

With the above legal and market trends in mind, fund managers must ensure that their ESG focus is more than a "badge" for marketing. At the same time, they must continually scrutinize their portfolios to ensure compliance with increasingly rigorous standards and expectations. Achieving strong returns within a strict investment mandate requires discipline and continual vigilance.

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