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Securities and Exchange Commission Alleges That Investment Adviser Failed to Adequately Disclose ESG Investment Policies and Procedures

Alan R. Friedman, Andrew Otis, Steven S. Sparling, Arielle Warshall Katz, Daniel M. Ketani, and David Richards*

In this article, the authors discuss an enforcement action brought recently by the Securities and Exchange Commission that highlights the agency's growing interest in environmental, social, and governance-related disclosures and alleged "greenwashing" by asset managers.

The Securities and Exchange Commission (SEC) has charged an investment adviser subsidiary of a major U.S. financial institution with violations of Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-7 thereunder relating to environmental, social, and governance (ESG) investments. The SEC alleged that the adviser's statements labeling certain investments as having been screened pursuant to its policies and procedures for ESG criteria were inaccurate because the policies and procedures the adviser used in selecting ESG-related investments were either nonexistent or ignored by employees. The adviser agreed to pay a $4 million penalty, to enter into a cease-and-desist order, and censure to resolve the charges.

This enforcement action, which follows similar recent actions by the SEC, highlights the SEC's growing interest in ESG-related disclosures and alleged "greenwashing" by asset managers. The SEC's focus on ESG disclosures underscores the need for issuers that market ESG products to accurately disclose their written policies and procedures when making investment decisions. Issuers should also be aware of the SEC's proposed rule regarding the naming,

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investment content and disclosure requirements for ESG-related funds.

The SEC's Enforcement of ESG Disclosures

ESG investing integrates ESG factors into investment decisions. To meet growing demand among investors for these products, asset managers have developed and marketed certain funds and strategies as ESG products. In March 2021, the SEC formed the Climate and ESG Task Force within the SEC's Division of Enforcement to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules" and "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."[1]

Since forming the Climate and ESG Task Force, the SEC has charged both issuers and investment advisers with violations related to their ESG disclosures. For instance, in April 2022, the SEC's Climate and ESG Task Force alleged that a Brazilian mining company, Vale S.A., misrepresented in SEC filings and other company documents that a failed tailings dam at its Brumadinho facility complied with international standards when the company had documented evidence that it did not. And in May 2022, the Climate and ESG Task Force brought and settled charges that an investment adviser subsidiary of Bank of New York Mellon falsely represented that investments in certain financial products had undergone an ESG quality review prior to their selection, when allegedly a significant percentage of those investments had not.

The SEC's Most Recent ESG Enforcement Action

The recent action marks the latest installment in the SEC's enforcement of ESG disclosures. The SEC alleged that, from 2017 through February 2020, the investment adviser at issue here—Goldman Sachs Asset Management L.P.—failed to implement adequate written policies and procedures governing the selection of ESG investments. Specifically, the SEC stated that the adviser made misrepresentations concerning the policies and procedures governing the selection of ESG-related investments in a separately managed

account and two mutual funds. After incorporating "ESG" into the names of these products, the adviser represented in prospectuses and other materials that each security would be subject to a two-step review that would screen certain industries and then apply proprietary research to eliminate investments that failed to meet ESG standards before making investment decisions.

When the adviser began marketing the separately managed account as ESG, however, the adviser allegedly had no written policies or procedures governing the selection of ESG investments. According to the SEC, only months later did the adviser implement a written framework to govern the second step of the ESG selection process—namely, the elimination based on proprietary research of investments that passed initial screening. Those written policies and procedures—which the adviser allegedly shared with third parties in pitch books, requests for proposals, and other materials—required the relevant investment teams to complete a proprietary questionnaire measuring specified ESG factors before making any investments. The results of that questionnaire would then be fed through a proprietary matrix to yield a numerical score determining the suitability of the investment for inclusion in the relevant financial product.

Despite the presence of these written policies and procedures, which existed for much of the life of the separately managed account and from the inception of the two mutual funds, the SEC alleged that the investment team routinely failed to complete the proprietary questionnaire before selecting investments. In many cases, the SEC alleged, the investment team instead relied on pre-existing research conducted pursuant to different processes and completed the proprietary questionnaires only after making the relevant investment.

Accordingly, the SEC alleged that the adviser violated the Advisers Act and related rule by failing to implement written policies and procedures governing the selection of securities when first marketing the separately managed account as ESG. It also failed to provide employees with adequate guidance, in both the separately managed account and the subsequent mutual funds, upon implementing the relevant written policies and procedures and thus failed to accurately characterize the implementation of its program in its public disclosures. In settling the action, the adviser agreed to a penalty of $4 million, to enter into a cease-and-desist order, and censure.

The SEC's Proposed "Names Rule"

On May 25, 2022, the SEC proposed an amendment to Rule 35d-1 under the Investment Company Act of 1940 that would expand the types of names subject to naming requirements. This new "Names Rule" would require any fund whose name suggests the fund focuses its investments on particular characteristics—including ESG—to invest at least 80% of the fund's value in those investments. The proposed rule would also classify fund names as materially misleading if, for instance, the fund's name suggests it invests in ESG but the ESG factors the fund uses are no more significant than other factors in the investment selection process. As proposed, the rule would be subject to only a few narrow exceptions, including when the valuation of a fund's assets changes due to sudden market fluctuations. The final version of the new Names Rule is expected to be issued in the first quarter of 2023.

Conclusion

The SEC Order is yet another example of the SEC's growing scrutiny of ESG-related disclosures and alleged "greenwashing" in the marketplace. Issuers that market ESG financial products should appropriately disclose criteria, policies, and procedures they employ in determining an investment as ESG favorable. Once they adopt such procedures, they need to take steps to ensure they consistently follow their policies and monitor such compliance. Furthermore, in developing such policies and procedures, issuers and advisers should consider how, along with fund names and investment strategies, they are consistent with the proposed Names Rule.

Notes

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1. Press Release, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues, SEC (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.