Weil

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SEC Targets "Greenwashing" by Investment Funds: More Proposals on the SEC ESG Agenda

Implications for Funds and Public Companies

On May 25, 2022, the Securities and Exchange Commission (SEC) released two proposals, available here and here, aimed at combating "greenwashing" – misleading claims by investment funds and their investment advisers regarding their environmental, social and governance (ESG) credentials. These proposals, if adopted, would increase the disclosure requirements of funds and advisors who make ESG-related investments. The proposed rules, among other things, would (i) revise Form ADV (the SEC registration form used by investment advisers) to improve disclosures by advisers purporting to take ESG factors into consideration when making investment decisions and (ii) update Rule 35d-1 under the Investment Company Act of 1940 ("the Names Rule") to ensure that registered fund names accurately reflect such funds' investment focuses and risks, particularly in relation to ESG factors. The two companion proposals passed by a 3-1 vote. The SEC's rule proposal fact sheets are available here and here. The comment period on the proposed rules will close on August 16, 2022. A summary and more comprehensive review of the proposed rules are included herein.

The proposed rules are the latest actions in a series of concerted efforts by the SEC that specifically target ESG-related disclosure and reporting. The proposals also come on the heels of two back-to-back enforcement actions in which the SEC filed complaints against companies for false or misleading claims relating to ESG practices. These are collective and clear signals from the SEC that it is scrutinizing ESG disclosures and taking "greenwashing" claims seriously.

SEC Targets ESG

The SEC had signaled in March that "greenwashing" would be a top priority for the agency when the term was listed on the agenda of the Division of Examinations for the first time. The proposed rules follow the long-awaited March 2022 rule proposal that, if adopted, would require public companies to provide detailed information about potential financial risks related to climate change and greenhouse gas (GHG) emissions. The SEC has extended the comment period on this proposal until June 17, 2022. These rule proposals are just the latest in a series of ESG-focused actions the SEC has taken recently, including: the March 2021 formation of the ESG Task Force within the Division of Enforcement to investigate ESG-related violations; the July 2021 issuance of the "Recommendations for ESG" bulletin detailing the SEC's recommendations for best practices to "enhance ESG investment product disclosure;" and the November 2021 issuance of guidance that suggested that ESG-related shareholder proposals could no longer be excluded from proxy materials under certain grounds. We discuss the SEC proposal and other regulatory actions in our prior Alerts available here, here and here.

Recent Enforcement Actions and Litigation Trends

On May 23, 2022, the SEC announced its first settlement of an enforcement action by its aforementioned ESG Task Force. The SEC settled with BNY Melon Investment Adviser, Inc. (BNY) for alleged misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds it managed. Specifically, the SEC order found that BNY represented or implied that all investments in the particular funds had undergone an ESG quality review, even though numerous investments had not undergone such reviews and did not have an ESG quality review score at the time of investment. Based on these facts, the SEC order charged BNY with violations of several provisions of the Investment Advisers Act of 1940, which prohibit any practices or courses of business that operate as a fraud, but do not require scienter. Rather, simple negligence was sufficient to support each violation. The SEC order also alleged that BNY lacked written policies and procedures reasonably designed to prevent misleading statements in marketing materials and disclosures presented to fund boards about its sub-adviser's use of ESG quality reviews, and noted that compliance personnel were unaware for a period of time that certain investments did not receive the ESG quality reviews. BNY agreed to pay a fine of $1.5 million.

The BNY settlement follows the announcement on April 28, 2022, of an action by the SEC against Vale S.A (Vale), a Brazilian iron ore producer, alleging securities fraud. See *Securities & Exchange Commission v. Vale S.A.* The *Vale* enforcement action was the first filed by the aforementioned Division of Enforcement's new Climate and ESG Task Force, which was formed with the "initial focus" of identifying "any material gaps or misstatements in issuers' disclosure of climate risks under existing rules." The complaint alleged that Vale made false and materially misleading statements relating to the safety and stability of its dams, which held toxic waste by-products from mining operations. The action was brought in the wake of the collapse of Vale's Brumadinho dam in Brazil that resulted in the release of toxic waste, significant environmental damage and hundreds of deaths caused by the collapse. The SEC alleges that the company knowingly or recklessly made false and misleading disclosures in its periodic filings, sustainability reports and other ESG disclosures, and manipulated dam safety audits and misled investors about the safety of the dam through its ESG disclosures. The complaint charges Vale with committing securities fraud in violation of Section 10(b) and 13(a) of the Securities Exchange Act and Section 17(a) of the Securities Act. Vale is litigating the matter.

Greenwashing investigations have not been limited to prosecutors in the US. The Frankfurt offices of Deutsche Bank and its asset-management subsidiary, DWS Group, were recently raided by German prosecutors after investigating allegations and whistleblower claims that DWS had exaggerated the credentials of mutual fund investments it marketed as "green." The raid added further pressure to the asset manager, which was already under an investigation by the SEC and U.S. federal prosecutors for allegedly overstating its ESG credentials.

As we discussed in our Litigation Trends Report available here, ESG litigation has also taken on increased importance as plaintiff-side firms seek to capitalize on the focus on ESG. ESG lawsuits have taken several forms, including challenges to labeling statements (such as 100% recyclable plastic bottles), challenges to more general statements of corporate commitments (such as being committed to animal welfare), and securities litigation (based on statements about ESG commitments and efforts in SEC filings).[1] The plaintiffs behind these lawsuits are varied, from individual consumers or investors, to activist groups and organizations. Recently, NGOs such as Greenpeace, Sierra Club, and other advocacy groups have filed ESG lawsuits challenging corporate statements and practices.[2]

Summary of Proposed Rules Regarding the Use of ESG by Investment Advisers and Funds

If adopted, the proposed rules, among other things, would (i) revise Form ADV to improve disclosures by investment advisers purporting to take ESG factors into consideration when making investment decisions and (ii) update the Names Rule to ensure that the names of ESG-marketed registered funds accurately reflect such funds' investment focuses and risks.

Under the first set of proposed rules governing ESG investment disclosures, as implemented through revisions to Form ADV, investment companies and advisers would be subject to heightened disclosure requirements relating to how ESG factors into a fund's or adviser's strategy. The proposed rule is intended to provide uniform requirements to help guide investors' understanding of an investment fund's ESG-related efforts. The proposal includes, among other elements, certain minimum disclosure requirements for any funds or other products that market themselves as ESG-focused in their prospectus, annual reports and advisor brochures, as well as requiring ESG impact funds to disclose how they measure progress on ESG goals. For proxy voting and other forms of shareholder engagement, funds would be subject to additional disclosure on how they exercise their influence in relation to ESG issues to assist investors in understanding how their fund adviser engages with portfolio companies on such issues. The proposed amendments would also require the fund to disclose, as applicable, the percentage of ESG-related voting matters during the reporting period for which the fund voted in furtherance of an ESG initiative. A more in-depth review of these rule proposals is set forth in Annex A to this alert.

The second set of proposed amendments, those to the "Names Rule," would expand the current requirement for certain funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus the fund's name suggests, as well as to enhance disclosure, reporting and record-keeping requirements. For example, this would include fund names indicating that the fund's investment decisions incorporate one or more ESG factors. Under the proposal, a fund that considers ESG factors alongside, but not more centrally than other non-ESG factors in its investment decisions, would not be permitted to use "ESG" or similar terminology in its name. Doing so would be defined to be materially deceptive or misleading.

What to Do Now

- A growing investor demand for ESG focused products has been accompanied by a corresponding increase in the number of ESG products offered by investment advisers. The SEC has taken notice and has become increasingly concerned with ensuring that investment advisers' disclosures and materials that market themselves as ESG-focused are accurate and consistent with actual practices. Investment advisers that incorporate ESG factors into their investment strategies and practices would be well-advised to review the accuracy of their ESG-related disclosures and ensure that their compliance policies and procedures are consistent with such disclosures, and that their portfolios are managed in a manner consistent with any stated ESG-related investment objectives.
- The SEC's intensified focus on ESG-related issues also has implications for public companies in general who tout their ESG bona fides. Specifically, such companies should review their ESG-related disclosures, including any "green" and "sustainable" claims, for accuracy and consistency across difference forms of disclosure. In light of the proposed proxy voting and shareholder engagement disclosure requirements, public companies should anticipate even more rigorous engagement from their ESG-focused investors. Pressure from institutional investors to engage on ESG issues will likely increase as these investors will need to support their ESG credentials and comply with enhanced disclosure requirements.
- Public companies should also reexamine their own ESG claims, as the SEC's scrutiny of ESG disclosures will likely not be limited solely to those made by investment funds. With respect to public disclosure and commitments to ESG goals, public companies should consider taking additional measures, including regular reviews of their ESG-related commitments and disclosures as part of their controls environment. Public companies should take actions to review the accuracy and verifiability of such statements made in their SEC reports, on their websites, and sustainability reports and representations regarding products in marketing materials and to regulators. Insofar as any review identifies issues, public companies should consider the best approach for proactively getting out in front of such issues, which can cause reputational damage, as well as legal and regulatory challenges.

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[1] *See, e.g.*, *Swartz v. The Coca-Cola Company, et al.*, No. 3:21-cv-04643 (N.D. Cal. 2021); *Bush v. Rust-Oleum Corp.*, 2021 WL 24842 (N.D. Cal. Jan. 4, 2021); *Lee v Canada Goose US, Inc.*, 2021 WL 2665955 (S.D.N.Y. June 29, 2021); *In re Oatly Group AB Securities Litigation*, No. 21-cv-6360 (S.D.N.Y. 2021).

[2] *See, e.g.*, *Greenpeace, Inc. v. Walmart, Inc.*, 2021 WL 4267536 (N.D. Cal. Sept. 20, 2021); *Sierra Club v. The Coca-Cola Company*, No. 3:21-cv-04644 (N.D. Cal. 2021).

Annex A

SEC's Rule Proposals Regarding the Use of ESG Factors by Investment Advisers

Proposed Revisions to Form ADV

The SEC stated that the proposed revisions to Form ADV will promote consistent, comparable and reliable information for investors concerning funds' and advisers' incorporation of ESG factors.

Adviser Brochure (ADV Part 2A): In its release, the SEC proposed amending Form ADV Part 2A (the brochure) to require ESG-related disclosures from registered investment advisers that consider ESG factors as part of their advisory businesses. Such amendments include:

- **Part 2A, Item 8: Methods of Analysis, Investment Strategies and Risk of Loss**

  The release proposed adding a new sub-Item 8.D to Part 2A which would require an adviser to provide a description of the ESG factors it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors. Additionally, advisers would be required to include an explanation of whether and how they incorporate a particular ESG factor into their operations. Sub-Item 8.D would also require any adviser using criteria or a methodology to evaluate, select or exclude investments based on ESG considerations to describe such criteria and/or methodologies and how they are used.[3]

- **Part 2A, Item 10: Other Financial Industry Activities and Affiliations**

  The SEC proposed an amendment to Item 10.C to require an adviser to describe any relationship or arrangement that is material to its advisory business or to its clients that the adviser or any of its management persons have with any related person that is an ESG consultant or other ESG service provider ("Related Person ESG Service Provider"). Specifically, the amendment would require the adviser to identify the Related Person ESG Service Provider, describe its relationship and, if the relationship creates a material conflict of interest with clients, describe the nature of the conflict, as well as how the adviser addresses it.

- **Part 2A, Item 17: Voting Client Securities**

  The SEC proposed amendments to Item 17.A to require advisers that incorporate ESG factors into specific voting policies or procedures when voting client securities to include in their brochures a description of all ESG factors they consider and how they consider them.

Form ADV Part 1A: The proposal also includes proposed amendments to Form ADV Part 1A (for both registered investment advisers and exempt reporting advisers) to collect certain census-type information regarding advisers' use of ESG factors (including their uses of third-party ESG service providers) using the structured XML-based (*i.e.*, machine-readable) data language, to provide the SEC and investors with consistent, usable and comparable data.[4]

- **ESG Data for Separately Managed Account Clients and Private Funds**

  The proposal includes amendments to Form ADV Part 1A Item 5.K (and the corresponding sections of Schedule D) as well as Section 7.B.(1) of Schedule D to collect information regarding advisers' use of ESG factors for separately-managed account ("SMA") clients and reported private funds, respectively. Specifically, an adviser would be required to disclose whether it considers ESG factors as part of one or more significant strategies in the advisory services it provides to its SMA clients and reported private funds. Such data would be collected in an effort to provide the SEC and clients/investors with important information about advisers' consideration of ESG factors in their advisory businesses, including the specific factors considered, the types of ESG-related strategies employed and potential conflicts of interest with Related Person ESG Service Providers.

- **Third-Party ESG Framework(s)**

  The SEC proposed to require advisers to report whether they follow any third-party ESG frameworks in connection with their advisory services and, if so, to disclose the names of such frameworks. Because third-party ESG frameworks are not uniform and may apply only to very specific investment types, this information would allow the SEC (and current and prospective advisory clients/investors) to more effectively analyze the guiding principles of advisers' selected frameworks as well as identify and evaluate industry-wide trends.

- **Additional Information about Other Business Activities and Financial Industry Affiliations**

  To allow for a fuller assessment of advisers' conflicts of interest as well as the attendant risks of such conflicts, the SEC proposed requiring advisers to disclose whether they conduct other business activities as ESG service providers or have related persons that are ESG service providers by amending Items 6 and 7 of Form ADV Part 1A (and Sections 6.A. and 7.A. of Schedule D).

Compliance Policies and Procedures and Marketing: In the proposing release, the SEC reaffirmed advisers' existing ESG-related obligations under the Advisers Act Compliance Rule, specifically that advisers' compliance policies and procedures should address (i) the accuracy of ESG disclosures made to clients, investors and regulators and (ii) the consistency of portfolio management processes with ESG-related investment objectives disclosed by the adviser. The release similarly reaffirmed advisers' obligations to avoid material misstatements or omissions in advertisements with respect to the incorporation of ESG factors into such advisers' compliance policies and procedures and the management of client portfolios.

[3] The proposal includes a non-exclusive list of criteria and methodologies to address, including: (i) an internal methodology, a third-party criterion or methodology such as a scoring provider or framework, or a combination of both, including an explanation of how the adviser evaluates the quality of relevant third-party data; (ii) an inclusionary or exclusionary screen, including an explanation of the factors the screen applies, such as particular industries or business activities it seeks to include or exclude and, if applicable, what exceptions apply to the inclusionary or exclusionary screen; and (iii) an index, including the name of the index and a description of the index and how the index utilizes ESG factors in determining its constituents.

[4] XML-based data language applies unique identifying tags to financial data items. These tags provide a range of information and show how items relate to one another, how they are calculated and whether they fall into particular groups for organizational or presentation purposes. XML tagging of information in a form makes the information computer-readable, extractable and searchable.