

ESG Considerations for Investment Advisers

By Amber Allen and Craig Watanabe



About the Authors:

Amber Allen is VP and General Counsel with Fairview Investment Services, LLC. She is reached at amber.allen@fairviewinvest.com.

Craig Watanabe is the Director of IA Compliance at DFGP Investments. He is reached at cwatanabe@dfpg.com.

Overview of “ESG”

On May 25, 2022, the SEC proposed a **rule** and form amendments that would require disclosures concerning ESG practices by certain registered investment advisers, advisers exempt from registration, registered mutual funds, and business development companies. “ESG” is an acronym for Environmental, Social and Governance. ESG investing is a socially conscious investment strategy that screens investments for desirable characteristics in the ESG categories. It is closely related to “socially responsible investing”, “impact investing”, “sustainable investing” and other titles, although there are subtle differences. The SEC has chosen to focus on ESG, as evidenced in the May 25th proposal. Accordingly, this article will do the same.

ESG Investing

According to Morningstar’s Global Sustainable Fund Flows Report Q4 2021¹, as of year-end 2021, assets in “sustainable” funds exceeded \$2.7 trillion and in the fourth quarter of 2021, there were net inflows of \$143 billion. A recent article in Reuters² quoted Refinitiv Lipper data showing 10% of global fund assets are allocated to ESG funds, and the trajectory of growth is explosive. The article went so far as to call 2021 the year of ESG investing. With the immense popularity of ESG investing, it should be no surprise that there is a regulatory focus on ESG investing.

Given the plethora of views on ESG topics, ESG investment models are broadly defined and vary significantly by firm. Firms have latitude to define what ESG means for their firm. However, it is essential that each firm utilizing an ESG investment model clearly define and consistently use ESG terminology. The definitions should be reflected in the investment standards, policies and procedures, proxy voting, and marketing for applicable ESG strategies.

SEC’s Focus on ESG Investing

The SEC’s May 25th rule proposal is far from the first time that the SEC has turned its attention to ESG. Over the last few years, the SEC has taken a number of steps to demonstrate its focus on ESG, including forming an ESG task force, issuing a risk alert, and bringing a number of enforcement actions.

ESG Task Force

In March 2021, the SEC announced the formation of an Enforcement Task Force focused on ESG issues³. The stated objective of the task force is to “develop initiatives and proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment.” Of note, the press release lists fourteen ESG-related enforcement actions dating back to 2008, which predates the term ESG. The formation of an enforcement task force announced the intention of the SEC to aggressively enforce compliance violations such as greenwashing.

2021 Risk Alert

In April 2021, the SEC released a risk alert on ESG investing.⁴ The following issues were highlighted from examinations:

- Compliance policies and procedures were not in place or were not adequately designed to prevent legal violations;

1. See “Global Sustainable Fund Flows: Q4 2021 in Review”, Morningstar (January 31, 2022), available at: [Global_ESG_Q4_2021_Flow_Report_FINAL.pdf \(contentstack.io\)](#)

2. See “How 2021 Became the Year of ESG Investing” by Ross Kerber and Simon Jessop, Reuters (December 23, 2021) available at: [Analysis: How 2021 became the year of ESG investing | Reuters](#)

3. See “Spotlight on Enforcement Task Force Focused on Climate and ESG Issues”, U.S. Securities and Exchange Commission Press Release (March 4, 2021), available at: [SEC.gov | Spotlight on Enforcement Task Force Focused on Climate and ESG Issues](#)

4. See “The Division of Examinations’ Review of ESG Investing (April 4, 2021), available at: <https://www.sec.gov/files/esg-risk-alert.pdf>

- Inadequate controls to maintain and monitor ESG-related investment guidelines and restrictions;
- Inconsistent voting of proxies and firm’s ESG guidelines;
- Marketing included misleading statements regarding ESG.

Further, compliance programs were less effective when personnel had limited ESG knowledge.

Examination Priorities

In 2020 and 2021,⁵ the SEC identified ESG as an examination priority area. The SEC 2022 Examination Priorities letter listed ESG Investing as one of the five Significant Focus Areas and provided a clue to future rulemaking, specifically with regard to standardized disclosures, proxy voting, and greenwashing.

SEC Enforcement Actions

In April 2022, the ESG Task Force announced its first enforcement action against Vale SA⁶ which was quickly followed by a settled charge against BNY Mellon⁷ and charges against Health Insurance Innovations⁸. There will almost certainly be more, likely many more, to come. The fact patterns in these cases are irrelevant to the point we are making, which is that there is stark evidence of increased regulatory scrutiny on ESG-related issues.

The SEC Proposes to Enhance Disclosures by Investment Advisers Related to ESG Investment Practices

Proposed Amendments to Form ADV⁹

As mentioned above, on May 25th, the SEC proposed a rule that would require investment advisers to provide additional information regarding their ESG investment practices. The rule proposal is a daunting 362 pages. It is best to read the proposal in its entirety; however, it is time consuming. An expedited effort would be to read the two-page SEC Fact Sheet¹⁰ and then jump to the text of the rule proposal on pages 354-362¹¹. Here are some highlights of the proposal:

- The proposal defines three categories of ESG strategies (Integration, Focused and Impact) and requires the adviser to identify the extent to which ESG factors are considered by identifying with one or more of the categories.
- Form ADV Part 2A, Item 5.M would require the firm to disclose any third-party ESG framework(s) used in connection with providing advisory services.
- Form ADV Part 2A, Item 6, 7, 10 and/or 12 would require firms to disclose any ESG consultant or other ESG service provider used in connection with providing advisory services.
- Form ADV Part 2A, Item 8.D – Methods of Analysis, Investment Strategies and Risk of Loss, would require extensive and specific disclosures regarding ESG screening.
- As described in the next section of this article, firms would need to disclose specific proxy voting policies in Form ADV Part 2A, Item 17 – Proxy Voting.

5. See “2022 Examination Priorities”, U.S. Securities and Exchange Commission, Division of Examinations (March 30, 2022) available at: [2022 Examination Priorities Report \(sec.gov\)](#)

6. See Securities and Exchange Commission v. Vale S.A., Complaint and Jury Trial Demand, Civil Action No. 22-cv-2405 (April 28, 2022) available at: [comp-pr2022-72.pdf \(sec.gov\)](#)

7. See “SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations”, U.S. Securities and Exchange Press Release 2022-86 (May 23, 2022) available at: [SEC.gov | SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations](#)

8. See “SEC Charges Tampa-Based Health Insurance Distributor and its Former CEO with Making False Statements to Investors”, U.S. Securities and Exchange Commission Press Release 2022-126 (July 20, 2022) available at: [SEC.gov | SEC Charges Tampa-Based Health Insurance Distributor and its Former CEO with Making False Statements to Investors](#)

9. “Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices” (footnote 5)

10. See “Fact Sheet: ESG Disclosures for Investment Advisers and Investment Companies”, U.S. Securities and Exchange Commission (May 25, 2022) available at: [ia-6034-fact-sheet.pdf \(sec.gov\)](#)

11. “Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices” pages 354-362 (footnote 5)

Integration, Focus, and Impact

The proposed rule creates three categories of ESG strategies depending on the how heavily weighted ESG factors are in the investment decision-making process.

- **Integration** – “consider one or more ESG factors alongside other, non-ESG factors in your investment advice, but such ESG factors are generally no more significant than other factors in advising your clients with respect to investments, such that ESG factors may not be determinative in providing advice with respect to any particular investment.”
- **Focused** – “focus on one or more ESG factors by using them as a significant or main consideration in advising your clients with respect to investments or in your engagement strategy with the companies in which your clients invest.”
- **Impact** – “ESG “impact” strategies or methods of analysis are those ESG-focused strategies or methods of analysis that seek to achieve a specific ESG impact or impacts. For any ESG impact strategy or methodology, you must provide an overview of the impact(s) you are seeking to achieve and how you are seeking to achieve the impact(s) (including how you measure progress toward the stated impact, disclosing the key performance indicators you analyze, the time horizon you use to analyze progress, and the relationship between the impact you are seeking to achieve and financial return(s)).”

Compliance Prerogatives

Greenwashing

Those in the compliance industry are familiar with the term, “say what you do and do what you say.” This means what you say (i.e., in your policies and procedures) and what you do need to be aligned. Regarding ESG investing, the term “greenwashing” means marketing or representing an investment strategy as socially conscious in some respect when the investments are not consistent with ESG mandates. Although ESG is a complex topic, compliance violations are predominantly greenwashing, which simplifies compliance and informs your efforts.

Proxy Voting

In addition to greenwashing, another ESG-related compliance prerogative is proxy voting. Proxies should be voted in a manner that is consistent with the firm’s ESG policies and procedures and any marketing materials. For example, if a firm states that a given ESG strategy will avoid investing in companies that manufacture widgets, it should, in general, vote against matters that would promote widget manufacturing.

The SEC’s May 25th rule proposal specifically addresses proxy voting responsibilities:

“If an adviser discloses to investors that ESG-related proxy proposals will be independently evaluated on a case-by-case basis, the adviser should adopt and implement policies and procedures for such evaluation. In addition, if an adviser advertises to its clients that they will have the opportunity to vote separately on ESG-related proxy proposals, the adviser must provide such opportunities to its clients to the extent applicable and should maintain internal policies and procedures accordingly.”

The proposed amendments to Form ADV included revised instructions for Form ADV Part 2A, Item 17 – Proxy Voting:

“If you have, or will accept, authority to vote client securities, describe briefly your voting policies and procedures, including those adopted pursuant to SEC rule 206(4)-6. If

you have specific voting policies or procedures to include one or more ESG considerations when voting client securities, describe which ESG factors you consider and how you consider them. Describe whether (and, if so, how) your clients can direct your vote in a particular solicitation. Describe how you address conflicts of interest between you and your clients with respect to voting their securities. Describe how clients may obtain information from you about how you voted their securities. Explain to clients that they may obtain a copy of your proxy voting policies and procedures upon request.”

Portfolio Monitoring

Regulators expect compliance testing to include reviews of portfolio mandates and restrictions, including those related to ESG. Portfolios should be reflective of the portfolio’s mandate, including any investment restrictions. The same goes for ESG portfolios. ESG portfolios should be reviewed regularly to ensure they align with the ESG investment standards. Firms should also implement processes to monitor the selection, investment, and monitoring of ESG investments. This can be done using portfolio monitoring systems. However, as with any automated process, you should use a trust but verify approach, and incorporate periodic testing as part of your compliance review.

Amendment to the Names Rule¹²

This is a proposal to amend rule 35d-1 under the Investment Company Act and does not directly affect investment advisers. However, we think the rule is telling and investment advisers should take notice. 35d-1 requires funds whose name suggests a focus in a particular type of investment to adopt a policy to invest at least 80% of the assets in a manner consistent with the name. The proposal would greatly broaden the requirements to names that are “suggestive” of a particular strategy. The SEC set a bar at 80% and advisers to ESG strategies would be well-advised to adhere to the same standard.

Regulatory Uncertainty

ESG and climate change are highly controversial topics. There have been anti-ESG bills proposed in Congress and states around the country.¹³ As we have seen previously, regulatory focus is subject to change with changes in our government. With elections quickly approaching in November, it is possible that changes in our House and / or Senate could result in additional ESG-related changes on the horizon.

Conclusion

Regulatory focus on ESG has continued to increase since 2020. The proposed rule further evidences that the current regulatory regime has no intention of shifting gears, so firms should review compliance programs closely to determine if any changes are needed.

Using the rule proposal as a template for an ESG assessment could be very beneficial. Should the proposal become final, you would know what changes need to be made to achieve alignment with ESG disclosures and screening.

Dealing with ESG issues can be challenging because it requires interaction with Senior Management and/or Marketing Departments. With the trends in ESG regulation and enforcement, the proposed rule will hopefully provide the impetus Compliance Officers need to prioritize changes needed to comply with best practices. ■

12. See “SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names”, U.S. Securities and Exchange Commission Press Release 2022-91 (May 25, 2022) available at: [SEC.gov | SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names](https://www.sec.gov/SEC-Proposes-Rule-Changes-to-Prevent-Misleading-or-Deceptive-Fund-Names)

13. See, e.g., Ensuring Sound Guidance Act, H.R. 7151, 117th Cong. (2022)

<https://www.congress.gov/bills/117/congress/house-bill/7151/text?r=1&s=1>; H.B. 2799, 2022 Leg. (Pa. 2022)<https://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2021&sessInd=0&billBody=H&billTyp=B&billNbr=2799&pn=3437>; AN ACT relating to state dealings with companies that engage in energy company boycotts, S.B. 2052022 Leg., (Ky. 2022), <https://apps.legislature.ky.gov/recorddocuments/bill/22RS/sb205/bill.pdf>.