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How Cos. Can Respond To ESG Focus In SEC Exam Priorities

By **Rebecca Fike and Kelly Rondinelli** (April 13, 2022, 2:37 PM EDT)

Following hot on the heels of the eagerly anticipated release of a proposed rule[1] regarding climate-related disclosures, the U.S. Securities and Exchange Commission's Division of Examinations released its examination priorities[2] for fiscal year 2022 on March 30.

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And, consistent with the SEC's current focus[3] on environmental, social and corporate governance issues, ESG investing is number two on the list of the division's significant focus areas.

ESG Investing

Central to the division's ESG investing focus is the underlying concern that disclosures relating to ESG strategies or the incorporation of certain ESG criteria "could involve materially false and misleading statements or omissions, which can result in misinformed investors."

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The risk of this, per the division, is further compounded by: (1) a lack of standardization in ESG investing terminology; (2) the varied approaches to ESG investing; and (3) the failure to address legal and compliance issues for new lines of business and products.

At the heart of the division's concern regarding the lack of standardization is the concept of "greenwashing."

Greenwashing is the provision of misleading or false information to consumers or investors that a company's products or services are more environmentally friendly or focused than they really are. The lack of standardized terminology exacerbates the problem and leads to further investor confusion, even where a company is trying to be accurate.

For example, more often than not, the terms "ESG" and "sustainability" are used interchangeably. Although similar, "sustainability" is vague in meaning and broad in coverage, while "ESG" is specific, measurable and focused on three distinct prongs.

The same idea is true in the division's second identified risk: the varied approaches to ESG investing.

The division gives the example that a company could label itself as utilizing ESG strategies and criteria and do so alongside consideration of other, more traditional financial and economic factors. Equally, another company could label itself as utilizing ESG strategies and use them as the central driving force behind its investment decisions, and investors might not be able to discern the difference between the two from disclosures alone.

The broad variation provides enough of a gap for companies to run afoul of SEC requirements and fall prey to greenwashing, resulting in both decreased consumer and investor confidence and also increased potential for an enforcement action.

The division's third identified risk — failure to address legal and compliance issues for new lines of business — is more forward-looking. However, it still stems from the problem that greenwashing can occur in situations where a company fails to accurately represent the relationship between its ESG strategies or criteria and its new lines of business and products.

For example, while preexisting ESG-related information may be appropriate for past or current business and products, a company could fail to modify or update such information for new lines, thereby leaving itself open to claims of false statements and misleading investors.

The Division's Focus

The Examination Division's priorities emphasize its continued focus on mutual funds, exchange-traded funds and private fund offerings, among others, with particular attention on the following:

1. Whether SEC-registered investment advisers and registered funds are "accurately disclosing their ESG investing approaches" and have implemented policies to prevent violations of securities laws in connection with such disclosures;

2. Whether registered investment advisers and registered funds are "voting client securities in accordance with proxy voting policies and procedures and whether the votes align with their ESG-related disclosures and mandates"; or

3. Whether registered investment advisers and registered funds are misrepresenting, or overstating, the ESG factors they consider or include into their portfolio selection.

This comes as no surprise given the SEC's risk alert[4] released on April 9, 2021, which summarized the division's observations from examinations of investment advisers, registered investment companies, and private funds and their offerings of ESG products and services. The risk alert noted several "deficiencies and internal control weaknesses" related to ESG investing, including a lack of ESG-specific policies, inconsistent disclosures and inadequate compliance programs to address relevant ESG issues.

ESG Investing as an Enforcement Priority

The proposed rule on climate-related disclosures combined with listing ESG investing as the second significant focus area for the division demonstrates a strong commitment to ensuring investors and consumers receive transparent, accurate and consistent information regarding companies' ESG approaches and strategies.

As the demand for ESG investing increases, it follows that the SEC is devoting additional enforcement resources in this area. Companies must ensure that their disclosures align not just with investor demands and market needs but also SEC expectations and requirements.

This commitment is evident elsewhere in the division's examination priorities. Fourth on the list of significant focus areas is information security and operational resiliency where, as the division explains, it will be reviewing business continuity and disaster recovery plans with particular attention "on the impact of climate risk and substantial disruptions to normal business operations."

For "systematically important registrants," the division's examinations will account for certain climate-related risks and include

a focus on the maturation and improvements to business continuity and disaster recovery plans ... as well as ... registrants' resiliency as organizations to anticipate, prepare for, respond to, and adapt to both sudden disruptions and incremental changes stemming from climate-related situations.

This provides another area of cross-over with the proposed rule on required climate disclosures regarding a company's analysis of its resiliency to physical and transition climate risks. Importantly, this falls under the "E" prong of ESG.

Next Steps

To avoid the receipt of an SEC comment letter, registered companies should evaluate their ESG-related disclosures, marketing and public statements to ensure accuracy and consistency, both externally and with respect to internal company practices.

With regard to the latter, companies should also check that their internal policies and procedures adequately address ESG investing and provide appropriate compliance oversight. Additional steps companies can take to avoid greenwashing and maintain both investor and consumer confidence are detailed below, with several building upon SEC staff observations of effective practices as detailed in the April 2021 risk alert:

Ensure the company's marketing and disclosure practices demonstrate a clear, standardized understanding of ESG.

Utilize consistent terminology to avoid misrepresentation, whether through false and misleading statements or simple confusion. Substantiate the claims the company makes to include documentation — e.g., research, selection, monitoring and, where applicable, due diligence — clear records, and robust written policies and procedures.

Be transparent as to the company's ESG investing strategy.

Make it clear to investors how ESG informs investment decisions, whether it is one of several factors considered or the driving force, and the incorporation, if applicable, of measurable ESG-related goals and metrics related to the same.

Be consistent.

Align portfolio management practices with disclosures concerning ESG approaches and strategies and, similarly, between actual firm practice and marketing. For example, as noted in the April 2021 risk alert, some companies lacked adherence to global ESG frameworks despite claiming such adherence. Equally important: Ensure that marketing, practices and disclosures are updated as ESG strategies, approaches and investing develop.

Evaluate and adjust internal compliance and controls to adequately address ESG issues.

A company should develop, implement and update all applicable policies and procedures regarding its ESG strategies to address, as appropriate, investing, analyses, processes, monitoring and compliance. Additionally, a company's internal compliance should ensure accuracy and consistency is present across portfolio management practices and ESG-related disclosures.

Educate personnel.

It cannot be overstated the importance of training a company's personnel on relevant ESG issues, such as disclosures or investment decisions. Knowledge is key here.

Takeaway

As the division explains, it will continue to allocate significant resources to the examination priorities for fiscal year 2022, conducting examinations on "new or emerging risks, products and services, market events, and investor concerns."

Companies subject to SEC regulations should take heed of the signs that the agency is committed to addressing ESG investing and will take enforcement action when necessary to ensure the SEC's mission of protecting investors is fulfilled.

By evaluating company practices, policies, procedures, disclosures, compliance and controls with respect to ESG investing, companies can avoid greenwashing and maintain investor and consumer confidence.

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[1] Securities and Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors (March 21, 2022), https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[2] Securities and Exchange Comm'n, Div. of Examinations, 2022 Examination Priorities (Mar. 2022). https://www.sec.gov/files/2022-exam-priorities.pdf.

[3] The SEC's Climate-Disclosures Proposed Rule – Eight Key Takeaways, V&E (Mar. 23, 2022), https://www.velaw.com/insights/the-secs-climate-disclosures-proposed-rule-eight-key-takeaways/.

[4] Risk Alert: The Division of Examinations' Review of ESG Investing, SEC (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.