# Coloring green within the lines: ESG imperative for asset management firms

**By Celia A. Soehner, Esq., and Lance Dial, Esq., Morgan, Lewis & Bockius LLP**

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Global interest in environmental, social, and governance (ESG) investing has never been greater. More and more investors are seeking investment strategies that further their ESG goals, capture ESG opportunities, or mitigate ESG risks. This new demand has created an imperative for asset management firms to think critically about how they should address ESG issues in their operations and their investment product offerings.

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This increase in demand has not gone unnoticed by global regulators. On the global front, the International Organization of Securities Commissioners (IOSCO) recently published new ESG-related regulatory recommendations. In the European Union, asset managers are busy implementing the Sustainable Financial Disclosure Regulation and associated regulatory technical standards.

Regulators in the United States are also paying attention. The Securities and Exchange Commission has demonstrated that ESG is a core focus, putting ESG-related matters on its rulemaking agenda (including matters relating to climate risk, workforce diversity, and corporate board diversity), creating a Division of Enforcement task force dedicated to climate and ESG issues, and focusing on climate and ESG-related risks in examinations. The Department of Labor has also crafted a rule proposal intended to expand the ability for U.S. retirement investors to put money into ESG-related investment products.

Unfortunately, despite the increased client demand for and regulatory scrutiny over ESG-related investment products, a clear definition of ESG investing remains elusive. This ambiguity creates significant regulatory risk for firms that seek to embrace their client demand, especially for asset managers who look to adapt existing product offerings. However, asset managers can mitigate this regulatory risk while maintaining the latitude to respond to client demands.

## Regulatory risks

There are two general areas in which asset managers face regulatory risk. First, and primarily, firms can face regulatory scrutiny for "greenwashing," which generally occurs when firms overstate their ESG practices and capabilities. Second, and less squarely in the crosshairs of regulatory bodies to date, firms face risks with respect to their fiduciary duties to existing clients, particularly when they materially alter their existing products to include ESG elements.

**Greenwashing**, Greenwashing is very much a focus of the current regulatory environment. Regulators are concerned that asset managers looking to satisfy the demands of clients and prospects may be overstating the scope and materiality of their ESG practices, and that their actual portfolio management practices employed by the manager do not live up to the ESG claims.

Since many investors take a manager's ESG capabilities into account when determining whether to make an investment, regulators are increasingly viewing ESG claims, even those that are very high-level or generic, to be material to the investors' decisions. As a result, asset managers are expected to substantiate even the most general of ESG claims, such as saying that "we consider ESG factors when making investment decisions."

**Fiduciary duties**. Asset managers everywhere owe fiduciary duties to their clients, which means that they must put clients' interests ahead of their own. The market opportunities available with respect to ESG investing create new potential conflicts of interest that implicate this core fiduciary duty.

Specifically, asset managers have an interest in demonstrating a broad and deep commitment to ESG investing by creating a large menu of ESG products or having a large collection of ESG-related assets under management. This interest may conflict with the interests of the manager's existing clients who may not have interest in ESG investing, if, for example, they are concerned that ESG factors could reduce performance or may have already-existing investment allocations to ESG strategies.

Given this potential conflict, asset managers who seek to adjust strategies in order to incorporate ESG management may face regulatory scrutiny over whether they are putting their existing clients' interests first when making those adjustments.

## Coloring within the lines

Mitigating these regulatory risks requires firms that are incorporating ESG into their investment products to take a very deliberate approach to ensure that their approach to ESG is understood by the entire firm and clearly and accurately communicated to clients.

**Develop an overarching firm strategy.** As an initial step, asset management firms should adopt a high-level firm strategy that addresses available opportunities. A clear, high-level firm strategy can help to ensure that the entire organization is coordinated in its efforts. Significant regulatory risk is created where, for example, marketing or client groups embark upon a business strategy that is not endorsed by portfolio managers or compliance officers.

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Part of this strategy should include whether the firm will be creating new products, evolving existing products, or highlighting ESG-related features of their existing products (or all of the above). Each of these approaches carries its own regulatory risk profile. From a regulatory perspective, firms face very few regulatory risks with respect to creating new ESG-focused products, provided the strategies are clearly described to investors.

On the other hand, firms that elect to integrate ESG risk assessments into existing strategies must ensure that they are complying with the fiduciary obligation to put their clients' interests first. In most jurisdictions, prior to implementation the firm is obliged to provide existing clients with clear disclosures of any material changes to its investment strategies.

Firms that seek to highlight the ESG-related features of existing products face the most complicated regulatory questions. They will have to substantiate that the ESG-related features have always been part of the product and, if those features were not highlighted before, identify what has changed to make them more relevant to prospective investors. In addition, this approach requires a retroactive review of existing marketing material and other disclosures to ensure that the firm is not contradicting any prior claims through new ESG-related disclosures.

**Define terms internally.** Armed with a clear strategy, firms should develop an internal glossary of ESG-related terms. By doing so, a firm can make certain that everyone is speaking the same language. For example, a firm could establish specific criteria that a strategy must meet to be defined as "sustainable."

Similarly, placing clear guidelines on what can be considered an "environmental" or "social" factor will ensure that the firm does not inadvertently exaggerate the role that ESG factors play in a given investment strategy.

Firms should also make certain that their investment-strategy disclosures are understood. When a portfolio manager notes that she "considers" ESG factors, firms should be clear as to what that consideration entails. One level of consideration could be an exclusion of investments that fail to meet certain criteria, and another can be investing only in ventures that exceed other ESG criteria.

On the other hand, a portfolio manager can consider ESG factors, but then make an investment notwithstanding those factors (e.g., investing in a polluting factory because the price is low enough to compensate for the increased ESG risk). These nuances need to be clear across an organization to make sure that investors, portfolio managers, and compliance professionals all have a common understanding.

**Ensure product integrity.** With a clear, high-level business strategy and agreed-upon terms, firms can then establish practices to make certain that their products are delivering on their ESG commitments. These practices should not be markedly different from what firms already do to confirm that their strategies are following their philosophies and processes. For example, a firm may be able to utilize the same processes that it applies to ensure that managers of "value" are actually managing assets consistent with a "value" strategy.

In addition, firms should focus on their compliance oversight to make sure that their offering documents clearly and accurately describe the products, that their investment-compliance infrastructure can confirm compliance with any investment guidelines, and, most importantly, that their marketing materials and client communications precisely detail the ESG features of these products.

## Conclusion

ESG is a rapidly developing space with many opportunities for asset managers and their clients, but it comes with the potential for increased regulatory risk. To mitigate that risk, asset managers should develop an overall strategy, establish agreed-upon defined terms, and create processes to ensure that products are being managed the way that they are described. In this way, asset managers will make certain that they say what they do and do what they say and avoid unintended regulatory issues.

## About the authors

**Celia A. Soehner** (L) is a partner with **Morgan, Lewis & Bockius LLP** in the Pittsburgh office and the deputy leader of the firm's capital markets and public company practice. She co-chairs the firm's ESG and sustainability team, and previously served as an attorney-advisor with the U.S. Securities and Exchange Commission (SEC) in the Division of Corporation Finance. She can be reached at celia.soehner@morganlewis.com. **Lance Dial** (R) is a partner at the firm in the Boston office. With more than a decade of experience as senior in-house counsel with global investment managers, he has a deep understanding of mutual fund law and operation and is fluent in the regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. He can be reached at lance.dial@morganlewis.com.

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