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ESG enforcement is on the rise: Are you ready?

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Investors and U.S. financial regulators have made clear that they seek to hold companies and asset managers responsible for public statements they make about ESG. When the Securities and Exchange Commission (SEC) created the Climate and ESG Task Force within the Division of Enforcement with the express purpose of identifying ESG-related misconduct, many public companies and investment advisers started preparing for expected enforcement actions.

The Task Force is using a variety of methods and potential sources to proactively identify "material gaps or misstatements in issuers' disclosure of climate risks under existing rules, and disclosure and compliance issues relating to investment advisers' and funds' ESG strategies." It also works closely with other SEC Divisions and Offices, including the Divisions of Corporation Finance, Investment Management, and Examinations.

While the SEC has proposed new rules to address climate and ESG-related disclosures by public companies and registered investment advisers and funds, the Task Force does not need to wait for new rules to police this misconduct — it applies longstanding principles of disclosure and fiduciary duty, which we have seen play out in a handful of enforcement actions filed to-date.

With those considerations in mind, companies and asset managers should take a thoughtful approach to how they handle ESG-related disclosures. While best practices differ based on specific circumstances, the overarching principle is the same: Do what you say and say what you do. Misstatements are the easiest things for the SEC to charge.

Companies and advisers should be careful to not make ESG-related statements that they cannot prove, whether in SEC-required filings or voluntary statements made, for example, in corporate sustainability reports, on websites, or in marketing materials. As with the law governing any type of disclosure, ESG statements should be accurate, consistent, and verifiable. We lay out several ways that companies and advisers can help ensure these disclosures don't invite an investigation or enforcement action.

Public companies

The SEC is closely scrutinizing ESG-related disclosures by public companies. To ensure that ESG practices and principles are adhered to throughout the organization — and portrayed accurately in public disclosures — it's important that companies start by setting the right tone at the top. If climate goals or ESG considerations are intended to be part of the company's fabric, then, as a foundation, it's important that the company has buy-in and support from those at all levels of the organization.

Companies should also take a close look at their corporate governance and oversight structures to see if any changes should be made to climate-related risk and disclosure controls and processes. Consider establishing a framework to facilitate board oversight of ESG processes and reporting by, for example, establishing an ESG committee at the board level. Board-level supervision of ESG-related processes and reporting will help mitigate against the risk of shareholder suits and SEC investigations scrutinizing the oversight and controls that companies have in place to govern ESG-related processes and reporting.

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For those that don't create a separate oversight committee, some public companies are including ESG processes within the scope of internal or even external audit functions, which can provide assurance that ESG processes described in disclosures are adhered to and provide helpful cover if an investigation is launched.

In addition, public companies should identify and assess high risk areas and the potential impact of climate-related strategies on their business models and financial outlooks. It follows that companies should consider including material ESG-related risk factors in their public disclosures to mitigate shareholder litigation concerning ESG disclosures and consider whether to engage third-party experts or legal counsel to review disclosures. Finally, company executives should be mindful that any public statements that they make, including voluntary and oral statements, are fair game for SEC enforcement staff and can create liability if false or misleading.

Investment advisers

As with public companies, the SEC is similarly focused on ESG disclosures and practices by registered investment advisers and funds. The SEC is looking at situations where, for example, fund materials state that investment advisers generally consider ESG principles, the adviser can demonstrate such consideration for each investment made by the fund.

Because the SEC takes a very broad view of materiality regarding ESG-related statements, to avoid regulatory scrutiny, advisers should be careful of the language they use to describe processes, especially where language suggests a definitive or categorical practice. Also be aware that using terms like "green" or "sustainable" in a fund's name or in related marketing materials may trigger greenwashing concerns and could raise questions about the basis for such statements. To the extent such terms are used, advisers should consider making clear their own definitions of the terms and why they believe such terms apply to the fund.

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More generally, ESG terminology can be somewhat ambiguous, so advisers should consider defining terms (*e.g.*, "ESG integration") internally before including those terms in investor-facing materials. Advisers and funds should confirm that any disclosures in marketing materials regarding fund statistics, investment strategies, investment selection, and research processes are reviewed by relevant subject matter experts. To that end, advisers should also not assume that standard language or presentation slides regarding ESG processes are applicable across strategies or funds; for example, a statement about how an adviser integrates ESG into its investment process might be applicable to Fund A but not Fund B even if the funds use the same adviser.

To ensure accuracy and consistency, firms should regularly review and update policies and procedures concerning investor-facing disclosures; regularly review and update routine responses to requests for proposals and information, due diligence questionnaires, and any investor presentation materials; and regularly review existing product review processes to confirm they are validating any ESG elements, including ensuring that materials from any sub-adviser are true and consistent for the adviser's product. Finally, firms should implement and regularly update trainings to ensure a comprehensive understanding around investment processes, disclosures, and marketing materials.

Advisers should also consider reviewing their ESG-related strategies on a regular basis to ensure they are managed consistent with their disclosures and marketing materials. This is especially important as ESG investing evolves and more ESG-related data becomes available. ESG considerations that may be considered material today may be supplanted by more nuanced considerations in the future; fund disclosure will need to stay consistent with those changes.

Further, such reviews can ensure that portfolio managers continue to authentically implement their ESG strategies and will build a helpful record in the event of an SEC examination/investigation or the veracity of fund disclosure is otherwise called into question.

Implementation of ESG-related principles will be unique to each organization — whether a public company or asset manager. But the SEC's (and investors') focus will remain the same. All must be able to prove the ESG-related disclosures they make to investors are true, consistent across the organization, and supportable. By implementing robust processes and controls such as those described above, firms will be on solid ground to respond to regulatory and investor scrutiny. Adoption of these best practices and having a comprehensive and holistic ESG approach that addresses factual and legal issues as part of the business strategy may not eliminate the risk of SEC and shareholder scrutiny, but these practices can help mitigate liability and provide viable defenses.

Morgan Lewis partner Lance Dial also contributed to the article.

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About the authors



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