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ALERT

SEC Enforcement Related to ESG Investing Likely to Increase in 2022

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In March 2021, the U.S. Securities and Exchange Commission (SEC) created a Climate and Environmental, Social, and Governance (ESG) Task Force (ESG Task Force) within the Division of Enforcement, the purpose of which is to identify and investigate ESG-related violations. And over the last year, the SEC has bolstered the ESG Task Force by adopting a new "all-agency approach" to tackling climate and ESG matters, including announced rulemaking and the appointment of ESG-friendly new leadership. Additionally, during 2021, demand for ESG investment opportunities skyrocketed and ESG-related concerns captivated boardrooms across the nation all while the regulatory scheme has stagnated, creating fertile ground for enforcement activity in the climate and ESG-investing space. In light of this, the ESG Task Force is poised to make a full court press in 2022.

ESG Task Force: Priorities and Fact Patterns of Interest Heading into 2022

Created in March 2021 and headed by Kelly Gibson, the Director of the SEC's Philadelphia Regional Office, the ESG Task Force is intended to "develop initiatives to proactively identify ESG-related misconduct" and "coordinate the effective use of Division resources . . . to identify potential violations." More specifically, the ESG Task Force works to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules" and "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."

During a recent conversation with the Environmental Law Institute, Ms. Gibson handed out a 2022 playbook, indicating that in the next year, the ESG Task Force will be concentrated on detecting and bringing

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enforcement actions for "greenwashing," which she defined as "exaggerating" a "commitment to, or achievement of climate . . . related goals." She explained that because there has been a "dramatic surge in popularity for ESG focused investment funds" without an associated evolution in U.S.-law and ESG criteria, there is a high risk that investors may be misled by greenwashing.

Despite the ESG Task Force's name and stated purpose, Ms. Gibson said that it is "not the environmental police," and instead, she described its "focus" as "making sure that investors are given the most accurate information possible in a timely manner, and that advisors are doing what they say they'll do." To that end, the ESG Task Force will be looking closely at,

- "What issuers say in their filings and elsewhere,"
- "What investment advisers say and do in terms of their stated investment strategies," and
- "How investments are labeled."

More specifically, Ms. Gibson outlined different scenarios that the SEC intends to pursue going forward.

- For issuers: Falsely stating that it met an ESG target and/or omitting disclosures of material events related to ESG issues.
- For funds: Selling an ESG product or service without a real and concrete plan as to how the adviser will follow through on the sales pitch. For example, how will adherence to a fund's ESG goals be measured?
- For proxy voting: Failing to vote in a manner consistent with fiduciary duties and the client's ESG mandate and restrictions.

Just five days after Ms. Gibson outlined the ESG Task Force's priorities, the new Director of the Division of Enforcement, Gurbir Grewal, publicly noted that while the task force was created to "sharpen [the SEC's] focus" on ESG-matters, there is "nothing 'new' about how the Task Force – or the Enforcement Division as a whole – investigates possible climate and ESG-related misconduct." Rather, the SEC applies "longstanding principles" in the ESG-space: for issuers, "long-standing principles of materiality and disclosure," and with respect to asset management, "long-standing principles regarding fiduciary duties and honest disclosure regarding how products will be managed." Mr. Grewal emphasized in his speech that the SEC—as it often claims—would not be engaging in "regulation by enforcement" of ESG matters.

The SEC's "All Agency Approach"

The SEC's new "all-agency approach" to addressing risks related to climate and ESG investing means that the ESG Task Force will enjoy the benefit of several inter-agency resources, as detailed below. Accordingly, the ESG Task Force should be expected to be a well-supported and highly coordinated effort heading into 2022.

First, in February, the SEC appointed a Senior Policy Advisor for Climate and ESG, a new position. The role will involve "advis[ing] the agency on [ESG] matters and advanc[ing] related new initiatives across its offices and divisions." Then- Acting Chair Allison Herren Lee stated: "Having a dedicated advisor on these issues will

allow [the SEC] to look broadly at how [ESG issues] intersect with our regulatory framework across our offices and divisions."

A month later, a day before the announcement of the ESG Task Force, the SEC Division of Examinations announced its Examination Priorities for 2021, which included an enhanced focus on climate-related risks. Ms. Lee specified that the Division of Examinations would zero in on risks related to climate and ESG by scrutinizing proxy voting policies and practices "to ensure voting aligns with investors' best interests and expectations, as well as firms' business continuity plans in light of intensifying physical risks associated with climate change." The Division of Examinations' emphasis on proxy voting was echoed several months later in Ms. Gibson's comments—strongly indicating the SEC's continued commission-wide focus and likely a harbinger of enforcement actions to come.

The Division of Examinations took swift action after announcing its priorities. Right away, it issued a risk alert to "highlight observations from recent exams of investment advisers, registered investment companies, and private funds offering ESG products and services." Consistent with Ms. Gibson's later comments to the Environmental Law Institute, the Division of Examinations flagged "rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions [as] present[ing] certain risks." Its responsive plan also tracks the ESG Task Force's fact patterns of interest described above. The Division of Examinations indicated that, for firms "claiming to engage in ESG investing," it would take a close look at portfolio management, performance advertising and marketing, and compliance programs. A consistent approach signals that the ESG Task Force and the Division of Examinations are likely to work in coordination in the year to come to uncover ESG related violations and bring subsequent enforcement actions.

Further, in June, SEC Chair Gary Gensler announced the SEC's rulemaking agenda, which included a proposed rulemaking for investment companies and investment advisers related to ESG factors. While the SEC has yet to issue any Notice of Proposed Rulemaking (NPRM) on ESG-matters, we should expect to see NPRMs in early 2022 regarding (1) the enhancement of "registrant disclosures regarding issuers' climate-related risks and opportunities" and (2) requirements for investment companies and investment advisers "related to [ESG] factors, including ESG claims and related disclosures."

Most recently, Republican Commissioner Elad Roisman, who has previously publicly questioned the SEC's focus on climate and ESG risks, announced that he will be leaving the agency. On December 20, 2021, he tendered his resignation, and he will be stepping down in January 2022. As of the date of this publication, President Biden has yet to nominate a replacement, but we expect a strong push for a nominee who at least indicates a receptiveness to the SEC's ESG priorities.

ESG in the Boardroom

As the SEC steps up its focus on ESG and climate matters, boards should understand that they too need to make ESG a top priority. PricewaterhouseCooper's (PwC) 2021 Corporate Directors Survey found that "ESG is the top issue shareholders want to discuss with directors, and is a critical area of board oversight." Further, "[t]he 2021 proxy season saw more ESG-focused shareholder proposals than ever before, and those

proposals received higher levels of support."

Despite ESG being a hot topic, PwC's research shows that boards "may not fully grasp the [associated] risks": "While 64% of directors say ESG is linked to their company's strategy[,] [o]nly 25% say their board understands ESG risks very well." Additionally, "only 28% of directors say their board has a strong understanding of the company's ESG/sustainability messaging." This lack of understanding leaves issuers particularly vulnerable—especially where the enforcement focus on ESG is increasing. Unless directors are properly educated, this gap may feed an uptick in SEC enforcement and increased penalties where issuers and boards have not adequately tested for and addressed ESG and climate risks.

Predictions & Takeaways

In 2022, the SEC's Enforcement Division can be expected to vigorously pursue ESG-related violations, specifically, violations related to greenwashing. Additionally, with the success of the SEC's Whistleblower program and the SEC's and public's focus on ESG, we expect a surge in ESG related tips to the SEC's Whistleblower program followed by significant awards in the coming years. With that in mind, issuers should closely examine how they set and communicate ESG goals; funds should implement internal compliance programs to ensure that policies and procedures are being followed; and boards should educate directors on ESG matters. More generally, greenwashing—that is, the exaggeration of compliance with ESG goals—should be avoided entirely.

Across all areas regulated by the SEC, the buzzword should be **metrics**—how do you as an issuer, fund, or other market participant measure compliance with stated ESG goals? Being able to point to concrete metrics demonstrating assessment of risk and adherence to ESG goals is critical to defending an enforcement action. Finally, because the ESG Task Force is still in its early phases and rulemaking has yet to crystalize, investors, issuers, and funds should all stay tuned-in to the SEC's NPRMs and consider participating in the comment process. Perhaps most importantly, despite the SEC's claims to eschew "regulation by enforcement," no one should be lulled into a false sense of security merely by the absence of concrete ESG regulations.

Along with the predicted increase in SEC enforcement actions, 2022 may also bring an increase in related criminal enforcement. The SEC and U.S. Department of Justice (DOJ) Criminal Division routinely bring parallel proceedings, particularly in the securities fraud arena. Additionally, DOJ's Environment and Natural Resources Division (ENRD) just announced that "enforcement of the criminal provisions of the environmental laws is a priority," and specified that ENRD may use Title 18 (to charge crimes such as fraud and conspiracy) in addition to traditional environmental statutes in its arsenal. Prioritizing criminal enforcement will likely lead to an increase in DOJ environmental investigations of public companies and increased cooperation between SEC and ENRD, resulting in additional parallel enforcement actions. Combined with DOJ's recent pronouncements about a stiffening of corporate enforcement, companies have even more reason to enhance their efforts to establish effective compliance programs related to ESG issues, but also to routinely test, review, and update those programs.