# The Name Game: Sorting Through the ESG Frenzy

The acronym "ESG" – Environment, Social, Governance – is everywhere, including its use in any number of "ESG"-targeted investment funds. Currently, there are over 800 registered investment companies that claim to consider "ESG" criteria in making investment decisions or to somehow further "ESG" goals, collectively representing $3.1 trillion in assets under management.[1] With this huge influx of "ESG" capital, and a new Administration, has come closer scrutiny of ESG-targeted funds and their regulation.

On March 3, 2021, the Securities and Exchange Commission's ("SEC") Division of Examinations announced that its 2021 examination priorities would include focusing on registered investment advisors "offering investment strategies that focus on ESG factors."[2] The next day, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement. The Task Force "will develop initiatives to proactively identify ESG-related misconduct."[3] Speaking before the Future of Asset Management North America Conference on September 29, 2021, SEC Chair Gary Gensler noted that one of the Staff's current projects relates to ESG disclosures, particularly focusing on funds' promoting themselves using terms like "green," "sustainable," or "low carbon."[4]

## Why Does the SEC Care So Much About "ESG"?

Why is the SEC so focused on "ESG" – going so far as to create a special ESG Task Force – when the core issue of accurate disclosure is nothing new? The answer is twofold: (1) the term "ESG" is both vague and broad, and (2) there is a moral-psychological component at play.

With respect to the acronym "ESG," the history is important. In 2004, Paul Clements-Hunt, Head of the United Nations Environment Programme Finance Initiative, along with two other UN officials, sought to name a report on social, environmental, and governance issues in the context of a capital markets analysis.[5] In his own words, Mr. Clements-Hunt explains that they were looking for "sexy phraseology" to "capture the mainstream's imagination," and his "UK tabloid journalistic instincts" were that "ESG" had a good ring to it.[6] Well, he was obviously right – the term has certainly gained traction. The problem, of course, is that sexy shorthand is the antithesis of sufficient disclosure.

A few examples highlight the uncertainty derived from the breadth of the term. An "ESG fund" could be comprised of portfolio companies focused on environmental sustainability and climate change, but be led by an all-white male board – potentially inconsistent with the "Social" component of ESG. Or, the fund could invest exclusively in companies with diverse boards, but whose product offerings expand the hole in the ozone layer. Advisers would be wise to state clearly if the fund is focused on the "E", the "S", the "G," or some combination.

1 https://www.ussif.org/sribasics (These numbers do not include private equity or venture capital funds).
2 https://www.sec.gov/news/press-release/2021-39
3 https://www.sec.gov/news/press-release/2021-42
4 SEC.gov | Prepared Remarks Before The Future of Asset Management North America Conference
5 "The Evolution of ESG," guest post by Paul Clements-Hunt, February 3, 2020: https://medium.com/artificial-heart/the-evolution-of-esg-4bd984657eb0
6 *Id.*

The moral question is more complicated. Given the issue is fundamentally one of accurate disclosure to investors, why is the SEC more focused on ESG-related disclosures than other types of disclosure? The disparate treatment can be seen in the SEC's reaction to use of the word "Blockchain" in fund names. In January 2018, the SEC encouraged two exchange-traded funds ("ETFs") that invested in companies involved in developing the technology for cryptocurrency transactions to remove the word "Blockchain" from their names. And the SEC has also altered the names of other funds that included "buzzwords" like "5G," "artificial intelligence," and "electric cars." But the SEC did not create an "Artificial Intelligence" task force, and its cryptocurrency task force –while another touted priority of the SEC – is focused on the underlying regulation of cryptocurrency itself, not disclosures using the terms "blockchain," "crypto," or "defi," for example. In fact, the "Blockchain" ETF name change issue is not referenced on the SEC's website. By contrast, there is a separate, special site on the SEC's webpage devoted to the "SEC Response to Climate and ESG Risks and Opportunities," with links to the Division of Examinations' Review of ESG Investing, an ESG Funds Investor Bulletin, and the announcement of the creation of the Task Force Focused on Climate and ESG Issues.

The SEC's disparate focus on ESG seems to be explained, at least in part, by the nature of the harm caused by the inaccurate disclosure. The notion that an investor would think her money is working toward improving the world, when it actually is not, seems worse than, say, when she thought she was investing in real estate, and instead her money was put into technology companies. The investor may have based her investment decision on a strongly held moral belief, rather than simply the desire to maximize returns held by all investors.

## What Can the SEC Do?

Regardless of the motivation, what are the SEC's options when it comes to regulating ESG-related disclosures? One answer is for the SEC to simply prohibit the use of the term "ESG" in fund names and marketing materials, much like it has done with other buzzwords. Many funds had been devoted to investing in companies that combat climate change or social issues before the 2004-creation of the term "ESG."[7] Even today, many funds still rely on more detailed language, rather than the term "ESG." Indeed, it is possible the SEC is heading in this direction; it was recently reported that the company Allbirds dropped a claim that it would be the first "sustainable" IPO in response to SEC objections.[8]

The other option is for the SEC to offer clear guidance on what "ESG" means with respect to funds, and what the SEC expects with respect to "ESG" disclosures. Generally, however, the SEC prefers a principles-based approach, rather than a prescriptive one, rejecting the provision of bright-line, quantitative, or other thresholds to identify when disclosure is required.[9] And in the ever-changing landscape of climate and social issues, even if the SEC were to provide guidance tomorrow, it would likely need to change with future developments in the space. If the SEC were to provide

[7] *See, e.g.*, the Domini Social Index, a cap-weighted index fund that met certain standards of environmental and social excellence. https://www.domini.com/insights/a-brief-history-of-sustainable-and-impact-investment-its-still-not-too-late-to-save-the-planet

[8] Allbirds dropped 'sustainable' claim from IPO after SEC objection | Financial Times

[9] Release Nos. 33-10825; 34-89670; File No. S7-11-19 ,RIN 3235-AL78 "Modernization of Regulation S-K Items 101, 103, and 105," August 2020: https://www.sec.gov/rules/final/2020/33-10825.pdf

guidance in the form of rulemaking – as it has indicated it will do this Fall 2021 – it still may take years before a rule is actually finalized and operative.

## What Should Advisers Do Now?

In the interim, as with all disclosure-based issues, advisers should go back to basics and review their disclosures – particularly the use of the term "ESG" – carefully and critically, as the SEC certainly will. In September 2021, the SEC's Division of Corporate Finance posted a sample letter that it "may issue to companies regarding their climate-related disclosure or the absence of such disclosure."[10] Such questions encourage companies to consider whether their disclosures adequately address both the physical effects of climate change on operations and the indirect consequences of climate-related regulation or business trends. The in-depth nature of the questions suggests that the SEC will look critically at any diligence processes or procedures, and expect them to cover "ESG" investments with the same level of detail.

In its Exams Risk Alert issued in April 2021, SEC Staff observed "some instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks."[11] The SEC went on to describe "a lack of policies and procedures related to ESG investing; policies and procedures that did not appear to be reasonably designed to prevent violations of law, or that were not implemented; documentation of ESG-related investment decisions that was weak or unclear; and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials."[12] Advisers would be wise to ensure "ESG" policies are robust, with investment decisions well documented and compliance check points to ensure procedures are followed.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to us.

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10 SEC.gov | Sample Letter to Companies Regarding Climate Change Disclosures[1]
11 https://www.sec.gov/files/esg-risk-alert.pdf
12 *Id.*