Morgan Lewis

2024 Investment Adviser Association
Investment Adviser Compliance Conference
March 7, 2024 3:30 – 4:30 p.m.

GENERAL SESSION: ESG Investing and Compliance: Adapting to the Changing Environment

While investor demand for investment products and financial services that incorporate environmental, social, and governance (ESG) investing factors continues to grow, regulatory requirements and scrutiny continue to increase. Hear about best practices in ESG and sustainable investing compliance programs, including disclosure, marketing, and data and portfolio management. Consider how the latest moves by the SEC, states, and other regulators may impact your firm.

- Zeena Abdul-Rahman, Branch Chief, SEC Division of Investment Management
- Kelly L. Gibson, Partner, Morgan, Lewis & Bockius LLP
- Dan Mistler, Partner, Head of ESG Advisory, ACA Group
- William Nelson, Associate General Counsel, Investment Adviser Association (Moderator)

Supplemental Outline
Relevant ESG Regulatory Developments

I. Introduction

This outline summarizes some of the recent regulatory developments in the United States regarding environmental, social and governance ("ESG") investment practices and focuses focus on the U.S. State Securities and Exchange Commission ("SEC"), federal and state-level legislation within the United States, as well as global developments on ESG investment regulations.

II. ESG Enforcement and Examinations

A. The SEC follows long-standing principles of disclosure and fiduciary duty to satisfy investor demand for information. The active regulatory and enforcement agendas include:

- ESG-focused exams and risk alerts warning against "greenwashing" and misstating sustainability practices
- Division of Enforcement's Climate and ESG Task Force
- Proposed Rules on Climate-Related Disclosure for Public Issuers and ESG Disclosures by Investment Advisers and Registered Funds

B. The SEC has publicly stated several areas of focus for examinations and enforcements, especially through the Division of Investment Management, which has been focusing on ESG Disclosure Rulemaking, the Names Rule Amendments, and Disclosure Review.

C. For 2023, the Division of Examinations again identified ESG as a "Significant Area of Focus", but it dropped that focus area as one of the named priorities for 2024.

D. The SEC's Division of Enforcement closed out the year with another enforcement action highlighting the Division's continued focus on ESG and advisers.

E. The SEC charged an investment adviser for alleged misstatements about its ESG investment process. According to the SEC, the adviser made materially misleading statements about its controls for incorporating ESG factors into research and investment recommendations for ESG integrated products, including certain actively managed mutual funds and separately managed accounts. Also, the adviser allegedly marketed itself as a leader in ESG that adhered to specific policies for integrating ESG considerations into its investments; however, for several years, the adviser failed to adequately implement certain provisions of its global ESG integration policy as it had led clients and investors to believe it would. The adviser neither admitted or denied the allegations and agreed to pay a $19 million penalty. *See* Press Release, Securities and Exchange Commission, Deutsche Bank Subsidiary DWS to Pay $25 Million for Anti-Money Laundering Violations and Misstatements Regarding ESG Investments (Sept. 25, 2023).

III. ESG Rule Proposals and Rulemaking

A. U.S. Securities and Exchange Commission

1. The Enhancement and Standardization of Climate-Related Disclosures for Investors, SEC Rel. No. 33-11042 (March 21, 2022).

a. These proposed rules would generally require public companies to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements.

b. The proposed rules would also require public companies to disclose their greenhouse gas emissions measured as Scope 1 (direct), Scope 2 (purchased), and, if material, Scope 3 (indirect, including suppliers and customers).

c. US public companies are awaiting final climate-related disclosure rules after an intense comment period that raised concerns about the feasibility of reporting all Scope 3 emissions. In the delay, some states have begun implementing their own rules. California Governor Gavin Newsom signed into law two watershed climate bills on October 7, 2023 that will require companies with significant revenue to make climate-related disclosures starting in 2026. The stated purpose of the new laws is to enhance transparency, standardize disclosures, align public investments with climate goals, and raise the standards for businesses to drive action on addressing climate change.

The bills—the Climate Corporate Data Accountability Act (SB 253) and Climate-Related Financial Risk Act (SB 261)—lay out new requirements that share similarities with federal rules proposed by the US Securities and Exchange Commission (SEC) and apply to essentially every large company operating in California. On January 30, A coalition of business groups sued California to overturn those laws on First Amendment grounds. [*Wall Street Journal*]

2. Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices ("ESG Fund Disclosure Proposal") SEC Rel. No. IC-34594 (May 25, 2022).

   a. These proposed amendments would impact how US mutual funds disclose their environmental and social governance ("ESG") programs, with increasing levels of detail depending on the level of ESG consideration.

      (1) Funds that incorporate ESG considerations into their overall investment programs as one factor among many (i.e., "Integration Funds") would have marginally increased disclosure obligations concerning how such factors are considered.

      (2) Funds that consider ESG factors as "significant or main" consideration (i.e., "ESG-Focused Funds") and funds that seek to achieve a particular ESG impact ("Impact Funds") would be subject to more granular disclosure obligations about their ESG considerations, including completing a standardized ESG disclosure in tabular format.

   b. The proposal generally would require ESG-Focused Funds that consider environmental factors in their investment strategies to disclose additional information regarding the GHG emissions associated with their investments. These funds would be required to disclose the carbon footprint and the weighted average carbon intensity of their portfolio.

   c. The proposal also included parallel disclosure for investment advisers that would be included in Form ADV.

3. Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940 (September 2023)

   a. On September 20, 2023, in a 4-1 vote, the US Securities and Exchange Commission (SEC) adopted amendments (the Amendments) to the rule governing fund names, which impose new disclosure, compliance, reporting, and recordkeeping requirements on certain funds. The Amendments expand the scope of Rule 35d-1 (the Names Rule) under the Investment Company Act of 1940 to apply to any fund name that includes terms that suggest a focus on investments that have, or investments whose issuers have, "particular characteristics" such as ESG, and will require an 80% investment policy for such funds. *See*

Names Rule Amendments Will Require Changes for Certain Funds.

b. In the Adopting Release, the SEC explained that the Amendments are designed to improve the protections that the Names Rule provides and to respond to the evolution of the fund industry over the last 20 years. Not only have registered fund assets under management nearly quadrupled during that time, but fund investment strategies also have become substantially more diverse. Despite the fact that few SEC enforcement cases involving Section 35(d) have been brought over the prior 20 years, the SEC asserted that industry changes and the SEC staff's experience with the Names Rule necessitates the Amendments.

IV. State Law Developments

A. ESG investing has been subject to increased US state and federal regulation over the last several years, and 2023 continued that status quo.

B. Categories of Anti-ESG Rules

1. Prohibition on ESG Consideration Laws

- Require that investment decisions be made based solely on financial considerations; and/or
- Restrict or prohibit (i) consideration of non-financial factors in making investments and/or (ii) the pursuit of non-financial–related goals.

2. Prohibition on ESG Discrimination Laws

- Prohibit state actors or companies operating in the state from "discriminating" based on ESG factors or scores or other values-based scores or metrics.

3. Boycott Laws

- Require a designated government official to determine which "financial companies" (including asset managers) boycott or "discriminate" against certain industries (e.g., firearms or fossil fuels), and
- Develop a list of such companies; or
- Prohibit state government entities from contracting with such companies.

C. As of January 1, 2024, 20 states have enacted anti-ESG investing rules, eight have enacted pro-ESG investing rules, and three have enacted disclosure of ESG investing rules. Many more proposed pieces of state legislation remain in the works, while at the federal level congressional interest has also seen an uptick.

- In December 2023, Tennessee's AG filed a consumer protection lawsuit against a prominent financial services firm alleging that the firm made false or misleading statements to consumers regarding the extent of its ESG investing activities and strategies and, in particular, allegedly "downplayed" its use of ESG factors in violation of consumer protection laws.

- Oklahoma is one state that has adopted a "No-Boycott Rule," the Energy Discrimination Elimination Act of 2022 (EDEA), which prohibits government entities such as public pension funds from investing state assets with firms determined to be boycotting the fossil fuel industry.

- Texas has been particularly active in its recent anti-ESG efforts. Similar to Oklahoma's rule, Texas Government Code Chapter 809 (the Texas Boycott Rule) requires divestment of Texas assets, including public retirement plan assets, from financial companies that are deemed to boycott fossil fuel industries. The Texas Boycott Rule empowers Texas to place either individual funds or entire entities on "restricted lists" if the Texas Comptroller's office determines they are "boycotting" energy companies.

  - If a fund is placed on Texas's **restricted fund list**, certain Texas state assets may not be invested in that fund and any then-current holdings in that fund must be divested.

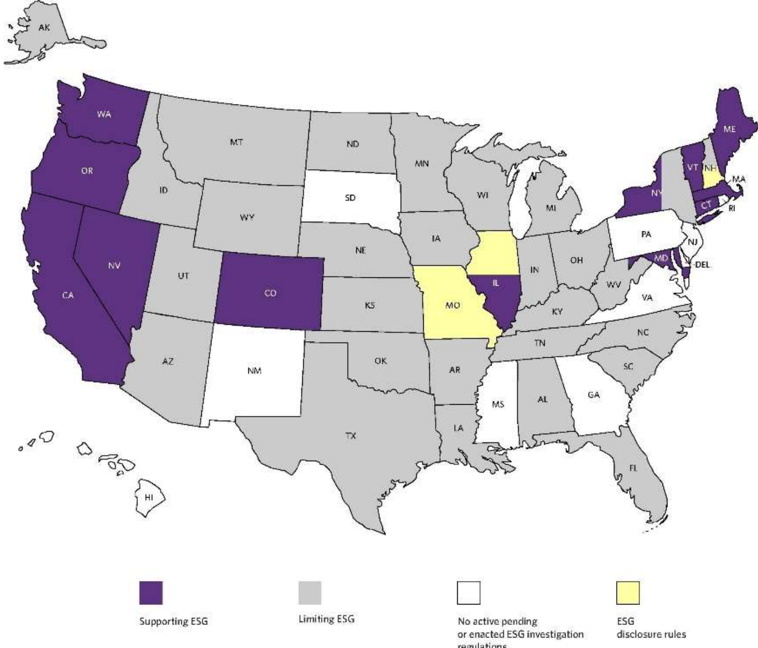
  - If an entity is placed on Texas's **restricted entity list**, Texas state assets may not be invested in publicly traded securities issued by that entity and any then-current holdings in that entity must be divested, and Texas state agencies and political subdivisions are prohibited from entering into certain types of contracts with that entity.

- A number of other states have similar rules in place and, as of the date of this draft, three others (including Oklahoma, West Virginia, and Kentucky) have published boycott lists.

D. Criminal Activity

- On January 30, 2024, New Hampshire lawmakers voted down a bill that would have made public investments in ESG a felony. This is the first bill proposed to criminalize ESG.

ESG State Legislation Tracker
(updated as of 1/1/2024)



V. Congressional & State Attorney General Developments

A. While ESG investing has remained an area of congressional focus for both sides of the aisle for years, there has recently been an uptick in both state and congressional involvement. These issues are the subject of highly partisan actions and we anticipate that businesses will find themselves in situations in which they may become the subjects of legal and other actions no matter the position they take.

1. In December 2023, 18 Attorneys General (AGs), led by Minnesota AG Keith Ellison and Arizona AG Kristin Mayes, sent a letter to the US Congress to defend fund managers' use of ESG factors as "consistent with prudent investment decision-making."

2. The AGs urged Congress not to prohibit fund managers from using ESG factors in investment decision-making, arguing that ESG considerations can offer key insights and inform fund managers' risk-return analyses resulting in reduced risks and greater returns for investors.

3. Also in December, House Judiciary Committee Chair Jim Jordan (R-OH) subpoenaed several large and prominent financial services firms as part of the committee's probe into the adequacy of US antitrust laws to address "collusive agreements" relating to pro-ESG investing laws and activities. This followed an earlier document and information request by the committee to a member of the Climate Action 100+ and the Glasgow Financial Alliance for Net Zero focused on investigating whether advancement of the consideration of ESG factors by these firms violated antitrust rules. [Black Rock and State Street subpoena, Vanguard and Arjuna Capital subpoena]

4. The House Judiciary Committee has also subpoenaed several proxy voting advisory firms as part of a probe into possible violations of antitrust laws based on alleged coordination on ESG issues.

VI. Global ESG Regulations

A. EU corporations and non-EU corporations should prepare for new sustainability reporting obligations under the European Corporate Sustainability Reporting Directive (CSRD). The United Kingdom continues to develop its own revised and updated corporate sustainability reporting regime that will apply to UK companies.

1. Sustainability has been at the forefront of the European Union's legislative activities for the last few years. The United Kingdom has begun passing its own economy-wide sustainability regulations that are distinct from EU laws. With respect to corporates, the EU and UK have opted for extensive reporting obligations to meet stakeholder demands for more sustainability transparency and accountability. The EU and UK laws both no longer focus only on listed companies or public-interest companies (such as banks and insurers); instead, the new laws will be triggered if certain size thresholds (e.g., revenue or employee thresholds) are met on an individual or consolidated basis. Notably, from 2025, large private EU companies will be in scope of the CSRD. The EU laws are phased in over time, with the largest companies becoming subject to the new rules the earliest. *See* Corporate Sustainability Reporting Obligations in the EU and UK.

2. In addition, the CSRD incorporates an extraterritorial element by (additionally) making non-EU corporations subject to the new sustainability reporting obligations—if certain revenue thresholds are met in the EU. Therefore, multinational corporations headquartered outside the EU with subsidiaries in an EU country need to assess whether their respective subsidiaries will become subject to the new reporting obligations. Also, the added attention of legislators, law enforcement authorities, and public interest groups in environmental, social, and governance (ESG) in general and CSRD in particular increases the pressure on multinational corporations to pay closer attention to these topics, even if they may seem (geographically) far away.

3. The extensive sustainability disclosures that multinational corporations will have to make if they are in-scope of CSRD (or other such regimes) also bear a considerable risk of nurturing climate activism and action, since one of the policy drivers of transparency obligations is to equip stakeholders such as shareholders, investors, employees, activists, and public interest groups with sustainability information about a certain corporation so it may potentially be challenged.

4. The UK has started to enact its own corporate sustainability reporting regime. In common with the EU approach, whether companies are in scope of those laws generally depends on whether they meet certain size thresholds on an individual or consolidated basis. In particular, certain UK companies with a high energy consumption are already required to report their energy and greenhouse gas (GHG) emissions under the UK Streamlined Energy and Carbon Reporting Regulation (SECR) and provide a statement on how managers have had regard to certain sustainability matters as part of their management duties.

5. In addition, high-turnover UK companies are already required to report in line with the Task Force on Climate-Related Financial Disclosures (TCFD) framework. Furthermore, the UK has signaled that it will likely adopt the sustainability disclosure standards developed by the International Sustainability Standards Board (ISSB) and make it mandatory for certain UK companies to report in line with the ISSB standards.