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SEC Continues Enforcement Scrutiny of ESG Claims by Investment Advisers

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In November 2022, the SEC announced a settlement with Goldman Sachs Asset Management, L.P. (GSAM), including a penalty in the amount of $4 million, in which the SEC alleged that GSAM initially failed to adopt procedures to ensure compliance with certain ESG claims made to GSAM clients/investors and then, once adopted, failed to follow such procedures. Like the BNY Mellon ESG order, which was settled last May for $1.5 million, the SEC focus was on statements made by the adviser regarding how it integrated ESG into its investment decision-making process. Notwithstanding the larger penalty in this GSAM order, the order only alleged an Advisers Act compliance rule violation while the BNY Mellon order included a compliance rule violation as well as additional allegations involving fraud/misstatements under the Advisers Act and the Investment Company Act. This order, the BNY order and the SEC proposed Advisers Act ESG rulemaking demonstrate the SEC's focus on ESG claims by registered investments advisers.

In the GSAM order, the allegations relate to certain separately managed accounts and mutual funds that incorporated the term "ESG" into their names (the "ESG Products"). In 2017, GSAM initially offered the ESG separately managed accounts without having developed associated ESG policies and procedures. Beginning in 2018, in communications to third parties, the adviser indicated that a proprietary ESG questionnaire combined with a materiality matrix were used to inform stock selection and portfolio construction and were considered in determining position sizing for each of the ESG Products. In 2018, the adviser also developed supporting ESG policies and procedures. The policies and procedures required investment teams to complete a questionnaire for a company prior to including it in the ESG Products. The responses to the questionnaire generated numerical scores which were then weighted using a sector-specific materiality matrix, and were intended to be among several factors considered in determining position sizing for the ESG Products. However, the order alleged that while the adviser did generally conduct some ESG diligence on investments, the detailed questionnaire process described above was not always followed between April 2017 and February 2020. Additional allegations include (1) failing to sufficiently train adviser staff on ESG policies and procedures and (2) failing to maintain completed questionnaires in a central location as required by the adviser's policies.

The GSAM order, like the BNY Mellon order, shows that the SEC will look very carefully at all statements made about an adviser's ESG strategy and is willing to bring enforcement actions regarding any perceived gaps between communications to investors/clients on ESG, an adviser's ESG compliance policies and procedures and the adviser's actual ESG investment process. While these orders relate to the management of public securities strategies, the same principles and SEC focus can occur in the private equity, real estate or other asset classes.

An adviser may wish to consider some or all of the following steps to mitigate SEC ESG enforcement risk:

1. **ESG Statement Inventory**: Conduct an inventory of all ESG statements that the firm has made in any investor communication (in both orders, the SEC cites to disclosures made in fund governing body materials, RFPs and pitch books in addition to prospectuses or PPMs) and ensure that the firm follows those statements in all material respects and that the firm has support for such statements. All new statements should be approved and inventoried prior to being communicated to clients/investors. Particular focus should be paid to statements regarding how the firm integrates ESG into investment processes.
2. **ESG Training**: Regularly train the firm's professionals on ESG policies and procedures, the importance of following them consistently, and the risk of making any statements that create greenwashing risk. This should include investment, compliance, marketing and ESG professionals.
3. **Re-Evaluate ESG Policy**: Review the firm's ESG policy and confirm that all aspects either apply to all funds and strategies or that each aspect is clear about the strategies and funds to which it applies. Here it appears that GSAM indicated that its ESG questionnaire strategy applied to all ESG Products when in fact it was only applied to some ESG Products.
4. **ESG Recordkeeping Checklist**: Go through any ESG policies and procedures and identify what records they require to demonstrate implementation. Develop a process for ensuring these records are created, maintained and easily retrievable in the event of an SEC examination.
5. **SEC Examination Prep**: Include ESG questions in any periodic SEC exam preparation exercises.

Related Professionals

Norm Champ, P.C.

Partner / New York

Scott A. Moehrke, P.C.

Partner / Chicago

Diane Blizzard

Partner / Washington, D.C.

Michael Chu

Partner / Chicago

Matthew Cohen

Partner / Bay Area – San Francisco / Los Angeles – Century City

Melissa S. Gainor

Partner / Washington, D.C.

Phil Vincent Giglio

Partner / Chicago

Nicholas A. Hemmingsen

Partner / Chicago

Daniel Kahl

Partner / Washington, D.C.

Alpa Patel, P.C.

Partner / Washington, D.C.

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Partner / Chicago

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Christopher J. Scully

Partner / Chicago

Ryan P. Swan

Partner / Chicago

Josh Westerholm, P.C.

Partner / Chicago

Jina K. Yun

Partner / Chicago

Alexandra N. Farmer, P.C.

Partner / Washington, D.C.

Mary Beth Houlihan

Partner / New York

Jennie Morawetz

Partner / Washington, D.C.

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Suggested Reading

- 15 November 2022 Kirkland AIM SEC Proposes New Rules on Adviser Oversight of Service Providers
- 03 June 2022 Kirkland AIM SEC Proposes Enhanced Disclosure by Certain Advisers on ESG Investment Practices
- 14 March 2022 Kirkland AIM SEC Proposes Significant New Cybersecurity Rules for Investment Advisers