May 26, 2022

SEC Settles Enforcement Action Against Mutual Fund Adviser Challenging Funds' ESG Disclosure

The Securities and Exchange Commission ("SEC") announced (here) settled cease and desist charges and a $1.5 million penalty against a mutual fund investment adviser on May 23, 2022 for alleged misstatements and omissions in fund disclosures regarding the adviser's incorporation of environmental, social, and governance ("ESG") factors into its investment process. The SEC alleged that the adviser represented that investments in the funds it advised had undergone an ESG quality review but in fact did not have ESG quality review scores for all investments held by the funds in question. The settlement marks the first enforcement action by the Division of Enforcement's Climate and ESG Task Force, formed in March 2021, and the first time in several years the SEC has brought an enforcement action based on ESG disclosures made by a registered fund.

The order previews the Task Force's legal theories and enforcement agenda for ESG funds, which threaten to prove aggressive and far-reaching. Although the adviser sponsored a suite of funds identified as "sustainable," those funds were not the subject of the SEC's action. Rather, the funds at issue were *not* represented to be ESG-specific or green funds. ESG factors or considerations were not listed among the principal investment strategies of the funds and the prospectuses did not include representations regarding ESG-related commitments or goals that the investments were to pursue.

Instead, the funds' prospectus indicated that the sub-adviser managing the funds at issue integrated a proprietary ESG ranking system in evaluating investments. According to the SEC's allegations, approximately 75% of the investments in the funds received a score under the sub-adviser's system, but a "reasonable investor" reviewing the prospectus "*could* mistakenly conclude that *all* portfolio holdings" had received an ESG review (emphasis added).

The order's characterization of the funds' disclosures strains and all but ignores the well-established law of materiality. Indeed, nowhere in the order does the SEC describe the alleged misstatements or omissions as being "material." Notwithstanding that fact, the order goes on to assert violations of Section 206(4) of the Investment Advisers Act of 1940 and 206(4)-8 promulgated thereunder, as well as Section 34(b) of the Investment Company Act of 1940, which require a showing of a misstatement or omission of a *material* fact. In order to charge a "material" misrepresentation, the SEC must demonstrate a misstatement or omission that presents a "substantial likelihood" of affecting the decision-making of a reasonable investor in light of the total mix of information. The statement in question may not be viewed in isolation. Here, where the funds at issue were not labeled as "green" or ESG funds, and did not feature ESG factors as a principal investment strategy, it is difficult to see how it would be material to a reasonable investor's decision-making whether the sub-adviser's proprietary internal ESG ranking system scored all securities in the portfolio as opposed to three-quarters of them. Such a theory, allowing liability for disclosure language where an investor "could" reach a misimpression based on what the SEC believes the language merely "implied" or "suggested," would represent a troubling new approach to enforcement.

In addition to those referenced above, the charges in the settled order include non-scienter based claims for material misstatements and for failure to adopt and implement reasonably designed policies and procedures, pursuant to Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, respectively. In the order, the SEC credited as grounds for the outcome the adviser's cooperation -- including "detailed factual summaries" and "substantive presentations on key topics" provided to the staff -- as well as its prompt remedial efforts, including revised disclosures and controls.

The order was published two days before the SEC's open meeting was held on May 25, during which the SEC proposed rule and form amendments that would, among other things, require registered investment advisers and registered funds to provide additional information about their ESG practices. While the SEC's recent enforcement action was not discussed

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during the open meeting, the majority of the Commissioners firmly reasserted their commitment to a strong regulatory and enforcement agenda in the ESG space. Notably, the proposed amendments released in conjunction with the meeting include a requirement that funds *considering* ESG factors in their investments, which the rule classifies as “integration funds,” include disclosures on their strategy for integrating ESG factors into their investment selection process. These rule proposals will be discussed in more detail in forthcoming Ropes & Gray client alerts.

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