



Navigating the evolving regulatory landscape to establish a compliant ESG investment practice

Emerging challenges and opportunities for investment managers that offer ESG, impact, and sustainable investment strategies

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Navigating uncertainty and evolving regulatory expectations

While both retail and institutional investor demand for ESG is growing, the investment management industry is simultaneously facing an unprecedented amount of external regulatory pressure. This pressure comes in the form of changes in government policies and increased regulatory expectations around establishing adequate processes to support ESG fund offerings. Frameworks are developing globally, including the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) and Europe's Corporate Sustainability Reporting (CSRD). The Securities and Exchange Commission (SEC) is also demanding that investment management firms take full accountability of their end-to-end ESG product and service life cycle, which includes the information that is detailed in the disclosures and sales literature that are provided to shareholders and investors.⁵ The lack of finalized ESG or climate-focused regulations in the United States also does not mean that the SEC is incapable of enforcing potential rule violations. In fact, it appears that the current SEC administration intends to take a more aggressive approach when holding investment management firms accountable.⁶ This approach is demonstrated by the SEC's announcement of three climate-focused rule proposals that are detailed further below.

The term "greenwashing" is often used to assert that investment managers are using ESG terminology as a marketing ploy to capitalize on a rise in demand.⁷ Such managers are often unable to demonstrate that they're fulfilling the ESG protocols and practices that have been established in-house. In 2022, the SEC fined three large asset managers for overstating ESG AUM and not performing the investment due diligence activities that were included in marketing materials for those particular products and services. Regulators, such as the SEC, have also begun to scrutinize ESG claims through new rulemaking and enforcement actions. The establishment of a Climate and ESG Task Force, the announcement of three climate-related rule proposals, and recent enforcement actions send a clear message: Instances of greenwashing will not be tolerated, and a failure to strictly comply with the regulators' expectations may have repercussions.



US policy: A constantly shifting target to address climate change

From the federal level to the local level, the pendulum swings each time elected offices change hands. Under the Biden administration, the federal government has pivoted toward adopting policies and regulations that seek to mitigate the impacts of climate change. These policies include the Department of Labor's recent final rule that allows fiduciaries to consider climate and ESG factors and replaces a 2020 rule that discouraged consideration of these factors.

Among the financial regulators, the SEC has been at the forefront with proposing climate-focused regulations. Its crowning proposal, "The Enhancement and Standardization of Climate-related Disclosures for Investors" (Climate Disclosure for Investors), is just one example of the agency's two-pronged approach, which includes both new rulemaking and enforcement.

Developing new regulations⁸

In 2022, the SEC created three rule proposals related to climate-risk disclosures, ESG advisory services, and ESG investment practices and reporting requirements:

- *Climate disclosure for investors:* The proposal positions investment managers as both consumers and, in certain cases, producers of new climate-related data by requiring public company issuers to report certain information related to the organization's climate strategy, if it has one, and various metrics associated with Scope 1, 2, and 3 emissions.

- *Investment company names:* The SEC's proposed amendments to Rule 35d-1 (the "Names Rule") of the Adviser's Act would require funds to invest at least 80% of their assets in alignment with the fund's name, among other expectations. The rule will have a material impact on the business operations of the investment and fund managers that offer ESG products and services, if finalized.⁹

- *ESG disclosures for investment advisers and investment companies:* This rule proposal creates three categories of ESG funds and sets disclosure requirements that vary depending on how central ESG is to the fund's investment strategy. The various disclosures will impact fund prospectuses, annual reports, and adviser brochures.

Among other things, the proposed rules that are briefly described above will require the diligent attention of investment managers as they begin to adopt their front-to-back ESG investment strategy and approach to conform to increased regulatory expectations. The SEC makes it clear the current trial-and-error approach to ESG that some investment management firms are taking in establishing their ESG investment approach, will need to be refined promptly as the SEC expects to release the final version of its climate disclosure rule by April 2023.¹⁰

Enforcing existing regulations

At the beginning of 2022, the SEC announced that ESG will be an exam priority for the agency. Shortly thereafter, the SEC issued an enforcement action against an investment adviser that resulted in a \$1.5 million fine for the firm's failure to develop and implement policies and procedures reasonably designed to achieve compliance with the applicable regulations. In addition, the firm failed to develop written policies and procedures that govern how ESG factors are evaluated during the investment due diligence process for their ESG funds and separately managed accounts until after the strategy was already introduced to customers. The findings cited in the SEC's most recent ESG-related enforcement action are not the first of its kind. Later in 2022, a global asset management firm was cited for a similar set of violations and was subsequently fined \$4 million.¹¹

In order to support the increasingly aggressive enforcement efforts, the SEC is adding 65 new resources to oversee the growing number of investment advisers. These resources are meant to facilitate a swelling number of examinations for newly registered and existing investment advisers. Thus, advisers should expect a growing number of SEC examinations where ESG investment practices, for advisers offering those services, will be increasingly scrutinized and examined.¹²

New and existing ESG-related regulations are making it critically important for wealth and investment managers to establish defined policies, procedures, processes, and controls to ensure that they are adequately prepared to mitigate the potential financial, compliance, and operational risks that may surface in an evolving regulatory environment.

Key focus areas and enhancement opportunities for investment managers looking to adopt an ESG approach to address regulatory expectations

Investment managers face increasing operational and compliance challenges with respect to ESG investing, where a commonly cited challenge is related to third-party ESG data. This includes data access, identification, verification, management, and use case development.

Offering ESG products and services and providing credible public disclosures requires investment managers to source a significant amount of net new data. Traditionally investment managers are no strangers to sourcing and utilizing service provider data (e.g., MSCI, Bloomberg) to aid in investment decision-making, but ESG presents a rather different challenge in that there are so many potential data providers with varying breadth and depth of ESG data. Investment managers are now tasked with parsing through the many available options to select a service provider that closely aligns to their own ESG investment philosophy, strategy, and data needs. Additionally, below is a list of considerations that investment managers should evaluate when deciding which data providers to partner with to source and utilize ESG data:

- **Clearly defining ESG data use cases.** Investment managers must clearly define and articulate how they intend to use the ESG data both internally and externally. This is accomplished by developing use cases that illustrate the different scenarios for how the data will be used and disclosed, with special attention to the intended external disclosure of the ESG data. Managers should closely partner with legal counsel to determine that each intended use case is permissible and explicitly defined in the terms and conditions of the contract with each data provider.

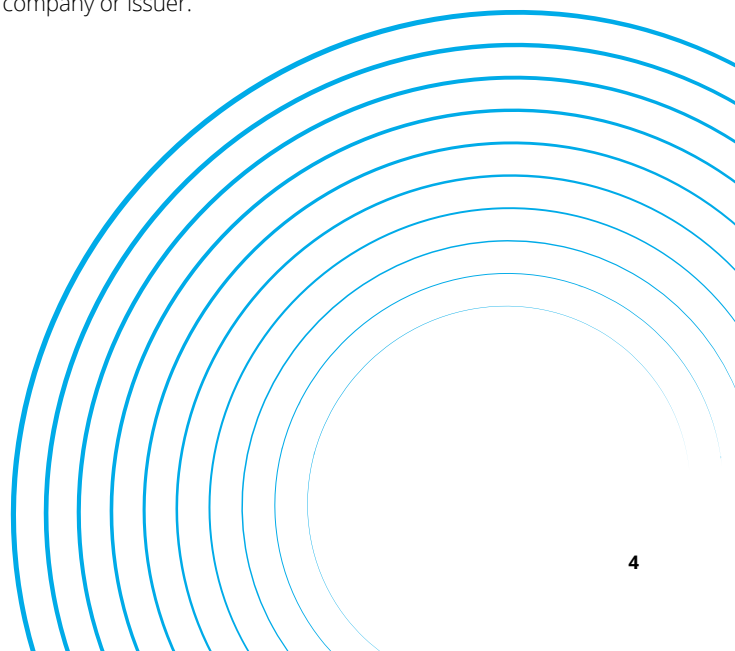
- **Centralized vs. decentralized enterprise approach to engaging data providers.** Organizational preferences may differ, but the benefits of centralization include greater negotiation power with data providers, savings on technology overhead costs with regard to acquisition, and tighter overall enterprise data governance. However, it is correct to expect that the ingestion of the data by each investment team will differ.

- **Proxy voting.** Given the overtly political nature of ESG investing in the United States, firms executing these strategies need to be aware of the risks associated with proxy voting and the potential for proxy battles as activist investors on both sides of the issue attempt to shape private sector strategies.

- **Number of ESG data providers.** Each data provider offers varying levels of access to ESG data, in both breadth and depth. The “appropriate” number of ESG data providers will be dependent on the clearly defined population of ESG data use cases and the issuer’s universe that the investment manager needs to cover. There are both established and numerous emerging industry leaders with respect to ESG data, but each investment manager’s ESG goals and objectives will ultimately dictate which providers and the number of providers and data sets that are preferred.

- **The need for real-time ESG data.** Typically, ESG data is only updated once per year. However, many of the emerging data providers use artificial intelligence (AI) to perform realtime web scrubbing, which can be extremely useful for delivering timely, relevant ESG insights that may impact a company (e.g., a negative or positive corporate incident that could have an immediate effect on an organization’s stock price).

- **Each third-party data provider has its own ESG materiality/scoring methodology.** Investment managers should review each data provider’s methodology documentation to assess alignment to the investment management’s own ESG philosophy and strategy. Often investment managers will need to leverage data from multiple providers and data sets to obtain coverage for a given investment universe. When this happens, managers may need to create their own internal processes for prioritizing ESG score preferences in the event that two or more data providers provide varying ESG scores for a single company or issuer.



ESG roles and responsibilities

Historically, organizational commitments to support an ESG practice have been wide-ranging, and the alignment of the ESG team could vary from an embedded function within marketing/external affairs to having a straight line to the CEO. From an investment management perspective, the role of the ESG team has evolved drastically over the past few years, as the team now plays a significantly enhanced role in the investment management enterprise, including some of the following:

- **ESG integration and strategy.** The ESG team is a steward of the enterprise ESG investment strategy, serving as the hub within with responsibility for organizing the many artifacts related to ESG across the organization. Typically, the ESG team will collaborate with each investment team to develop a specific investment philosophy and processes that align with the specific asset class and investment thesis. Additionally, the ESG team is tasked with guiding leadership in the development of an organization's overall ESG approach.
- **ESG data due diligence.** The ESG team drives the integration of ESG metrics and principles into the investment decision-making activities of the investment teams. The team works to determine whether investment teams are optimally and properly using third-party data. The ESG team works with the investment teams to identify its ESG data needs and to select the ESG data sets that closely align to the organization's investment thesis for the applicable products and services
- **Collaboration with other business functions on ESG-related matters:**
 - **Compliance** – Build out policies, procedures, and processes for risk mitigation, monitoring activities (including pre and post trade compliance monitoring), and risk disclosure. Some ESG teams take on significant compliance support functions at either the first line of defense (LOD) or second LOD level; others serve in a more advisory capacity. This will depend on the existing compliance landscape and governance structure for each investment manager.
 - **Legal** – Assist in negotiating with vendors around data use meeting the needs of defined use cases. Also provide legal guidance to determine that the organization has properly interpreted and addressed the applicable ESG regulations and rule requirements.
 - **Internal audit** – Aid in designing audit procedures and ensuring that sufficient governance and segregation of duties processes are established to hold the relevant parties accountable to their assigned responsibilities.



◦ **Finance (corporate finance and/or fund treasury)** – Depending on the organization, process ownership can be shared across several finance-related business functions where the primary responsibilities include managing the classification taxonomy and methodologies across asset classes. Finance is also responsible for the reconciliation, validation, and reporting of ESG data, as well as monitoring the underlying processes and infrastructure that hosts the data. The responsibility of handling internal ESG data and metrics for internal and external reporting may vary depending on the organizational structure and business capabilities of the investment manager.

When thinking about ESG roles and responsibilities, investment managers should scan the organizational hierarchy vertically and horizontally to assess if the stakeholders and process owners impacted by their organization's ESG practice currently have a seat at the table. The path forward for developing an ESG strategy that's tactically sound and inclusive of the topical areas laid out previously will require cross-functional coordination among disparate parties. This cross-functional collaboration is often achieved by establishing a formal ESG committee with oversight by the board and/or C-suite. The ESG committee should include representatives from the impacted functions within the organization.

Key ESG focus areas and enhancement opportunities

Investment managers are experiencing increased compliance pain points as a result of the need to effectively adapt and implement formal ESG governance processes and controls across investment, operations, and compliance functions. While each enterprise's framework and approach to ESG is their own, investment managers should pay close attention to the following tenets:

- **ESG data ownership and control** – From acquisition to validation, use, disclosure, and reporting, investment managers should have clear definitions of ESG data and control ownership across the organization. This includes the roles and responsibilities for access, delivery, and maintaining and providing evidence of control operating effectiveness.
- **Embedded controls** – Integrating ESG controls across the investment technology ecosystem enables near-real-time oversight and monitoring capabilities. Investment managers should actively incorporate ESG control considerations to existing and future data and technology transformation initiatives.
- **Internal readiness assessment** – Coordinated control design and effectiveness assessments, as well as independent compliance testing, should be coordinated and executed. This is an important aspect that should be done for each use case.
- **Define and integrate ESG into the risk management framework**
– Adequately designed policies, procedures, processes, and controls ensure that the organization is prepared to mitigate the potential financial, compliance and operational risks that may surface in an unpredictable regulatory environment. The design and implementation of this ESG risk management framework is crucial for investment managers to attain both immediate and long-term operational readiness.



Charting the path forward for ESG in investment management

In order to build an effective ESG investment approach, it is critical for investment managers to capitalize on the industry guidance for addressing common ESG practice deficiencies, such as the issues detailed in the recent SEC enforcement actions.

Subsequently, investment managers should continue to monitor examination priorities as the regulatory agencies begin to further scrutinize ESG investing practices. The task of attempting to tackle a growing, independently important list of ESG-related compliance and operational challenges is an exercise that will require buy-in from stakeholders across the three LODs, as well as members of the C-suite.

As we move forward in 2023, the pressure to adapt to the tumultuous market conditions and evolving regulatory environment is only expected to increase. A failure to engage in thoughtful discussion across the organization about what the firm is doing to assess the design and operational effectiveness of its current-state ESG practice and the inclusion of ESG considerations within its risk management framework may result in punitive consequences.

Investment managers are facing a critical opportunity to evolve their investment thesis, and subsequently, their business overall. The recent actions initiated by the SEC and other regulatory bodies makes one point extremely clear: There are both risks and opportunities that investment managers face when offering ESG products and services to their clients. This growing investment space poses a distinct opportunity for advisers to build strong compliance, reporting, and investment programs to comply with the ESG guidelines proposed by the SEC and other applicable regulatory entities. The path forward for investment managers to manage both present and pending ESG risks and opportunities starts with taking a critical eye to the risk management framework that's in place to support the overall organization.

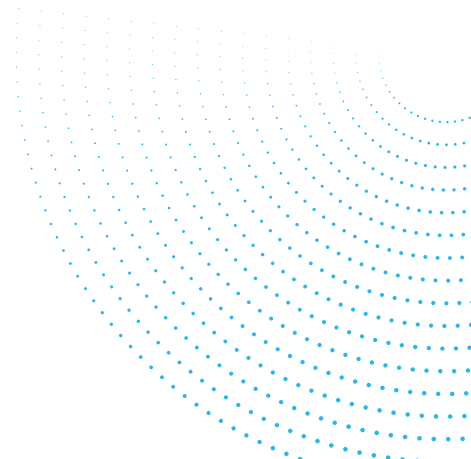
When correctly done, the integration of ESG considerations and data into an investment manager's broader investment strategy and internal structure and operations will provide greater transparency into the current and emerging risks and opportunities on the horizon. This level of transparency will equip managers with the foresight needed to take decisive action in the marketplace that ultimately will have a positive effect on overall financial performance.



As the global and regionally focused ESG disclosure requirements continue to heighten, the volume and quality of ESG data is only expected to improve. With the current growth rate of AUM for ESG-related products and services expected to continue to rise, it's only a matter of time before ESG data is as fundamental as audited financial data is to making investment decisions. In fact, for many investment managers, it already is.

Endnotes

- 1 Bloomberg, "[ESG may surpass \\$41 trillion assets in 2022, but not without challenges, finds Bloomberg Intelligence](#)," press release, January 24, 2022.
- 2 Sustainable Investing, "[A decade of sustainable funds investing: 10 years/10 charts](#)," accessed March 2, 2023.
- 3 Qontigo, "[ESG fund flows show resilience amid 2022 market sell-off](#)," August 17, 2022.
- 4 Jennifer Wu, "[ESG outlook 2022: The future of ESG investing](#)," JPMorgan Asset Management, January 2, 2022.
- 5 US Securities and Exchange Commission (SEC), "[SEC proposes to enhance disclosures by certain investment advisers and investment companies about ESG investment practices](#)," press release 2022-92, May 25, 2022.
- 6 Chris Prentice, "[U.S. SEC levied \\$6.4 bln from enforcement in fiscal 2022](#)," Reuters, November 2, 2022.
- 7 Kelly Anne Smith, "[Greenwashing and ESG: What you need to know](#)," *Forbes Advisor*, August 25, 2022.
- 8 For a deeper dive into these proposals and the full regulatory agenda, read our [2023 investment management regulatory outlook](#).
- 9 Refer to our "[Make ready for long-awaited ESG rules](#)" for additional details on the ESG fund names rules.
- 10 Refer to the "[Climate Change Disclosure Rule](#)," for the final action announcement.
- 11 The SEC's enforcement action against the global asset manager is summarized for convenience purposes. See the [SEC's Enforcement Action](#) for a full transcript of the Order filed against the firm.
- 12 Melanie Waddell, "[SEC plans hiring push for exams, enforcement in 2022](#)," Think Advisor, June 7, 2021.



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Center for Regulatory Strategy US

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