March 2020

Wells Fargo Prime Services

Industry and Regulatory Updates

Previously published in Wells Fargo Prime Service's Industry and Regulatory Updates, March 2020 edition

As the SEC Takes on Greenwashing, Here's What Hedge Funds Need to Know

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The SEC—just like seemingly every investor, business, policymaker and regulator in the world—is taking a closer look at ESG.

The recent proliferation of ESG funds and strategies has the potential to, in the words of Larry Fink, create a "fundamental reshaping of finance." Recent studies put the global amount of professional assets under management that apply an ESG lens at about $30 trillion. Approximately $12 trillion of this AUM is in the U.S., with researchers at Deloitte predicting that ESG-mandated assets could nearly triple and make up half of all managed assets by 2025.

Reports of recent ESG-specific fund launches and inflows suggests these numbers will continue to increase. According to Morningstar, more than $20.6 billion flowed into ESG-oriented ETFs and mutual funds in 2019, quadruple the total from the previous year. Also, several prominent hedge fund managers are launching ESG- or impact-focused funds and others publishing their first ESG policies.

As such, it comes as no surprise that the SEC has included ESG among its 2020 exam priorities, specifically referencing their intention to look into disclosure practices. It also recently put out a "Request for Comments on Fund Names" in which they asked if there should be specific requirements that funds must comply with to characterize their investments as "ESG" or "sustainable." While the SEC has been vague about exactly what they're looking for in terms of ESG compliance and disclosure, initial indications suggest that officials want to understand how different investment advisers are positioning, marketing, and evaluating their ESG products and strategies.

In particular, the SEC is expected to be examining if these products and strategies (and how they are marketed) are in compliance with Rule 206(4)-7 of the Investment Advisers Act of 1940, which requires registered advisers to "adopt and implement written policies and procedures reasonably designed to prevent violation" of the Act.

This rule could have significant ramifications for hedge funds that are new to ESG, whether it's their first time publishing an ESG policy, launching an ESG fund, or adding ESG to their marketing materials. Hedge funds could run afoul of SEC regulations if they materially rely on ESG considerations to make investment decisions but do not articulate this criteria and how they are deciding which ESG factors are material through investor disclosures. The SEC would also expect to see a formal ESG policy or procedure in place to describe these practices. Likewise, hedge funds could also be in violation if they do not have a reasonable program to execute on what their investment policies or marketing documents say they are doing on ESG. This latter violation is better known as "greenwashing".

The Greenwashing Problem

The rise in the amount of ESG-branded products has led to a simultaneous rise in the amount of debate and consternation about "greenwashing," which is loosely defined as the use of green, sustainable or impact labels for an investment strategy that does not effectively take into account ESG considerations. While there can be legitimate disagreements about what is or isn't greenwashing, most market participants would agree that the financial industry is suffering from a proliferation of greenwashing.

According to a February 2020 study published by KPMG, AIMA, CAIA and CREATE-Research, 52% of institutional investors said that there is a significant (41%) or some amount (11%) of greenwashing in the hedge fund industry. This should serve as a warning sign for hedge funds actively marketing their ESG products to institutional investors, especially since the same study found that 55% of investors look at ESG as part of their due diligence prior to making an allocation to a hedge fund manager.

The SEC's ESG sweep exam, among other points of interest, may signal that the regulator suspects there may be a greenwashing problem. But greenwashing can come in many different shapes and sizes, just as ESG can be applied differently depending on the investment strategy and asset class. This lack of an agreement on what constitutes best practices in ESG and lack of regulation of ESG standards, presents both a risk and an opportunity for hedge fund managers—the risk is that managers could be held accountable for potentially misleading investors and suffer redemptions and regulatory scrutiny as a result; the opportunity is that hedge funds can clearly define in their own terms how they think about ESG, and what their practices look like.

The Anti-Greenwashing Checklist

To provide some clarity on what constitutes best practices in the ESG space and to mitigate the risk of SEC scrutiny, here is a five-part anti-greenwashing checklist:

- Develop and publish an ESG policy: Publish an ESG policy or statement that clearly articulates how ESG factors are used to inform and improve investment decision-making. This policy should be shared with investors annually and also made publicly available on the firm's website. If appropriate, the policy should also include case studies that detail how an ESG lens was used to decide whether or not to make an investment in a particular company.

- Hire or appoint an ESG specialist: Designate one or more employees of the firm as the dedicated ESG specialist. This person should ideally have actual ESG or impact investing experience, or a background in sustainability, science, engineering or a similar field. Avoid designating someone who will have difficulty answering basic questions about different ESG market trends, as this could be an immediate red flag for an investor or regulator.
- Conduct ESG training sessions: The ESG specialist(s), either independently, through a committee or with third-party consultants, should host regular training sessions for staff to keep them abreast of changes and development in the ESG space. This also helps prevent miscommunication and confusion across the firm and ensures that employees are able to answer most if not all investor or regulator questions about ESG.
- Participate in industry organizations: In looking for industry standards, there are various organizations to learn from and contribute to. The most ubiquitous is the UN PRI, but there is also the Global Impact Investing Network (GIIN), the Impact Management Program (IMP), the Operating Principles for Impact Management, Ceres, Climate Action 100+ and various regional stewardship codes.
- Report on ESG outcomes: If ESG factors are being used to influence investment decisions, then a hedge fund should be able to report on the outcome of those decisions. Many investment advisers already use the UN's Sustainable Development Goals (SDGs) as their benchmark.. There are plenty of other data frameworks to choose from such as SASB, GRI, CDP and TCFD, just to name a few. Each of these non-profit organizations offers a template for reporting on the different aspects of non-financial performance, so funds should choose the framework that best aligns with their particular investment strategy. Meanwhile, the Big Four accounting firms and the International Business Council are reportedly working on a standardized set of ESG metrics for demonstrating the "long-term sustainability" of companies.

Each of these items is an important part of a hedge fund manager's overall ESG journey. Given that the majority of ESG and impact funds were recently launched and have a limited track record, it's inevitable that best practices will continue to evolve as the market matures. Hedge funds that are serious about protecting their reputation and preserving their business from both investor criticism and regulatory attention should embrace these initial steps to lay a strong foundation for their ESG programs.

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