2020 ESG Outlook: The SEC, Congress, and ESG's Coming of Age

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The SEC and the United States Congress now care about ESG investing – investors and asset managers alike should pay close attention to developments in 2020. The SEC and Congressional initiatives in progress will likely lead to a meaningful shock to the ESG investing ecosystem, and a shakeout that leads to real winners and losers in the effort for firms to establish their credentials in this area.

The SEC and Congress are behind the curve. Regulators around the world, other legislative bodies, and important not for profits and think tanks have been hard at work for years creating a framework that provides product transparency, clear definitions, and a path forward for ESG integration and impact investing.

For example, over 20 nations as well as the European Union have taken action to acknowledge that ESG integration in the investment process is necessary. Stock exchanges in seven countries have put in place rules that mandate the disclosure of ESG data.[1] The pressure on the SEC to take action is great. Over a year ago, large institutional investors overseeing more than $5 trillion in assets asked the SEC to require public companies to use standardized ESG disclosures.[2]

U.S. States are setting the pace. In January of 2020 the Sustainable Investing Act became law in the State of Illinois. This law mandates that any public or government entity that manages public funds "develop, publish, and implement sustainable investment policies…." implicating $8.5 billion in assets in Chicago alone. Legislation on ESG related matters is pending in Massachusetts, Minnesota, New Jersey, New York and Vermont.[3] Michael Frerichs, Illinois State Treasurer, explained why ESG is important. He noted, "The use of sustainability factors has been shown to minimize risk and maximize returns and is considered a best practice in the investment industry. Integrating these factors helps public funds better fulfill their fiduciary duty".[4] The words "fiduciary duty" will resonate and other states will likely follow.

With pressure building, 2020 is likely the year that the SEC and the US Congress enter this dialogue in a more meaningful way, resulting in a higher standard for firms offering ESG strategies, greater transparency for investors, and the end of the noisy start-up phase of ESG development and the beginning of a period of maturation. Here is why 2020 is already shaping up to be a year when the SEC pivots from talk to action…

On January 7th the Securities and Exchange Committee announced its examination priorities for 2020 and ESG is one of them. Investment firms are subject to examination by the SEC's Office of Compliance Inspections and Examinations (OCIE).The OCIE has flagged ESG and sustainable investing as a focus issue with language that should serve notice to any firm that has been greenwashing: "OCIE has a particular interest in the *accuracy and adequacy* of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria".[5]

This has significant consequences for investment firms, some of whom may be challenged to rise to the occasion of an SEC examination on ESG integration. To the extent that investment firms thought that subscribing to an ESG database offered by leading firms like MSCI or Sustainalytics was adequate to convince the world that they were on the path to ESG integration, they are about to be surprised. Though both MSCI and Sustainalytics have done pioneering work in ESG research, they charge high prices and, significantly, the two entities have a low correlation in their ESG scores.

This means that when a firm selects a vendor, the firm needs to defend its due diligence process, and its view as to why it believes one firm's research better supports its investment process than the competing vendor.[6]

For those firms that use an ESG data provider, the SEC will likely be asking how the data impacts the investment process, risk management, buy and sell decisions, and portfolio construction. For those firms that have built their own ESG scoring process, they will need to be able the demonstrate that they have the resources to support this effort, that it is authentic, and integrated. This higher level of regulatory scrutiny may contribute to a pause in ESG product proliferation and will likely increase the cost of entering the field as companies will have to think more carefully before putting an ESG label on a product.

Asset managers need to pay attention not only because of a new regulatory focus on ESG investing, but the focus of credit ratings agencies as well. In late 2019, Moody's announced that it will not only evaluate an asset manager's corporate management of ESG issues, but how they integrate these factors in their work. Moody's thinks those asset management firms that focus on ESG will "stand out". Needless to say, there will be ratings consequences for those that do not begin to address ESG.[7]

SEC examinations in 2020 could also create benefits for investors. A strengthened regulatory regime should increase the probability that when an investor chooses a manager because of its ESG capabilities, those capabilities truly exist and reflect more than the purchase of an ESG database.

There is also significant global pressure on the SEC to move forward and assume leadership to ensure the successful adoption, quality control, and transparency of ESG practices in the US asset management industry. The SEC is a member of IOSCO (The International Organization of Securities Commissions), which convenes the leading securities regulators in the world and works to "promote adherence to internationally recognized standards".[8] In 2019, the IOSCO published a set of standards related to ESG information. The organization emphasized "that ESG matters, though sometimes characterized as non-financial, may have a material short-term and long-term impact on the business operations of the issuers as well as on risks and returns for investors and their investment and voting decisions."

The United States Congress is focusing on this issue as well and committee hearings launched in late 2019 have put in place an important foundation for further work in 2020. The ESG Disclosure and Simplification Act of 2019 (H.R. 4329) is making its way through the United States Congress with far reaching implications if it becomes law. This legislation would make several important revisions to the Securities Exchange Act of 1934. It would require:

- Issuers of securities to clearly explain the link between ESG metrics and their long-term business strategy and the process they use to determine this impact
- ESG disclosures in public filings
- The SEC to consider the use of international standards that have already been created

This legislation would also create a Sustainable Finance Advisory Committee at the SEC that would "submit to the Commission recommendations about what ESG metrics the Commission should require issuers to disclose." Importantly, the legislation requires the committee to complete this work within 180 days of its first meeting.

The Sustainable Finance Advisory Committee is awarded a sweeping mandate that has the potential to impact capital flows and the relative performances of various sectors within asset classes. For example, the legislation grants the committee the mandate to "recommend policy changes to facilitate the flow of capital towards sustainable investments, in particular environmentally sustainable investments."[9]

The US Chamber of Commerce supports the ESG movement and will likely add momentum to the effort to improve disclosure and transparency. The organization recently launched Project Go: Project for Growth, Opportunity and Innovation. An important objective of

this initiative is to promote corporate disclosure of relevant ESG metrics in a consistent manner. The US Chamber of Commerce believes that ESG reporting should be driven by criteria that are:

- Tied to long-term value creation
- Written in plain English that simply describes the metrics used
- Fit the needs of that particular company and industry[10]

The work of the US Chamber of Commerce will likely accelerate trends towards ESG disclosure, a process that will put pressure on companies to act even before the initiatives at the SEC and Congress have their full impact. So will the growing view within the legal community that corporations will need to think through these disclosures with great deliberation and give them great care, regardless of if the SEC is regulating their behavior on these points. While there may be no laws to compel issuers regarding the types of ESG disclosures they make, or whether they even make them, "recent U.S. case law underscores that ESG disclosures may be actionable if found to be materially false or misleading." If these disclosures are in official quarterly or annual securities reports, "issuers could find their CEO's and CFO's open to liability."

Companies will likely need to rethink their disclosure practices, governance of ESG disclosures, and how they quality control these disclosures for consistency and accuracy.[11]

We view enhancements in disclosure processes as a positive. The level of disclosure is critical for investors to accurately assess risk and, with increased stakeholder scrutiny, transparency should continue to improve. Our corporate ESG model includes around 20 factors that cover environmental, social and governance factors. As part of corporate governance, we assess the level of disclosure companies provide around these ESG factors.

The pressure building on investment firms for genuine, demonstrable ESG integration is reaching a critical point. And, the pressure on both securities issuers and asset managers on improved disclosures has been building for years. In 2020, the SEC and Congress will be adding their powerful voices to this national debate and there can be little doubt that a major evolution of ESG integration is happening before our very eyes.

Important Disclosures

ENDNOTES - SOURCES

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