ESG Enforcement Actions Underscore SEC Focus on Public Company and Investment Adviser Disclosure

Written by John W.R. Murray, Fernando Berdion-Del Valle

June 16, 2022

Key Takeaways:

- The U.S. Securities and Exchange Commission's (SEC's) Climate and ESG (Environmental, Social, and Governance)Task Force has brought its first two enforcement actions for allegedly misleading ESG-related disclosures by a public company and an investment adviser, respectively.
- The actions reflect the close and continuing focus on ESG by the SEC's Division of Enforcement (Enforcement); more such actions are virtually certain to follow.
- These cases also underscore the importance for issuers and advisers of mitigating the risk of ESG-related disclosure violations through robust internal controls and careful vetting of public statements about ESG impacts and investments.

The formation of SEC Enforcement's Climate and ESG Task Force last year confirmed that ESG had become one of the agency's top enforcement priorities, and signaled that an uptick in investigations and enforcement actions against public companies and investment advisers would follow. Those expectations have been borne out by the Task Force's first two enforcement actions, against a public company and an investment adviser, respectively. Through these actions, the SEC has further made clear that it will pursue issuers and advisers that it deems to have engaged in "greenwashing" or otherwise inaccurately represented ESG-related information about their operations or investment practices.

Alleged Issuer Misrepresentation of ESG Risks

On April 28, 2022, the SEC charged Brazilian mining and metals company Vale S.A. with making allegedly misleading claims about the safety of its dams prior to the collapse of its Brumadinho dam in Minas Gerais State, Brazil in January 2019. According to the SEC's complaint, filed in the U.S. District Court for the Eastern District of New York, the collapse killed 270 people and released 12 million cubic tons of toxic waste, causing irreversible environmental harm to the region's Paraopeba River. Of particular significance, the action is based not on misrepresentations concerning Vale's ESG policies or practices, but more broadly, allegedly misleading statements about its safety practices and standards that concealed environmental and social risks.

According to the complaint, the company's Brumadinho dam failed as a result of liquefaction, a phenomenon in which waste deposits build up and saturate the dam, dramatically increasing the risk of structural failure and collapse. Vale allegedly was aware of risks to the Brumadinho dam from liquefaction from a similar dam collapse in 2015, and as early as 2003 that the Brumadinho dam was "dangerously fragile" with "significant liquefaction risk."

The SEC further alleges that the company "knowingly or recklessly suppressed the findings of its own retained experts" and engaged in a "pattern of deceptive acts designed to skirt the applicable regulatory requirements related to dam safety." In particular, the complaint alleges that between 2016 and 2018, the company obtained numerous deceptive stability declarations from auditors tasked with reporting on the dam's structural integrity that it knew did not meet international safety standards, and cut "backroom deals" and employed "blackmail" to encourage or coerce compliance with its demands for reports that reflected positively on the operational safety of the dam.

During the same period, Vale allegedly made a series of misrepresentations to investors with respect to dam safety. For example, in an October 2016 investor presentation, the company allegedly claimed, among other things, that its dams had been audited in 2016 to address the potential for liquefaction using a "rigorous" process; that the audit process was "conservative" in modeling for liquefaction; and that the presentation reflected a "rigorous review of existing engineering studies[.]" In fact, the SEC alleges, a separate liquefaction expert had told the auditor and the company that the relevant laboratory data was not sufficiently reliable to be used in the safety evaluation.

Similarly, Vale's 2016 SEC Forms 6-K and 20-F allegedly contained materially false and misleading statements, including representations that the company had conducted "extraordinary audits" on the stability of its dams and that "no anomalies were identified," even though the company and its auditor had learned through one audit that the Brumadinho dam was in precarious condition and company executives had decided to suspend operations due to concerns about liquefaction.

In addition, the SEC alleges that Vale executives made false statements in sustainability reports, allegedly asserting in one that after a cycle of dam auditing, "100% of the audited structures were certified to be in stable condition, physically and hydraulically," and that Vale adhered to "good and strictest international practices" and "rigorously" and "strictly" complied with legislative requirements.

Alleged Adviser Misrepresentation of ESG Investment Practices

The Task Force followed up the Vale action with a settled administrative proceeding, filed on May 23, 2022 against BNY Mellon Investment Adviser (BNYMIA) for alleged misstatements and omissions about the use of ESG considerations in the selection of investments for certain mutual funds advised by BNYMIA. BNYMIA agreed to pay a $1.5 million penalty to resolve the action.

According to the Order, BNYMIA's affiliated sub-adviser to the funds maintained a "Responsible Investment Team" that prepared ESG quality reviews for equities and corporate bonds. For certain mutual funds that the sub-adviser advised, the sub-adviser required the Team to perform a proprietary ESG "quality review" for all investments, which included identifying the ESG risks and opportunities presented by potential investments and assigning a numerical ESG quality review score for the investments reviewed. For other funds, including the funds at issue in this case, the sub-adviser allegedly could, and did, select investments that did not undergo the ESG review.

The SEC found that between July 2018 and September 2021, BNYMIA inaccurately represented to investors in the fund prospectuses and to the funds' boards that the sub-adviser conducted proprietary ESG reviews as part of the investment research process for all investments. The Order also found that BNYMIA made similar representations in written responses to requests for proposals (RFPs) from other investment firms that were considering investing in the funds.

In particular, BNYMIA allegedly represented in the "Goal and Approach" section of its fund prospectuses that the sub-adviser had a "well-established approach to responsible investment" including "identifying and considering the [ESG] risks, opportunities, and issues throughout the research process via [. . .] proprietary quality reviews in an effort to ensure that any material ESG issues are considered." The prospectuses also allegedly stated that this approach was "[i]ntegrated into the investment process" for the funds.

The SEC found, however, that of 185 investments made by the fund at issue, 67 did not have an ESG quality review score at the time of the investment, which represented approximately 25% of the fund's net assets as of the time of the statements. The SEC therefore found that a "reasonable investor" reading the prospectuses could inaccurately conclude that all portfolio holdings in the fund had undergone an ESG quality review.

In addition, the SEC found that BNYMIA's RFP responses to other firms considering the funds described the sub-adviser's research process, including the performance of ESG quality reviews, and stated that the sub-adviser performed an ESG quality review for every security recommended by the sub-adviser's analysts. One RFP response, for example, stated that "ESG considerations are taken into account at every stage of the investment process" and that "ahead of investing, each security being considered for investment by our global industry analysts must have an ESG quality review conducted by a member of [the Responsible Investment Team]."

Finally, the SEC found that BNYMIA lacked written policies and procedures reasonably designed to prevent inaccurate or materially incomplete statements in prospectuses, RFP responses, or to the funds' boards about the sub-adviser's use of ESG quality reviews. It further found that BNYMIA compliance personnel were not aware before mid-March 2020 that quality reviews were not performed for all of the funds' investments.

The Commission charged BNYMIA with negligence-based violations of the anti-fraud provisions of the Investment Advisers Act of 1940 and failure to have in place adequate written policies and procedures as required under the Advisers Act. It also charged BNYMIA with non-scienter violations of Section 34(b) of the Investment Company Act of 1940, which prohibits untrue statements of material fact and misleading omissions in registration statements or other documents filed pursuant to the Company Act.

Implications for Issuers and Advisers

These actions are very likely only the first in a series of ESG-related disclosure cases to come. In allocating human and financial resources to the Climate and ESG Task Force last year, Enforcement sent a strong signal that it perceived widespread violations by issuers and advisers and that enforcement activity would follow. (Indeed, Enforcement reportedly has been investigating the asset-management arms of Goldman Sachs and, in parallel with the Department of Justice, Deutsche Bank, in connection with their ESG disclosures.) Given that the Task Force has been in operation for less than 16 months, and that SEC investigations tend to last roughly two years on average, we expect to see an increasing number of investigations and enforcement actions as the Task Force continues to ramp up.

Moreover, the SEC has recently proposed significant new rules for issuers with respect to climate-related disclosures and investment advisers and investment companies governing disclosures about their ESG investment practices. If adopted, these rules would provide Enforcement with a range of additional violations with which to charge these entities.

In view of these developments, issuers and advisers should be vigilant about and expect heightened SEC scrutiny of their ESG-related disclosures. Issuers should not assume that disclosure violations need rise to the level of egregiousness of those alleged in the Vale action in order to attract Enforcement's attention. Rather, they should anticipate that the SEC will target any public statements that it construes as concealing or downplaying environmental, social, or governance risks from their operations, and make certain that their internal controls are designed to ensure that those risks are accurately disclosed and that their controls function effectively. Advisers should likewise be attentive to their disclosure controls and confirm that information they provide to current and prospective investors about their ESG investing practices is accurate with respect to each fund to which the information refers.

We will continue to provide updates on the SEC's evolving ESG focus.

RELATED PRACTICES

- White Collar Crime & Government Investigations
- Environmental, Social and Governance (ESG)
- Private Funds
- Global Business & Human Rights

This communication is intended for general information purposes and as a service to clients and friends of Foley Hoag LLP. This communication should not be construed as legal advice or a legal opinion on any specific facts or circumstances, and does not create an attorney-client relationship.

United States Treasury Regulations require us to disclose the following: Any tax advice included in this document was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Attorney advertising. Prior results do not guarantee a similar outcome. © 2022 Foley Hoag LLP. All rights reserved.