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What Asset Managers Need to Know—and Do—About the SEC's Recent Focus on Impact Investment Strategies

By Vadim Avdeychik

The Wall Street Journal recently reported that the SEC's Office of Compliance Inspections and Examinations ("OCIE") has sent letters to asset management firms that market and offer environmental, social, and governance ("ESG") investment products. Below are some key takeaways that asset managers should know and do as the SEC focuses in on asset managers that offer impact investment strategies.

Impact Investing's Big Impact on Asset Allocations

Over the last few years, impact investment strategies have seen outsized asset allocations. According to a U.S. SIF Foundation report, as of the end of 2017, approximately $12 trillion in total assets under management in the U.S. used one or more sustainable, responsible, or impact investment strategies.[1] The report specifically notes that this figure "continued to grow at a strong pace." Assets in U.S. mutual funds reached $2.6 trillion, up 34% from 2016, with the number of ETFs more than doubling from 25 to 69. With respect to alternative investment vehicles (e.g., private equity and hedge funds), ESG assets under management in 780 alternative investment vehicles totaled $588 billion at the start of 2018.[2] In order to meet this demand, several global asset managers, including Vanguard, DWS, Blackrock, Bain Capital, TPG, and Goldman Sachs, have launched new impact investment products.

SEC's Focuses in on Impact Investment Strategies

With impact investing seeing outsized investor demand, SEC staff has apparently turned its attention to asset managers that offer and market impact investing strategies. According to *The Wall Street Journal*, the OCIE staff is focusing on a variety of topics, including:

- Policies that an asset manager is following when making impact investments;
- ESG products that an asset manager is offering;
- Methodologies that an asset manager uses to make ESG investments;
- Information relating to proxy voting on ESG matters; and
- Information about service providers used by an asset manager with respect to ESG due diligence and product structuring.

Avoid Risky Business: Understand Legal and Compliance Risk

Before marketing themselves as "impact investors," asset managers need to be aware of the many legal and compliance challenges that can arise with these strategies. Some of the biggest risks include:

- "Greenwashing" (conveying investments and funds as overly environmentally responsible);
- Conflicts of interest between multiple investment groups within an asset management firm;
- Reliance on third-party services to provide the classifications for compliance frameworks (*more on this below*); and
- Accurately measuring the impact of investments (due to the lack of standardized guidelines).

Frame it Right

Due to the lack of standardized taxonomy and terminology, asset managers typically rely on third-party service providers to provide the classifications needed for compliance frameworks in order to measure the impact of a particular investment. Third-party service providers, however, can make significant errors when, for example, aggregating data or setting up a custom index. Such an error could lead to an investment that is inconsistent with a client's initial mandate or provide inaccurate measure of the impact associated with the specific investment. That is why it is critical to conduct appropriate due diligence of third-party service providers on the front end and maintain a robust compliance framework throughout the lifecycle of the relationship with the provider.

"Dear SEC": How to Be Prepared to Respond to an SEC Examination Letter

Asset managers that offer impact investment strategies must take steps to ensure that even before an SEC examination letter arrives that, among other things, their policies and procedures are consistent with the asset manager's investment approach and such policies must take into consideration other parts of its business, including those parts which do not pursue an impact investment strategy.

If an asset manager receives an examination letter, it is recommended that the asset manager set up an internal working group, which would be responsible for providing the requested information on a timely basis. Such internal working group should include the asset manager's chief compliance officer. Questions presented in the examination letter should be reviewed closely; if a question or request is unclear, the person responsible for overseeing the response process should ask the OCIE staff to clarify their request in order to ensure that appropriate information is provided to the staff.

To Sum It Up

As demand for impact investments continues to grow, such demand presents an opportunity for asset managers. However, asset managers must take the time to understand the legal and compliance risks that are associated with impact investing. Those who ignore building out a robust compliance and legal framework run the risk of reputational damage, regulatory penalties, and not being able to capitalize on the growing investor demand for these strategies.[3]

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings New York lawyer:

Vadim Avdeychik
1.212.318.6054
vadimavdeychik@paulhastings.com

[1] U.S. SIF, *Report on US Sustainable, Responsible and Impact Investing Trends 2018*, U.S. SIF FOUND. REP. (2018).

[2] *Id.*

[3] Vadim Avdeychik, "Responsible Investing: Legal and Compliance Considerations for Asset Managers," *The Review of Securities & Commodities Regulation* (RSCR Publications LLC), December 18, 2019.