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Don’t Forget the G: After Years of “Environmental” and “Social” Regulations and Enforcement, the SEC’s Recent Priorities Demonstrate a Focus on “Governance”

Insight

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The SEC has been busy under the Biden administration. From rulemaking to enforcement, the agency is pushing boundaries and expanding its reach into new and active areas of the market. Here, we provide updates on the Commission’s activity in several high-priority areas, including ESG, insider trading, ephemeral messaging, and the clawback of executive incentive-based compensation.

ESG Regulation and Enforcement Using Preexisting Rules and Historical Causes of Action

SEC Chair Gary Gensler recently spoke about how various types of crypto technology, like "crypto token, stablecoin, or decentralized finance platform (DeFi) . . . are covered by [existing] securities laws."[1] Paraphrasing Aristotle, Gensler concluded, "[t]reat like cases alike."[2] Those observations mirrored earlier comments by Commissioner Hester M. Peirce on ESG regulation and enforcement:

> We can bring, and already have brought, greenwashing cases *using existing rules*, so why is additional rulemaking necessary? Should our focus instead be on identifying where there may be gaps in Commission rules and tailor[ing] any new rulemaking accordingly, rather than producing a new rule that is arguably redundant?[3]

Such comments may reflect an institutional preference for amending preexisting rules and relying on historical causes of action rather than inventing new theories for ESG regulation and enforcement. This focus is evident in recent rulemaking, investigations, and enforcement actions — specifically, proposed amendments to the Names Rule, recent administrative proceedings against Bank of New York Mellon Investment Adviser, Inc. ("BNY Mellon"), and an ongoing investigation into Activision Blizzard, Inc. ("Activision Blizzard").

1. **Proposed Amendments to the Names Rule**

The Names Rule was adopted two decades ago to protect the public from "materially deceptive and misleading [fund] name[s]."[4] Among other things, it forbids names "suggesting guarantee or approval by the United States government."[5] The rule also prohibits names which suggest that a fund focuses on "certain investments or industries," "certain countries or geographic regions," or has "[t]ax-exempt" status, unless the fund's name accurately reflects "at least 80%" of the value of its assets.[6] This is also known as the 80% rule.

The SEC recognizes when a fund's name includes the term "ESG" or "similar terminology,"[7] that "[i]nvestors may reasonably expect [such] funds . . . to invest in companies with policies, practices, or characteristics that are consistent with these standards."[8] The proposed amendments to the Names Rule would provide that "fund names with ESG and similar terminology . . . are subject to the rule's 80% investment policy requirement."[9] The amendments would also "defin[e] certain uses of ESG terminology in fund names as materially deceptive and misleading."[10] The purpose of both amendments would be to stamp out "greenwashing."[11]

Among the proposals the SEC is considering is whether the names of "integration funds" should be categorically deemed to be "materially deceptive or misleading" if those names indicate that a fund's "investment decisions incorporate one or more ESG factors."[12] The SEC is also mulling over whether a fund's investment policy "must address each element in the fund name that suggests an investment focus."[13] For instance, a fund named "XYZ Environmental, Social, and Governance Fund" may be required to "adopt an 80% investment policy to address all three of those elements."[14]

On October 7, 2022, the SEC reopened the comment period for the proposed amendments to the Names Rule.[15] So, it remains to be seen whether these amendments will emerge intact. For the time being, this serves as a useful reminder to embrace progress while keeping one foot firmly planted in the past, where much of the regulatory action still is.

2. **Settlement with Bank of New York Mellon Investment Adviser, Inc.**

For companies concerned with ESG, the SEC has emphasized that "all three of those elements" matter.[16] However, "G," for governance, is sometimes overlooked.[17] This may be a risky assumption, as seen in a recent settled administrative action against BNY Mellon, and a private lawsuit and ongoing SEC investigation into Activision Blizzard.

BNY Mellon recently found itself the subject of an administrative proceeding. At issue were alleged misstatements and omissions about how ESG principles informed the investment decisions of certain funds it advised.[18] The decisional processes of two funds, the "Sustainable Funds" and the "Overlay Funds," were scrutinized closely.[19] Investment decisions for the Sustainable Funds always required adherence to a "proprietary ESG quality review."[20] To pass muster, securities had to "demonstrate attractive

investment attributes and sustainable business practices," and could not have any "material unresolvable environmental, social and governance (ESG) issues."[21] By contrast, investment decisions for the Overlay Funds were "not subject to that specific investment criteria."[22]

But the SEC found that BNY Mellon misrepresented in board minutes and prospectuses the extent to which ESG quality reviews were part of the investment process of the Overlay Funds.[23] The following statement was viewed as misleading:

> Integrated into the investment process [is] a well-established approach to responsible investment. This process includes identifying and considering the [ESG] risks, opportunities and issues through the research process via . . . proprietary quality reviews, in an effort to ensure that any material ESG issues are considered.[24]

This was because "[a] reasonable investor . . . could mistakenly conclude that all portfolio holdings selected [for the Overlay Fund] were subject to an ESG quality review."[25] Also problematic was an RFP response which stated that, as part of the "due diligence process ahead of investing, each security being considered for investment . . . must have an ESG quality review conducted."[26]

The SEC concluded BNY Mellon had willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act, and Rules 206(4)-8 and 206(4)-7 promulgated thereunder, and had also violated Section 34(b) of the Investment Company Act, which prohibit fraud or deceit and untrue statements or omissions of material fact.[27] Without admitting or denying any of the SEC's findings, BNY Mellon agreed to an order requiring that it cease and desist from current and future violations, a censure, and a penalty payment of $1,500,000.[28]

3. **Investigation into Activision Blizzard, Inc.**

Activision Blizzard has been the subject of an investigation for different governance reasons. It started when a federal class action lawsuit claimed that Activision Blizzard had violated federal securities law by misleading investors, in significant part, through its 2020 ESG Report:

> Plaintiffs allege that [the ESG Report's] provisions regarding no toleration of retaliation were materially false and misleading because during the Class Period retaliation against female employees of the Company who made sexual harassment and discrimination claims was rampant and tolerated by the Company.[29]

While the plaintiffs' first two complaints were dismissed, they recently filed a third amended complaint, reasserting their claims that Activision Blizzard's public commitment to ESG materially misled investors. [30] Activision Blizzard has also announced that the SEC is investigating the company on "employment matters and related issues." [31]

It is unclear whether any formal enforcement will materialize out of the Activision Blizzard investigation. Regardless, in light of administrative proceedings brought against BNY Mellon and other companies[32] based upon their internal and external compliance efforts, this may indicate the form that future SEC enforcement may take against companies seeking to implement ESG protocols, especially in the area of governance.

Insider Trading Enforcement Based on Companies' Own Insider Trading Language and Policies

In another trend, the language and provisions of several companies' own insider trading policies have played a significant role in helping the Commission expand its insider trading litigation. While the SEC has made reference to companies' insider trading policies in prior enforcement actions, those references have generally served to establish scienter.[33] And when the SEC has tried to use the provisions of a company's own insider trading policies to expand the definition of insider trading in the past, those efforts have often failed.[34] In a recent line of cases, however, the specific language and provisions of companies' own insider trading policies have been outcome determinative.

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