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GIVING THE GREENLIGHT: THE SEC ENCOURAGES INVESTMENT ADVISERS TO CONSIDER DEI FACTORS

On October 12, 2022, the United States Securities and Exchange Commission ("SEC") released guidance pertaining to the consideration of Diversity, Equity, and Inclusion ("DEI") factors by investment advisers. In it, the SEC clarified that an investment adviser, in accordance with its fiduciary duty, may consider DEI factors when recommending or selecting other advisers for clients, "provided that the use of such factors is consistent with a client's objectives, the scope of the relationship, and the adviser's disclosures." While the SEC made clear that the guidance has no legal effect or force, it further contributes to the blurring of the lines between seeking to maximize investor returns and social considerations.

The most recent guidance is consistent with a broader initiative and movement by the SEC to regulate Environmental, Social, and Governance ("ESG") issues both formally and informally. A day after the guidance was issued, Commissioner Jaime Lizárraga spoke at the ICI Securities Development Conference, and specifically mentioned the guidance within a larger backdrop of related actions by the SEC, including an examination of the current state of DEI initiatives completed by the SEC's Asset Management Advisory Committee (AMAC) under former Chairman Jay Clayton. The results of this examination reflected that investors are increasingly interested in DEI information, potentially making it material to such investors' investment decisions. In reviewing its findings, the AMAC made four recommendations for the Commission, including: (1) requiring gender and racial diversity disclosures to be provided by funds and investment advisers; (2) issuing guidance for fiduciaries that select asset managers; (3) establishing a centralized way through which records pertaining to discriminatory practices found within the securities industry may be kept; and (4) conducting a study covering how pay-to-play practices have changed over time.

The guidance fits squarely into these recommendations by providing greater clarity for fiduciaries that select or recommend asset managers. Notably, while Commissioner Lizárraga mentions this guidance and the initial examination by

AMAC, he also asserts that more must be done to "help move the needle" in terms of diversity initiatives, which, given the SEC's latest actions regarding ESG issues and diversity in particular, may come as no surprise.

In both its 2022 Examination Priorities as well as its Spring 2022 Rulemaking Agenda, the SEC repeatedly articulated a continued interest in ESG-related investing and disclosures as well as DEI-specific disclosures. In its examination priorities, the SEC outlined concerns relating to ESG such as the risk that ESG-specific disclosures could be potentially misleading or false, resulting in misinformation finding its way to investors; greenwashing; misalignment of policies and procedures with actions taken by registered investment advisors; and the general lack of consistency in ESG criteria, investing approaches, and terminology. As for the SEC's 2022 rulemaking agenda, it includes proposed rules requiring disclosures relating to board diversity as well as human capital management.

Reactions to these current efforts by the SEC as well as ESG in general have been mixed. For example, in a recent survey of CFOs conducted by CNBC, notable concern was expressed as to the increased regulation of ESG.[1] Specifically, CFOs seemed concerned about requirements that would be imposed without any nuance (i.e. a one size fits all approach), the lack of consistent definitions and difficulties in ascertaining materiality when it comes to issues such as the climate and financial statements. In addition, some companies that have utilized ESG-based investment policies have faced significant backlash from investors. Recently, BlackRock lost over $1 billion dollars as public officials from South Carolina, Louisiana, Utah, and Arkansas withdrew their assets from BlackRock's funds.[2] And lastly, two different laws in California targeted at improving diversity on corporate boards have been struck down as violative of state and federal constitutions.[3]

While current opposition to the way in which ESG policies are being implemented clearly exists, the SEC's latest actions signal a continued push towards developing and employing frameworks meant to address ESG, and more specifically, DEI issues. The most recent guidance, albeit brief, coupled with the SEC's 2022 examination priorities and rulemaking agenda demonstrate this. Investment advisers and related fiduciaries affected by this guidance should continue to monitor these developments as well as the countering actions of many states, to manage the competing risks. Investment advisers should focus in particular on completeness and accuracy of disclosures on ESG objectives, and the internal audit trail to back them up.

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1 *There's an ESG backlash inside the executive ranks at top corporations*, CNBC (Sep. 29, 2022), https://www.cnbc.com/2022/09/29/the-esg-backlash-inside-the-executive-ranks-at-top-corporations.html.

2 *US Republicans pull $1bn from BlackRock over ESG investing concerns*, FINANCIAL TIMES (Oct. 9, 2022), https://www.ft.com/content/41de28af-a487-473e-bc17-5e8cb71f4ced.

3 *Diversity Disclosure Rules Thrive as Mandates Die*, BLOOMBERG LAW (June 14, 2022), https://news.bloomberglaw.com/esg/board-diversity-disclosure-rules-thrive-as-mandates-die-in-court.

CLIFFORD CHANCE

CONTACTS

Michelle Williams
Partner

T +1 202 912 5011
E michelle.williams@cliffordchance.com

Vadim Avdeychik
Partner

T +1 212 878 3055
E vadim.avdeychik@cliffordchance.com

David DiBari
Partner

T +1 202 912 5098
E david.dibari@cliffordchance.com

Steven Gatti
Partner

T +1 202 912 5095
E steven.gatti@cliffordchance.com

Steve Nickelsburg
Partner

T +1 202 912 5108
E steve.nickelsburg@cliffordchance.com

Karina Bashir
Associate

T +1 202 912 5010
E karina.bashir@cliffordchance.com

Alexandra Coyle
Associate

T +1 212 880 5719
E alexandra.coyle@cliffordchance.com