Case Studies:

ESG Greenwashing and the Recent SEC Actions [†]

Ye Cai
Associate Professor of Finance
Santa Clara University

Seoyoung Kim
Associate Professor of Finance
Santa Clara University

August 2022

[For *Journal of Investment Management*]

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

[†] The authors may be reached at: ycai@scu.edu, srkim@scu.edu; 500 El Camino Real; Santa Clara, CA 95053.

In the last two decades, the growing supply of low-fee index funds and ETFs has significantly reduced the expense ratio investors are willing to pay. In response, fund managers naturally seek ways to maintain revenue streams, and the hot topic of the moment is Environmental, Social, and Governance (ESG) investing. ESG investing has grown drastically in recent years, moving from the periphery to mainstream finance. According to Morningstar, sustainable funds globally attracted $97 billion of net new money in the first quarter of 2022, despite recent market turmoil and investor concerns on inflation and the war in Ukraine, reaching $2.78 trillion AUM by the end of Q1 2022.[2] (For reference, ESG funds had a combined global AUM of just $195 billion in 2010.[3]) The Securities and Exchange Commission (SEC) has even proposed a rule requiring public companies to disclose extensive climate-related information in their registration statements and annual filings.[4]

Indeed, the ESG label is a lucrative one. ESG funds command a sizable green premium (or, *greenium*), with an asset-weighted average expense ratio of 0.55% versus 0.39% compared to their non-ESG peers in 2021. [5] Globally, ESG funds collected $1.8 billion in fees in 2021, up from almost $1.1 billion in 2020. Historic inflows resulted in lucrative fees for the largest sustainable fund managers, with Parnassus Investments, Calvert Investments, and BlackRock each levying $320.7 million, $227.7 million, and $116.5 million, respectively, in fees from sustainable products in 2021.[6]

---

[2] See "Morningstar Global Sustainable Fund Flows: Q1 2022 in Review" (Morningstar Manager Research, May 3, 2022).
[3] See "The Rise of the Sustainable Fund Market and Its Role in Financing Sustainable Development" for the United Nations Conference on Trade and Development (United Nation, 2021).
[4] See "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors" (SEC Press Release, March 21, 2022).
[5] See "Morningstar 2021 U.S. Fund Fee Study" (Morningstar Manager Research, June 2022).
[6] See "ESG by the Numbers: Sustainable Investing Set Records in 2021" (Bloomberg, February 3, 2022).

Despite the substantial greenium commanded by ESG funds, there are few consistent standards for what constitutes ESG investing. Some ESG fund managers invest in companies that already have a small carbon footprint, while others invest in heavy polluters that have publicly committed to improve. What's more worrisome, though, is that fund managers can craft their own definitions of ESG to simply rename and rebrand their existing products with an ethical allusion, adding buzzwords like "sustainable" or "ESG", without meaningfully altering their investment holdings. Tesla CEO Elon Musk recently called ESG "an outrageous scam" after S&P Dow Jones Indices removed the electric-vehicle maker from its ESG index.[7] "Exxon is rated top ten best in world for ESG by S&P 500, while Tesla didn't make the list!" Musk said on Twitter, adding that ESG "has been weaponized by phony social justice warriors."[8]

The ambiguity and inconsistencies have led to a greater widespread concern among investors and regulators that the banks and asset managers who sell ESG funds are exaggerating their commitment to environmental or social sustainability, a practice known as *greenwashing*, to boost their own revenues. In response, the Securities and Exchange Commission (SEC) issued two proposals in May 2022 to promote consistent, comparable, and reliable information for investors concerning ESG funds. One proposal seeks to expand regulation on the naming of funds,[9] and the other seeks to enhance and standardize disclosures related to ESG factors considered by funds and advisers.[10] In Europe, a similar anti-greenwashing rule known as the Sustainable Finance Disclosure Regulation (SFDR) aims to prevent fund companies from exaggerating sustainability

---

[7] See Elon Musk's tweet on May 18, 2022, accessed at https://twitter.com/elonmusk/status/1526957672200908801.
[8] See Elon Musk's tweet on May 18, 2022, accessed at https://twitter.com/elonmusk/status/1526958110023245829.
[9] See "SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names" (SEC Press Release, May 25, 2022).
[10] See "SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices" (SEC Press Release, May 25, 2022).

claims to make their products seem more attractive and to provide more clarity to investors looking for ESG products.

The SEC's reactions extend beyond press releases and proposals, as evidenced by the formation of a Climate and ESG Task Force in the Division of Enforcement.[11] In May 2022, it fined the investment management arm of Bank of New York Mellon $1.5 million for misleading claims it made about funds that use environmental and social criteria to pick stocks.[12] In the following month, the chief executive of DWS, Deutsche Bank AG's asset management arm, resigned amidst a raid by German authorities and ongoing probes by the SEC and the U.S. Department of Justice with regard to allegations that DWS made misleading claims about ESG funds.[13] Shortly thereafter, the SEC announced an investigation of Goldman Sachs looking into whether two of its funds included investments that conflicted with the ESG claims made in the funds' marketing materials.[14]

Overall, regulatory bodies are clearly taking initiatives to proactively identify ESG-related misconduct to preserve the integrity of investor reliance on climate and ESG-related disclosures. Thus, the early benefits to fund managers operating in this undefined, wild-west environment with outsized fees may quickly dissipate and even pose legal risks. Once the dust settles, the investment management community will likely find that ESG is no longer the high-yield, low-hanging fruit it once was. That is, an ESG fund may have to invest in actual ESG firms after all.

[11] See "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues" (SEC Press Release, March 4, 2021).
[12] See "SEC Fines BNY Mellon Over ESG Claims" (Wall Street Journal, May23, 2022).
[13] See "Time to Take the 'E' Out of ESG Investing" (Wall Street Journal, June 1, 2022).
[14] See "SEC Is Investigating Goldman Sachs Over ESG Funds" (Wall Street Journal, June 10, 2022).

Questions:

- As an asset manager planning to launch a new ESG fund, how would the recent regulatory climate affect your plans?
- Similarly, as an asset manager of an active ESG fund, how would the recent regulatory changes impact your P&L and overall investment strategy?
- What are the potential drawbacks, to investors versus fund managers, of increased regulation in this area?
- With the proposed ESG regulatory changes, do you expect to see fewer or more ESG funds? Similarly, do you expect to see fewer or more ESG firms?
- What might be the next trending investment category?

References:

Kishan, Saijel. "ESG by the Numbers: Sustainable Investing Set Records in 2021." Bloomberg, February 3, 2022.

Michaels, Dave. "SEC Is Investigating Goldman Sachs Over ESG Funds." Wall Street Journal, June 10, 2022.

Morningstar. "Morningstar Global Sustainable Fund Flows: Q1 2022 in Review." Morningstar Manager Research, May 3, 2022.

Morningstar. "Morningstar 2021 U.S. Fund Fee Study." Morningstar Manager Research, July 2022.

Musk, Elon (@elonmusk). "ESG is an outrageous scam! Shame on @SPGlobal." Twitter, May 18, 2022, accessed at https://twitter.com/elonmusk/status/1526957672200908801.

Musk, Elon (@elonmusk). "Exxon is rated top ten best in world for environment, social & governance (ESG) by S&P 500, while Tesla didn't make the list! ESG is a scam. It has been weaponized by phony social justice warriors." Twitter, May 18, 2022, accessed at https://twitter.com/elonmusk/status/1526958110023245829.

United Nations. “The Rise of the Sustainable Fund Market and Its Role in Financing Sustainable Development.” United Nations Conference on Trade and Development (Geneva), 2021.

Seal, Dean, and Amrith Ramkumar. “SEC Fines BNY Mellon Over ESG Claims.” Wall Street Journal, May 23, 2022.

Securities and Exchange Commission. “SEC Announces Enforcement Task Force Focused on Climate and ESG Issues.” SEC Press release, March 4, 2022.

Securities and Exchange Commission. “SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors.” SEC Press release, March 21, 2022.

Securities and Exchange Commission. “SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names.” SEC Press release, May 25, 2022.

Securities and Exchange Commission. “SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices.” SEC Press release, May 25, 2022.

Toplensky, Rochelle. “Time to Take the ‘E’ Out of ESG Investing.” Wall Street Journal, June 1, 2022.