Navigating the New ESG Whistleblower Landscape

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The power of markets can have a transformative effect on society, and lately investors have sought to harness that power to build a more just and sustainable world. As a result, money has poured into managed funds and companies that claim to deliver on that promise.

Investments using an environmental, social and governance framework have grown in popularity over the past decade. By early 2022, ESG investment assets reached $8.4 trillion and accounted for 13% of the total amount of U.S. assets being managed professionally.[1]

Unfortunately, not all those claims are backed by practice or performance, and now the U.S. Securities and Exchange Commission, with the help of conscientious insiders, is taking a careful look at both the claims and those who make them to ensure that money is being invested as promised.

This rapid rise has intensified government enforcement efforts.

Companies and funds are coming under increasing scrutiny by the SEC, backed by an array of enforcement tactics and penalties for identifying and punishing ESG-related misconduct. Recent and future SEC rule changes are continuing to expand the agency's authority to enforce ESG-related misconduct and are making it more lucrative for whistleblowers who report wrongdoing.

Navigating this new ESG landscape can be complex, but there are several preventative actions that funds and companies can take to protect themselves from government scrutiny.

In March 2021, the SEC announced the creation of the Climate and ESG Task Force in its Division of Enforcement. The task force's focus has been (1) identifying material gaps or misstatements in issuers' disclosure of climate risk and (2) analyzing disclosure issues relating to investment advisers and funds' ESG strategies.

To do so, the task force relies on whistleblowers to submit tips, complaints and referrals using the SEC's online complaint form.

Under the SEC's whistleblower program, administered by the Office of the Whistleblower, the SEC is authorized by Congress to provide monetary awards to eligible whistleblowers who come forward with information leading to an SEC enforcement action resulting in a sanction of $1 million or greater. The range for whistleblower awards is between 10% and 30% of the money collected from the sanction.

In fiscal year 2022, the SEC's whistleblower program received 12,322 tips — marking the largest number of whistleblower tips received by the SEC in a fiscal year since the program's inception in 2011 — and granted 103 whistleblower awards for a total of $229 million.

Whistleblower awards may continue to rise in 2023 with two new rules, which SEC Chair Gary Gensler claims will strengthen the commission's whistleblower program.

On Aug. 26, 2022, the SEC adopted two amendments to the whistleblower program, expanding the circumstances in which a whistleblower can receive an award for a non-SEC enforcement action and permitting the commission to consider the dollar amount of a potential whistleblower award for the limited purpose of increasing an award. Both rules signal the SEC's resolve to encourage whistleblowers to report corporate wrongdoing and regulatory violations.

SEC Already Aggressively Pursuing ESG Enforcement Actions

Using the Enforcement Division's existing authority, the SEC is already aggressively going after ESG-related enforcement actions. In 2022 alone, the commission pursued six ESG-related enforcement actions regarding failures to enforce ESG policies and procedures and misleading investors as to ESG investments.

In 2023, the SEC continues to enforce ESG-related misconduct, as the agency's authority continues to expand.

BNY Mellon's $1.5M Settlement

On May 23, 2022, the SEC settled charges with BNY Mellon Investment Adviser for misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds that it managed.

According to the SEC's order, BNY Mellon represented that its mutual fund had received "proprietary ESG quality reviews" as part of the investment research process. The SEC, however, determined that such ESG quality reviews had not been conducted for numerous investments held by certain BNY Mellon overlay funds.

Accordingly, BNY Mellon lacked adequate policies and procedures to prevent inaccurate or materially incomplete statements in prospectuses for its mutual funds, and failed to implement policies and procedures reasonably designed to prevent the inclusion of untrue statements of facts in prospectuses or to the overlay funds' boards. BNY Mellon agreed to pay a $1.5 million settlement with the SEC as a result.

Activision Blizzard's $35M Settlement

On Feb. 23, the SEC settled charges with Activision Blizzard resolving claims that it failed to maintain adequate disclosure controls tracking workplace misconduct complaints and that its separation agreements with departing employees violated whistleblower protection rules. According to the commission, Activision Blizzard's failure to track workplace complaints prevented management from having adequate information to assess whether its public disclosures concerning its workforce were fulsome, accurate and not misleading by omission.

The SEC's order also claimed that the terms of Activision Blizzard's separation agreement violated whistleblower rules, alleging that the company executed separation agreements that required former employees to provide notice upon receiving a request for information from the SEC.

Despite language in the separation agreement expressly stating that it should not be interpreted to prevent "communicating or filing a charge with government or regulatory entities," the company was still charged with violating the Securities Exchange Act Rule 21F-17(a), which prohibits any person from impeding an individual from communicating directly with the SEC about a possible securities law violation.

Activision Blizzard agreed to pay $35 million to settle the allegations.

Vale's $55.9M Settlement

Most recently, on March 28, the SEC settled charges with Vale SA, a publicly traded Brazilian mining company. Notably, this was the first enforcement action brought by the ESG Task Force, filed in April 2022.

This case highlights the SEC's willingness to enforce ESG-related disclosure violations within the same enforcement framework as traditional disclosure failures.

The SEC's complaint involved allegations against Vale for intentionally concealing safety risks for its dam, which collapsed and resulted in the deaths of 270 people. Specifically, the SEC alleged that Vale's audit reports, sustainability reports, public disclosures, and various presentation and promotional materials contained material misstatements and omissions regarding the safety of the dam. Vale agreed to pay $55.9 million to settle the charges.

The SEC's recent ESG-related enforcement actions highlight the commission's continued vigilance in pursuing companies' ESG failures, and the Activision Blizzard case showcases the SEC's continued vigilance in enforcing whistleblower protection laws.

Looking ahead, the SEC has affirmed its continuing focus on ESG enforcement actions, listing it among its 2023 priorities. This comes at a time when the SEC is sharpening its focus on ESG and extending its whistleblower program to cover ESG-related misconduct.

The SEC's 3 ESG Rule Amendments in 2023

To equip the SEC with additional enforcement tools, the commission is set to finalize three ESG-related rules in 2023 involving climate change disclosures, naming rules and ESG investment strategy disclosures. These rules will expand the SEC's authority to combat ESG failures and provide three additional avenues for ESG-related enforcement actions.

First, despite delays from the anticipated April 2023 rule adoption timeline caused by a fierce commenting period, the SEC still appears resolved in moving forward this year with a proposed rule amending existing regulation to now necessitate further disclosures on climate-related risks, including greenhouse gas emissions, climate-related targets and goals, and more.

For the first time, registrants will be required to disclose direct and indirect greenhouse gas emissions, information regarding climate-related risks, the impact of climate-related events and information on publicly set climate targets or goals. Companies registered with the SEC will now be required to provide these disclosures in annual filings and financial statements.

Second, in October, the SEC will adopt a proposed rule amending Rule 35d-1 of the Investment Company Act, or the "names rule." Under this amendment, ESG funds would be required to invest 80% of their assets in securities associated with its name.

This includes names like "growth" or "value," as well as fund names that reference aspects of environmental, social or governance in their names. Funds will be required to disclose, in the fund's prospectus, definitions of terms used in the fund's name, as well as the criteria used in selecting investments associated with the fund's name.

Third, also in October, the SEC will adopt a proposed rule, which would require extra ESG-related disclosures. Specifically, the rule would require regulated entities to disclose additional information regarding how ESG factors are considered.

The rule segments ESG approaches into three categories: (1) strategies that consider ESG factors alongside non-ESG factors will be required to disclose how ESG factors are incorporated into their investment funds; (2) strategies for which ESG factors are a main consideration would be required to include a more detailed disclosure and a standardized overview of the fund's ESG strategy; and (3) strategies that seek to achieve a particular ESG outcome would be required to disclose how it measures progress toward its ESG outcomes.

Best Practices for Avoiding and Handling ESG-Related Whistleblower Complaints

The combination of the SEC's heightened attention to ESG concerns and the extended reach of the commission's whistleblower protections in the wake of the Activision Blizzard resolution has created a new regulatory landscape for many companies.

Companies should take solace in the fact that their treatment of internal whistleblowers who report potential ESG disclosure misconduct should be handled similarly to any other whistleblower. Thus, the best way to navigate the SEC's focus on ESG is a return to familiar best practices:

Encourage a culture of internal disclosure.

Companies typically benefit from receiving internal complaints before possible misconduct is reported to the SEC.

For instance, functioning ethics hotlines and compliance programs that encourage reporting position a company to quickly act on complaints that warrant an internal or independent investigation. Those benefits will take on heightened significance in the current enforcement climate, given the emphasis on more aggressive enforcement and heightened standards for individuals and companies receiving cooperation credit.

Adopt and adhere to ESG policies and procedures.

Companies with ESG funds must adopt written policies and procedures that are reasonably designed to comply with the SEC's rules and must also adhere to those policies and procedures diligently.

As the SEC's settlements with BNY Mellon and Vale illustrate, companies must ensure that their ESG-related public disclosures are pressure-tested to guarantee that investors are receiving truthful and complete information. Companies should implement policies and procedures to ensure that ESG-related statements are vetted for complete accuracy.

Review agreements to ensure that they are not impeding whistleblowers.

The SEC's resolution with Activision Blizzard is a reminder that any perceived discouragement of or impediment to employees' ability to communicate with regulators will be scrutinized and could result in significant civil liability.

Under Exchange Act Rule 12F-17, regulated entities and public companies should avoid restricting the kinds of information that employees may voluntarily disclose to the SEC, and instead should make clear in internal trainings that employees may voluntarily disclose confidential information to the SEC.

To do so, regulated entities and public companies should periodically review their employment, confidentiality and severance agreements to determine how to protect their confidential information without impeding potential whistleblowers.

Avoid actual or perceived retaliation against whistleblowers.

Upon being served with a complaint or otherwise first learning of an investigation prompted by a whistleblower, the company must take immediate steps to protect the whistleblower from any real or perceived retaliation and to maintain his or her anonymity.

Under Exchange Act Rule 21F(h)(1), regulated entities and public companies are prohibited from discharging, demoting, suspending, threatening, harassing or discriminating against a whistleblower as a result of the whistleblower providing information to the SEC. Counsel and compliance officers should coordinate with human resources to ensure that performance reviews and personnel actions avoid actual or the appearance of retaliation.

Take proactive steps to preserve relevant documents.

At the beginning of any investigation, the company should proactively preserve relevant documents by sending out document retention notices.

Management needs to get an early handle on what's involved in terms of documents and people, and make sure that all employees holding potentially relevant information are quickly advised to cease all routine destruction policies. Improper document destruction or alteration can result in significant fines and penalties.

Conduct an objective investigation to remediate.

Once an internal complaint is received, a company should immediately conduct an objective investigation to determine how to rectify and remediate.

Remediation efforts reduce the likelihood that the whistleblower will go directly to the SEC and earn cooperation credit from the government when negotiating a settlement.

A whistleblower has 120 days to go to the SEC to preserve rights to an award. During this period, counsel should work to sufficiently understand the issues and prepare a formal investigation plan to present to the SEC.

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[1] https://www.benefitspro.com/2022/12/14/esg-investments-lower-than-expected-totaling-8-4-trillion/.

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