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Lessons From SEC Goldman Sachs ESG Policy Adoption Fine

By **Eric Rubenfeld** (January 25, 2023, 5:17 PM EST)

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Registered investment advisers are warned that the U.S. Securities and Exchange Commission will impose significant fines on investment advisers whose policies and procedures are inconsistent with their marketing materials, even without direct harm to investors.

In a recent settlement with Goldman Sachs Asset Management LP, or GSAM, the SEC imposed a significant civil monetary penalty on GSAM for failing to timely adopt and implement policies and procedures regarding its investment process, despite the commission not alleging or documenting any financial harm to investors or imposing restitution.

Registered investment advisers are thus on notice that the SEC will not accept a "no harm, no foul" defense when marketing materials make promises that an investment adviser's policies and procedures fail to keep.

Background

GSAM is a registered investment adviser with approximately $1.5 trillion in regulatory assets under management. As part of its business, GSAM served as the investment adviser to two funds and a separately managed account that promised to employ an environmental, social and governance, or ESG, strategy in their investment portfolios.

The SEC alleged that from April 2017 to February 2020, GSAM failed to timely adopt and implement policies and procedures "reasonably designed to prevent violations of the federal securities laws" concerning the investment process GSAM utilized in advising these ESG investors,[1] in violation of Section 206(4) of the Investment Advisers Act of 1940, or the Advisers Act, [2] and Rule 206(4)-7 thereunder.[3]

Specifically, with respect to the separately managed account, GSAM did not "adopt written policies and procedures governing how" it evaluated ESG factors as part of the investment process until after the strategy was introduced, and, concerning the ESG investment products in general, "once GSAM adopted the written policies and procedures relating to the ESG investment process, it failed to consistently follow them."[4]

The SEC found that GSAM's failure to adequately implement its policies and procedures during the period at issue was systemic, saying the investment adviser "did not provide its staff with sufficient guidance concerning the applicability and scope of the 2018 policies and procedures that covered the ESG investment process" and determining that GSAM investment staff applied the policy incorrectly.[5]

The Law

Section 206 contains the basic anti-fraud provisions of the Advisers Act. Like other federal securities law anti-fraud provisions, it contains a mix of prohibitions, some that require a finding of scienter — the intent to deceive or defraud — such as Section 206(1),[6] and some that require a finding of mere negligence, including Sections 206(2) and (4).[7]

Generally, prohibitions on employing a "device, scheme, or artifice,"[8] or words of similar effect, to defraud indicate a scienter requirement, while prohibitions on engaging in the more neutral "transaction, practice, or course of business"[9] or "act, practice, or course of business"[10] indicate a negligence standard.

Section 206(4) of the Advisers Act states that "it shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly ... to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." The SEC has the rulemaking authority to "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."

Because Section 206(4) prohibits an "act, practice, or course of business," rather than a "device, scheme, or artifice," it does not require a finding of scienter.

In SEC v. Steadman, the U.S. Court of Appeals for the District of Columbia Circuit in 1992 explicitly rejected a scienter requirement under Section 206(4) of the Advisers Act.[11] The agency alleged that the defendants — a registered investment adviser and certain affiliated persons — failed to comply with maintenance and surprise auditing of certain bank accounts for client funds and securities as required by Section 206(4) of the Advisers Act and certain rules promulgated thereunder.

The defendants argued that they did not violate Rule 206(4) of the Advisers Act because they did not act with scienter. The court rejected the defendants' claims, finding that:

> Although [Section 206(4)] uses the adjectives "fraudulent, deceptive, or manipulative," section 206(4) does not speak in terms of the "device, scheme, or artifice" that the Aaron Court[12] believed connoted so strongly a knowledge or intent requirement.[13] Rather, section 206(4) uses the more neutral "act, practice, or course or business" language. This is similar to section 17(a)(3)'s [of the Securities Act of 1933] "transaction, practice, or course of business," which "quite plainly focuses upon the effect of particular conduct ... rather than upon the culpability of the person responsible."[14] Accordingly, scienter is not required under section 206(4).[15]

Rule 206(4)-7 states that it is a violation of Section 206 of the Advisers Act for an investment adviser registered or required to be registered under the Advisers Act "to provide investment advice to clients" unless, among other things, the adviser adopts and implements "written policies and procedures reasonably designed to prevent violation" of the Advisers Act and the rules promulgated thereunder by the adviser and its supervised persons.

Analysis

The GSAM case contains two important lessons for registered investment advisers.

First, the SEC imposed significant monetary penalties on GSAM even though no financial harm to investors was alleged. Rather, the SEC based its case on the simple facts that the investment adviser did not have written policies and procedures in place to satisfy the investment mandate of the ESG-separately managed account before launching the strategy and that with respect to the ESG investment products in general, GSAM did not consistently follow its written policies and procedures during the time at issue.[16]

Accordingly, investment advisers should be on notice that not only is scienter not required to establish a Section 206(4) violation, but neither is actual investor harm.

Second, the commission did not feel compelled to identify a specific Advisers Act provision that GSAM violated because of its failure to timely adopt and effectively implement a written ESG investment policy.

The plain language of Rule 206(4)-7 states that the failure to adopt and implement a written policy should only cause a Rule 206(4)-7 violation if the policy failure results, or at least could result, in a violation of the Advisers Act. Put another way, an investment adviser's failure to implement an adopted policy should not result in a 206(4)-7 violation if the policy at issue is not itself designed to comply with the terms of the Advisers Act.

However, the SEC's failure to allege a specific Advisers Act violation may be the result of poor drafting of the order rather than an intent to remove the requirement from the rule.

The SEC order in this instance states that GSAM described the ESG investment strategy in the marketing materials for the ESG investment products and presented it to the funds' boards of trustees as governing investment decisions.

This suggests that the SEC was prepared to argue that the failure to timely adopt and implement the ESG investment policy resulted in the preparation of false and misleading marketing materials and misrepresentations to the board of trustees, in violation of Section 206 of the Advisers Act, and that the failure to adopt and implement such policies therefore constitutes a Rule 206(4)-7 violation.

The GSAM settlement is in line with other SEC actions that have found liability based on the gap between marketing materials and policies and procedures, for example, with respect to expense allocations and reimbursements.

The SEC has been clear in its public statements and enforcement actions that while the Advisers Act does not, outside of limited exceptions, dictate the business terms between an investment adviser and its clients, it does require that investment advisers operate in accordance with representations voluntarily made to those clients, such as in marketing materials.

As the GSAM case demonstrates, many investment advisers, even highly experienced ones, often fail to harmonize policies and procedures with marketing materials.

Investment advisers often include aspirational descriptions of their processes in their marketing materials based on best practices in the marketplace, rather than accurately describing their current practices. Unfortunately, investment advisers often fail to update their written policies and procedures to match the marketing materials or fail to effectively implement policies and procedures once promulgated.

Investment advisers that lack a dedicated compliance staff and rely on off-the-shelf compliance materials are especially vulnerable to such failures because off-the-shelf compliance materials, by definition, will not accurately reflect the investment adviser's actual policies and procedures to the extent that those policies and procedures are adviser-specific.

Further, "dual-hatted" compliance staff may lack the time and expertise to promulgate and implement policies and procedures to keep pace with marketing promises.

To avoid public censure and financial penalties, investment advisers must fully integrate their compliance function into their business processes so that compliance professionals can identify gaps between what is promised and what is performed, as well as provide adequate resources so that the compliance function can address such gaps on a timely basis.

Investment advisers should also not rely on investment performance to mitigate compliance failures.

The SEC, through its rigorous examination process, is not reliant upon investor complaints to identify noncompliant investment advisers. Rather, investment advisers should expect the SEC, as part of its routine examination process, to compare marketing materials with policies and procedures to ensure that representations made to investors are supported by written policies and procedures that have been fully implemented.

Investment advisers with under-resourced compliance departments and off-the-shelf policies and procedures should expect the SEC to find gaps in their compliance program that may expose them to public punishment and financial penalties.

As GSAM can attest, an ounce of compliance prevention can prevent a pound of compliance cure.

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[1] In re Goldman Sachs Asset Management, L.P.

[2] 15 U.S.C.S § 80b-6.

[3] 17 C.F.R. § 275.206(4)-7.

[4] In re Goldman Sachs Asset Management, L.P. at *2-3.

[5] Id. at *13.

[6] 15 U.S.C.S § 80b-6(1).

[7] 15 U.S.C.S § 80b-6(2) and (4).

[8] 15 U.S.C.S § 80b-6(1).

[9] 15 U.S.C.S § 80b-6(2).

[10] 15 U.S.C.S § 80b-6(4).

[11] SEC v. Steadman, 967 F.2d 636 (1992).

[12] Aaron v. SEC, 446 U.S. 680 (1980).

[13] See 446 U.S. at 696.

[14] Id. at 697.

[15] 967 F.2d 647.

[16] In re Goldman Sachs Asset Management, L.P. at *2-3.