The SEC's Latest Risk Alert Puts ESG Investing in the Crosshairs

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The Securities and Exchange Commission's (SEC, or Commission) Division of Examinations (Division) recently issued a Risk Alert highlighting staff observations from examinations of investment advisers, registered investment companies and private funds (firms) engaged in environmental, social, and governance (ESG) investing. This post summarizes the Risk Alert, including focus areas and observations of *deficiencies* and internal control weaknesses, as well as recommendations of *effective* practices relating to ESG investing that may be helpful in developing and enhancing a firm's compliance practices.

As investor demand for ESG information rises, the need for investment firms to align their disclosure with actual practice and to integrate compliance personnel into their ESG-related practices will continue to grow.

I. On which areas has SEC staff focused its examinations of firms engaged in ESG investing?

The staff continues to examine whether firms accurately disclose their ESG investing approaches and adopt and implement policies, procedures and practices that accord with their ESG-related disclosures. In particular, the staff noted that its examinations would focus on, among other matters, portfolio management, performance advertising and marketing and compliance programs.

Within these areas, SEC staff will continue to review both internal and external documents to ensure that firms articulate what ESG means to them and take care not to mislead investors. With respect to portfolio management, the SEC will examine firms' policies, procedures and practices (including written compliance policies) related to ESG and the use of ESG-related terminology.

The Commission also will evaluate regulatory filings, websites, reports to sponsors of global ESG frameworks, client presentations and responses to due diligence questionnaires, requests for proposals and client/investor-facing documents, including marketing materials. Firms should be aware that the SEC will compare firms' actual due diligence practices (e.g., investment selection and monitoring processes) and proxy voting decision-making processes with their disclosed ESG investing approaches.

II. What *deficiencies* have the staff observed?

During its examinations, the staff observed some instances of potentially misleading statements regarding ESG investing processes and representations regarding firms' adherence to global ESG frameworks. To illuminate these issues further for the regulated community, the staff provided the following examples of deficiencies:

- *Portfolio management practices were inconsistent with disclosures about ESG approaches* (e.g., portfolio management practices that differed from client disclosures in required disclosure and other client/investor-facing documents, including lack of adherence to ESG frameworks where firms claimed adherence).
- *Controls were inadequate to maintain, monitor and update clients' ESG-related investing guidelines, mandates and restrictions* (e.g., weaknesses in policies and procedures governing implementation and monitoring of the advisers' clients' or funds' ESG-related directives, leading to the risk that prohibited securities could be included in client portfolios despite the security being flagged with negative ESG attributes).
- *Proxy voting may have been inconsistent with advisers' stated approaches* (e.g., inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices, especially regarding the level of detailed analysis employed for each security).
- *Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches* (e.g., unsubstantiated, potentially misleading claims regarding ESG investing or omissions necessary to make the claims not misleading).
- *Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices* (e.g., inconsistencies between actual firm practices and ESG-related disclosures and marketing materials because of a weakness in controls over public disclosures and client/investor-facing statements or a failure to fully document compliance with controls).
- *Compliance programs did not adequately address relevant ESG issues* (e.g., lack of policies and procedures addressing ESG investing analyses, decision-making processes or compliance review and oversight, including the failure to follow global ESG frameworks despite claiming adherence thereto and the failure to ensure compliance by any sub-adviser that is retained for ESG diligence).
- *Compliance programs were less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions* (e.g., weaknesses in compliance controls regarding performance metrics and a failure to review the underlying data).

III. What *effective* practices have the staff observed?

During its examinations, the staff identified effective practices that help firms comply with current regulations. These include clear disclosures, policies and procedures that specifically address ESG investing and with oversight from knowledgeable compliance personnel. These and the following practices might help firms avoid or address the compliance issues discussed above:

- **Disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing and which aligned with the firms' actual practices, including:**
    - *Simple and clear disclosures regarding the firms' approaches to ESG investing* (e.g., clear disclosures in client-facing materials as to (i) whether the adviser offers clients choices among standardized portfolios focused on particular ESG issues, or alternatively, customized separately managed accounts designed to accommodate particular client preferences, (ii) whether ESG could be considered alongside may other factors notified clients and investors that adherence to certain global ESG frameworks did not necessarily alter long-standing and seemingly contrary investment strategies, and (iii) reliance on sub-advisers and disclosure of sub-advisers' conflict of interests)
    - *Explanations regarding how investments were evaluated using goals established under global ESG frameworks* (e.g., investment statements posted on adviser websites, client presentations and annual reports detailing how firms approached the U.N.-sponsored Principles for Responsible Investment or Sustainable Development Goals).
- **Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices** (e.g., detailed, comprehensive investment policies and procedures that addressed ESG investing resulted in contemporaneous documentation of the ESG factors considered in specific investment decisions at different stages of the investment process, such as research, due diligence, selection and monitoring).
- **Compliance personnel that are knowledgeable about the firms' specific ESG-related practices** (e.g., firms were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents with compliance personnel who provide more meaningful reviews of firms' public disclosures and marketing materials, test the adequacy and specificity of existing ESG-related policies and procedures, evaluate whether firms' portfolio management processes aligned with their stated ESG investing approaches and test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences)

Conclusion

The Division encourages firms to (a) promote ESG investing to current and prospective clients and investors to evaluate whether their disclosures, marketing claims and other public statements related to ESG investing are accurate and consistent with internal firm practices; (b) ensure that their approaches to ESG investing are implemented consistently throughout the firm where relevant and adequately addressed in the firm's policies and procedures and subject to appropriate oversight by compliance personnel; and (c) take steps to document and maintain records relating to important stages of the ESG investing process.

The Risk Alert reflects the Commission's seemingly newfound focus on ESG issues, but not all commissioners are necessarily on board. A few days after the Division issued the Risk Alert, Commissioner Hester Peirce issued a public statement in which she underscored the importance of asset manager accountability in the ESG space, but also reiterated her and fellow Commissioner Elad Roisman's critique of the recent initiatives as potentially unwarranted departures from the Commission's longstanding practices. While reminding advisers and funds not to "make claims that do not accord with their practices," Commissioner Peirce noted that the issuance of an ESG-specific risk alert "should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners."

Ultimately, it remains to be seen what impact this Risk Alert and the SEC's other ESG-focused actions will have in the near term. As newly confirmed Chair Gary Gensler solidifies the Democratic commissioners' majority, however, we expect ESG and climate to continue to attract the Commission's attention.