

April 14, 2021

## **UNDERSTANDING THE SEC’S FOCUS ON ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING AND INVESTMENT ADVISERS**

### *SEC Division of Examinations Risk Alert Provides a Useful Roadmap on Compliance Issues for Fund Managers*

To Our Clients and Friends:

On Friday, April 9, 2021, the Securities and Exchange Commission (“SEC”) Division of Examinations (the “Division”), issued a Risk Alert detailing its observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding investing that incorporates environmental, social, and governance factors (“ESG investing”).<sup>[1]</sup> This alert follows another recent announcement of the creation of a Climate and ESG Task Force within the Division of Enforcement to focus on ESG-related disclosures by public companies and ESG investment practices by investment funds.<sup>[2]</sup>

#### **Key Takeaways**

The Risk Alert provides useful guidance regarding the types of compliance issues the Staff is reviewing in its examinations of investment advisers, examples of deficiencies the Staff is finding, as well as instances in which the Staff has observed effective compliance practices. Accordingly, the Risk Alert provides a useful roadmap to assist investment advisers in developing, testing and enhancing their compliance policies, procedures and practices.

On the heels of the Risk Alert, Commissioner Peirce issued a cautionary statement to express her view that the alert, “should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners,” but simply that, as with any other investment strategy, “[f]irms claiming to be conducting ESG investing need to explain to investors what they mean by ESG and they need to do what they say they are doing.”<sup>[3]</sup>

In sum, the SEC’s focus on ESG investment strategies heightens the need for investment advisers to make sure their disclosures align with investment practices and that there is sufficient and knowledgeable oversight and review by compliance personnel to avoid a divergence between the two over time.

#### **Concerns Identified by the Division**

In the Division’s examination of investment advisers, registered investment companies, and private funds engaged in ESG investing, the Staff observed the following weaknesses:

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- Lack of adherence to global ESG frameworks where firms claimed such adherence.
- Weakness in policies and procedures governing implementation and monitoring of ESG-related directives. For example, the Staff observed that advisers did not have adequate controls around implementation and monitoring of clients' negative screens.
- Inconsistency between public ESG-related proxy voting claims and internal voting policies and practices, including the dissemination of public statements that ESG-related proxy proposals would be independently evaluated on a case-by-case basis, while internal deadlines generally did not provide such case-by-case analysis.
- Unsubstantiated or otherwise potentially misleading claims regarding ESG investing in marketing materials that touted favorable risk, return, and correlation metrics related to ESG investing, without disclosing material facts regarding the significant expense reimbursement received from the fund-sponsor, which inflated returns for those ESG-oriented funds.
- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices, including lack of documentation of ESG investing decisions and issuer engagement efforts, as well as a failure to update marketing materials timely.
- Limited knowledge by compliance personnel of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions.

## **Guidance for ESG Investing Disclosures and Procedures**

The Staff also observed policies, procedures, and practices which were reasonably designed to convey approaches to ESG investing. The Division noted that the following practices may be helpful to address the compliance issues identified above:

- Simple and clear disclosures regarding the firm's approach to ESG investments in client-facing materials.
- Explanations regarding how ESG investments are evaluated using goals established under global ESG frameworks on the firm's website, client presentations, and annual reports.
- Detailed, comprehensive investment policies and procedures regarding ESG investments and factors considered in specific investment decisions; when multiple ESG investing approaches are considered, specific written procedures, due diligence documentation, and separate specialized personnel who provide additional rigor to the portfolio management process.
- Compliance personnel who are knowledgeable about the firm's ESG approaches and practices. Firms with dedicated ESG compliance personnel were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents.

## Conclusion

In conclusion, the SEC's Risk Alert reaffirms the need for firms involved in ESG investing to ensure that their disclosures accurately describe their ESG-related investment practices. Periodic reviews of marketing materials and other investor disclosures against current investment strategy and adherence to stated ESG metrics will avoid the types of deficiencies the Staff has observed in recent inspections, and, in the worst cases, avoid even greater scrutiny from the Division of Enforcement.

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[1] Division of Examinations, *Risk Alert*, Securities and Exchange Commission (Apr. 9, 2021), <https://www.sec.gov/files/esg-risk-alert.pdf>.

[2] Press Release, U.S. Securities and Exchange Commission, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), [https://www.sec.gov/news/press-release/2021-42?\\_sm\\_au\\_=iHVN4cW7DnktSD5NFcVTvKQkcK8MG](https://www.sec.gov/news/press-release/2021-42?_sm_au_=iHVN4cW7DnktSD5NFcVTvKQkcK8MG).

[3] Public Statement, Statement on the Staff ESG Risk Alert (Apr. 12, 2021), <https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert>.



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