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SEC Division of Examinations Issues ESG Risk Alert

April 16, 2021

On April 9, 2021, the Division of Examinations of the Securities and Exchange Commission (the "Commission") issued a Risk Alert regarding investment advisers, registered investment companies, and private funds offering ESG[1] products and services. The Risk Alert highlights observations from recent exams of these businesses and provides examples of both problematic conduct and best practices with respect to ESG issues. The Risk Alert comes at a time of unprecedented focus on ESG issues by the Commission and its staff,[2] and confirms that the staff intends to apply the existing disclosure and fiduciary framework to ESG issues in the asset management industry rather than develop a new substantive or procedural framework.

THE DIVISION OF EXAMINATIONS' ONGOING REVIEW OF ESG INVESTING

The Division of Examinations noted that it will continue to examine firms to evaluate whether they are accurately disclosing their ESG investment practices and have maintained an adequate control environment to ensure ESG disclosures accord with their practices. These ongoing exams—much like the ESG exam sweeps undertaken over the last two years—will focus on firms' disclosure and procedures in three primary areas: portfolio management, performance advertising, and compliance programs, each discussed briefly below.

Portfolio Management

The Division of Examinations intends to focus on reviewing firms' policies, procedures, and practices related to ESG issues broadly, including ESG-related terminology, due diligence with respect to selecting and monitoring investments in view of firms'

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1 Environmental, social, and governance.

2 Over the last several months alone, the Commission and the SEC staff have made a series of high profile announcements reflecting this focus, including the formation of a Division of Enforcement Climate and ESG Task Force, the appointment of a Senior Policy Adviser for Climate and ESG, the publication of the Division of Examinations' 2021 Exam Priorities, which prominently featured ESG, a statement by Acting Chair Lee seeking public comment on climate change and ESG disclosures, and a number of statements and speeches by multiple Commissioners and the Acting Director of the Division of Corporation Finance discussing ESG as a priority.

disclosed ESG investing approaches, and whether proxy voting decision-making processes accord with ESG disclosures and relevant marketing materials.

Performance Advertising and Marketing

For firms that have chosen to adhere to a voluntary global ESG framework, set of principles, or standards, the Division of Examinations intends to review firms' regulatory filings, websites, and reports to sponsors regarding global ESG frameworks. For all firms, the Division of Examinations intends to focus on reviewing client presentations, responses to due diligence questionnaires, requests for proposals, and other client- or investor-facing documents.

Compliance Programs

The Division of Examinations intends to focus on reviewing firms' written policies and procedures and their implementation and compliance oversight, including compliance reviews of ESG investing practices and disclosures.

THE DIVISION OF EXAMINATIONS' RECENT ESG FINDINGS

The Risk Alert also set forth instances of recently observed deficiencies regarding ESG-related practices from prior examination periods, as discussed below.

- *Portfolio management practices inconsistent with ESG disclosures*, such as where a firm claims adherence to a global ESG framework but in fact fails to meet these standards, or where the stated approach is to limit investments to issuers with certain ESG scores, yet many fund holdings include issuers with low ESG scores.

- *Weaknesses in policies and procedures governing the implementation and monitoring of funds' ESG-related directives*, such as where advisers have inadequate controls around the implementation and monitoring of clients' positive screens (i.e., preferences for certain industries or issuers) or negative screens (i.e., prohibitions on investments in certain industries), causing particularly acute problems where ESG directives are "ill-defined, vague, or inconsistent."

- *Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches*, such as where marketing materials tout favorable risk, return, and correlation metrics related to ESG investing without disclosing materials facts, including omitting material facts impacting ESG investment performance (e.g., significant expense reimbursements from ESG fund sponsors that inflate returns). Of note, the Division of Examinations also observed instances where advisers claimed to have contributed substantially to the development of certain ESG products, when in fact their roles were very limited.

- *Compliance programs inadequately addressing relevant ESG issues*, such as where firms "substantially engaged in ESG investing" nonetheless lack policies and procedures to address their ESG investing analyses, decision-making processes, or compliance review and oversight. Specific examples included firms that claim to adhere to global ESG frameworks yet do not address such frameworks in their compliance programs, firms without policies and procedures to ensure reasonable support for ESG-related marketing claims, and firms with inadequate policies regarding oversight of ESG-focused sub-advisers.

IDENTIFIED BEST PRACTICES

The Risk Alert also highlighted the following as best practices with respect to ESG issues in the asset management space: (i) clear, precise disclosures tailored to firms' specific approaches to ESG investing and that align with the firms' actual practices; (ii) policies and procedures that address ESG investing and cover key aspects of the firms' relevant practices; and (iii) compliance personnel that are knowledgeable about the firms' specific ESG-related practices.

KEY TAKEAWAYS

The Risk Alert represents the clearest and most granular articulation of the SEC's concerns about the marketing of ESG-related investment products, and the sufficiency of the practices, related documentation, policies and procedures of the asset managers that sell these products.

When considered in connection with the SEC Enforcement Division's new Climate and ESG Task Force, the Risk Alert appears to present a roadmap that the SEC will follow in pursuing enforcement actions against managers. Asset managers that offer ESG-related products or strategies should review the Risk Alert carefully and evaluate their regulatory risks and exposure.

The Risk Alert specifically focuses on managers that have marketed to investors the adoption of global ESG frameworks, including the UN Principles for Responsible Investment (UNPRI) and Sustainable Development Goals (SDGs). Private fund sponsors that have embraced UNPRI should be aware that the SEC staff is carefully scrutinizing signatories' compliance with the framework, including by reviewing annual reports of ESG investment practices. Signatories to UNPRI (or other published ESG frameworks) should ensure that their ESG policies and practices match the representations the manager has provided to investors of their commitment to those standards.

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Please do not hesitate to contact us with any questions.

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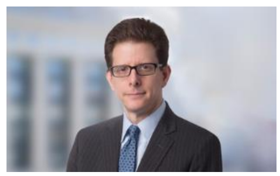

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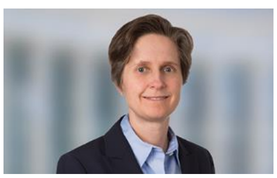

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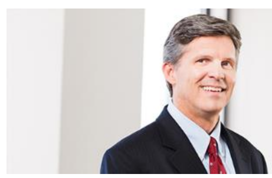

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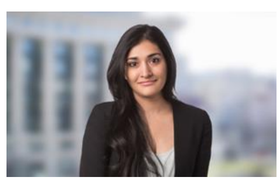

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