Securities Regulation Daily Wrap Up, INVESTOR EDUCATION—Division of Examinations issues ESG Risk Alert, (Apr. 12, 2021)

Securities Regulation Daily Wrap Up

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By Rodney F. Tonkovic, J.D.

The Risk Alert tells what the Division's examinations will focus on and gives examples of both good and bad practices.

The SEC's Division of Examinations has issued a risk alert highlighting its recent observations from exams of firms offering ESG products and services. The alert gives the Division's observations of deficiencies and internal control weaknesses derived from examinations of ESG investing by advisers and funds.

The Risk Alert notes that in response to increased demand for investment products and financial services incorporating environmental, social, and governance (ESG) factors, a range of investment advisers have offered several ESG investment options. These options include registered investment companies and pooled investment vehicles, and separately managed accounts. In making investment decisions, some advisers consider ESG among a number of other factors, while others focus on those practices.

The Division notes that the increase in the number of ESG products and services, plus a lack of standardization, presents certain risks. The Risk Alert is intended to highlight risks and help firms to develop and enhance their compliance practices. The Division also seeks to provide insight into the areas in which examinations on the topic will focus.

Examinations. Among other matters, examinations of firms claiming to engage in ESG investing will focus on:

- Portfolio management, including a review of the firm's policies, procedures, and practices related to ESG; due diligence and other processes in light of the firm's ESG investing approaches; and whether proxy voting decision-making processes are consistent with ESG disclosures and marketing materials.
- Performance advertising and marketing, including a review of the firm's regulatory filings; websites; reports to sponsors of global ESG frameworks, and responses to due diligence questionnaires and other client/investor-facing documents.
- Compliance programs, including a review of the firm's written policies and procedures and their implementation, compliance oversight, and review.

Issues observed by staff. During examinations, the staff took note of instances of potentially misleading statements about ESG investing processes and the adherence to global ESG frameworks. Despite firms' claims of formal processes, the staff saw a lack of policies and procedures related to ESG investing or, where implemented, that did not appear to be designed to prevent violations. These observations fell into the following categories, and are explained further in the alert:

- Portfolio management practices were inconsistent with disclosures about ESG approaches.
- Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.
- Proxy voting may have been inconsistent with advisers' stated approaches.
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.
- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.
- Compliance programs did not adequately address relevant ESG issues.

- The staff also observed that 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.

Effective practices. Finally, the Division observed that some advisers and funds had effective practices, and the staff believes that a sample may be helpful in addressing compliance issues such as those noted above. For example, the examinations found:

- *Disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices*. This includes: simple and clear disclosures regarding the firms' approaches to ESG investing; ESG factors that could be considered alongside many other factors; and explanations regarding how investments were evaluated using goals established under global ESG frameworks.
- *Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices*. Here, the staff took particular note of detailed investment policies and procedures that addressed ESG investing.
- *Compliance personnel that are knowledgeable about the firms' specific ESG-related practices*. Specifically, where compliance personnel were integrated into firms' ESG-related processes, firms were more likely to avoid materially misleading claims about ESG in their marketing materials and other client/investor-facing documents.

In sum, the Division encourages market participants to evaluate whether their ESG-related disclosures, marketing claims, and other public statements are accurate and consistent with internal firm practices. Firms should also ensure a consistent approach to ESG investing and that the firm's policies and procedures are given proper oversight by compliance personnel. Finally, firms should consider documenting and maintaining records on important stages of the ESG investing process.

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