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CLIENT ALERT

SEC Issues Risk Alert Highlighting ESG Deficiencies at Investment Advisers

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The staff of the Securities and Exchange Commission's (the "SEC") Division of Examinations (the "Division") published a risk alert on April 9, 2021,[1] highlighting observations of the Division staff (the "Staff") from its recent examinations of investment advisers, investment companies, and private funds that offer environmental, social, and governance ("ESG") investment products and services (collectively, "firms"). The risk alert provides examples of what the Staff views as deficient practices and internal control weaknesses as well as effective practices that the Staff observed during recent examinations of firms. In addition, and consistent with the Division's March 3 publication on 2021 examination priorities,[2] the risk alert provides guidance to firms on the ESG-related areas the Division will continue to focus on during examinations.

The risk alert is the most recent in a series of publications and statements by Commissioner Allison Herren Lee, Commissioner Caroline Crenshaw and the Staff regarding ESG issues,[3] further demonstrating the importance placed on the topic by the agency and the Biden administration more generally.[4] Importantly, Gary Gensler, recently sworn in as

[1] The Division of Examinations' Review of ESG Investing, Division of Examinations Risk Alert (April 9, 2021), available here.

[2] 2021 Examination Priorities, Division of Examinations, available here. Our client alert discussing the 2021 Examination Priorities is available here.

[3] Our client alert discussing recent communications from the SEC on ESG is available here.

[4] It is important to note, however, that the enhanced SEC focus on ESG issues does not have unanimous support within the agency. For example, following the release of the risk alert, Commissioner Hester M. Peirce issued a statement on April 12, 2021 in which she cautioned that the ESG-specific risk alert should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners. Hester M. Peirce, *Statement*

SEC Chairman, also has expressed support for increasing the SEC's focus on ESG issues, indicating that the agency's prioritization of the issue is not likely to change with Mr. Gensler as the Chairman.[5]

Despite the SEC leadership clearly communicating the importance of ESG issues to the agency, there remains uncertainty about what the final scope and requirements of any SEC rulemaking will look like. Previous releases have provided some suggestions for what aspects of a regulatory framework could look like in response to the rapid increase in ESG investing.[6] The risk alert provides more concrete guidance to regulated firms regarding the Staff's expectations under the existing regulatory framework, which is important in light of the agency's heightened focus on ESG issues, including creation of the Climate and ESG Task Force in the Division of Enforcement. The SEC announced the creation of the Climate and ESG Task Force on March 4, 2021, and appointed Kelly Gibson, the Acting Deputy Director of Enforcement, as its leader. The task force said its initial focus will be to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules and to analyze disclosure and compliance issues relating to investment advisors' and funds' ESG strategies.[7]

Risk Alert

At the beginning of the risk alert, the Division notes that investor demand for investment products and financial services incorporating ESG factors has recently increased, and that investment advisers have responded to the increased demand by offering potential investors a variety of products that use a range of ESG investment approaches. The Division explains that a lack of standardized ESG definitions, combined with this rapid growth in demand for, and approaches to, ESG investment products can lead to investor confusion, especially for retail investors.

Notably, while the risk alert focuses on ESG-specific issues, the key themes running through the risk alert reflect long-standing SEC expectations for regulated entities. These key themes are: (1) portfolio management and internal processes must match disclosures that firms provide to clients and investors; (2) firms must have adequate data and records to support claims made to clients and investors, particularly performance-related claims; and (3) compliance personnel need to have a sufficient level of knowledge of and involvement with an adviser's activities to provide adequate oversight of those activities. These themes are consistent with recent statements from the SEC's Division of

on the Staff ESG Risk Alert (April 12, 2021), available here. Commissioner Peirce's recent statement is consistent with views she has expressed following other recent SEC releases on ESG issues.

5 Mr. Gensler reportedly indicated during his confirmation hearing that both investors and issuers would benefit from more robust disclosures regarding climate risk. *See* Tory Newmyer, ***President Biden's SEC Pick Signals Companies Could Face Wave of New Disclosure Rules***, THE WASHINGTON POST (March 2, 2021).

6 *See, e.g.*, Potential Recommendations of ESG Subcommittee of the SEC Asset Management Advisory Committee (December 1, 2020), available here.

7 Our client alert discussing the creation of the Climate and ESG Task Force in the Division of Enforcement is available here.

Enforcement's ESG Task Force that ESG enforcement will be based on existing rules, guidance and long-standing principles of materiality and disclosure.

In addition to highlighting what the Staff views as deficiencies and effective practices, the risk alert states that the Division will prioritize: (1) policies, procedures, and practices related to ESG, and firms' use of ESG-related terminology; (2) due diligence and other processes for selecting, making, and monitoring investments in view of firms' disclosed approaches to ESG; (3) firm regulatory filings, websites, reports to sponsors of global ESG frameworks, and communications to clients and prospective clients regarding firms' ESG practices; (4) proxy voting decision-making processes; and (5) compliance oversight of firms' ESG investing practices and disclosures.

Deficiencies Observed by the Staff

The Staff stated that they had observed numerous deficiencies and internal control weaknesses during examinations of investment advisers and funds engaged in ESG investing, many of which related to marketing or disclosures concerning ESG investing and proxy voting, including the following:

- *Portfolio management practices that were inconsistent with disclosure*: The Staff identified misleading statements regarding firms' adherence to global groups' standards (*e.g.*, U.N.-sponsored Principles for Responsible Investment ("UNPRI")). In addition, the Staff observed fund holdings that consisted predominately of issuers with low ESG scores, which appeared to be inconsistent with disclosures made to investors and clients.

- *Inadequate controls and documentation:* The Staff observed firms that had inadequate controls for implementing, monitoring, and tracking updates to client directives to exclude certain holdings (negative screens) or client preferences for certain holdings (positive screens), despite claims to have such client screens. The Staff attributed inconsistencies between actual firm practices and disclosures and a lack of documentation of ESG investing decisions and issuer engagement efforts to weaknesses in internal controls.

- *Proxy voting practices inconsistent with disclosure:* The Staff identified ESG-related proxy voting disclosures that were inconsistent with internal proxy voting policies and practices; for example, claims that the firm would assess ESG-related proxy proposals on a case-by-case basis or permit clients to vote separately on ESG-related proposals without having processes consistent with those disclosures.

- *Unsubstantiated or misleading ESG claims:* The Staff observed firms touting favorable risk, return, and correlation metrics of ESG products without disclosing significant expense reimbursement they received from the product's sponsor, inflating the stated returns of the product. The Staff also observed firms overstating their contributions to creating ESG products.

- *Compliance programs not tailored to ESG:* The Staff also observed firms lacking adequate policies and procedures to address their ESG investing analyses, decision-making processes, or compliance review and oversight. The Staff identified specific areas that were not adequately addressed in compliance programs, including:
  - actual adherence to global ESG frameworks to which a firm claimed to be adhering;
  - ensuring firms obtained reasonable support for ESG-related marketing claims;
  - oversight of ESG-focused sub-advisers; and
  - substantiating adherence to stated investment processes, such as supporting claims made to clients that each fund investment had received a high score for each separate component of ESG, when relying instead on composite ESG scores provided by a sub-adviser.
- *Compliance personnel with limited knowledge about ESG:* The Staff observed that firms with compliance personnel that had limited knowledge of ESG investment analyses or oversight over disclosures and marketing decisions had less effective compliance programs. The Staff specifically noted weaknesses in oversight related to reporting to sponsors of global ESG frameworks, responses to requests for proposals and due diligence questionnaires, and performance metrics included in marketing materials (including data underlying those metrics).

Effective Practices Observed by the Staff

The Staff also provided examples of effective practices that they observed during examinations, including the following:

- *Simple, clear disclosures of firms' approaches to ESG investing:* The Staff noted examples of good disclosure practices, such as making clear when an adviser was relying on unaffiliated subadvisers for ESG analysis and asset allocation and when an adviser was offering standardized ESG portfolios or customized, separately managed accounts designed to accommodate client preferences.
- *Disclosure that ESG factors could be considered among other factors:* The Staff observed that disclosure of such practices served to notify clients that firms could adhere to identified global ESG frameworks while making certain investments or pursuing investment strategies that are seemingly inconsistent with those global frameworks.
- *Detailed disclosures about how firms comply with UNPRI or Sustainable Development Goals.* The Staff noted that these disclosures included quantitative information on the local impacts of investments.

- *Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices.* The Staff highlighted detailed investment policies and procedures that addressed ESG investing, including specific and contemporaneous documentation to be completed at various stages of the investment process. The Staff also noted that specific written procedures, due diligence documentation, and separate specialized personnel at firms that employ multiple ESG investing approaches at the same time provided additional rigor to the portfolio management process.
- *Compliance personnel that are integrated into ESG processes*: The Staff observed that firms that integrate compliance personnel into ESG processes and had compliance personnel who are knowledgeable about ESG approaches and practices provided better oversight of disclosures and testing of ESG-related policies and procedures. Furthermore, these firms were more likely to avoid materially misleading claims in their client-facing materials.

Conclusion

The Division, through the risk alert, offers valuable insight into the specific areas of focus related to ESG investing that it will concentrate on during examinations of firms, with a particular focus on marketing activities, fund and adviser disclosures and compliance procedures (including oversight procedures of third parties). While there is considerable uncertainty as to how the SEC will apply this guidance in practice, firms engaged in ESG investing may wish to review their policies and procedures and consider whether revisions or enhancements are warranted based on the guidance in this risk alert, including whether specific ESG-related compliance and/or oversight procedures are necessary. Further, firms may wish to review their marketing materials and investor disclosures regarding ESG investing and proxy voting, given the SEC's focus on these areas. In light of the close working relationship between the Division of the Division of Enforcement, and the multi-disciplinary approach of the ESG Task Force, firms should expect coordination between the two Divisions on these ESG initiatives.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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