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SEC Risk Alert: Review of ESG Investing

As we know from the SEC's recent 2021 Examination Priorities[1], ESG remains a top focus for SEC staff this year, and is likely to remain in the spotlight for some time to come. On April 9, 2021, the SEC's Division of Examinations released a Risk Alert to highlight observations from recent exams of asset managers offering products and services that incorporate Environmental, Social and Governance (ESG) factors. The Risk Alert provides observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing and provides observations of effective practices from such examinations.

Examination Focus Areas

Examinations of firms claiming to engage in ESG investing will focus on, among other matters, the following:

- The portfolio management policies, procedures, and practices related to ESG and advisers' use of ESG-related terminology; due diligence and other processes for selecting, investing in, and monitoring investments in view of advisers' disclosed ESG investing approaches;
- Whether proxy voting decision making processes are consistent with ESG disclosures and marketing materials;
- A review of advisers' marketing materials and performance advertising and regulatory filings, including, among other things, responses to due diligence questionnaires, client presentations, websites and reports to sponsors of global ESG frameworks; and
- Compliance programs of advisers, including written policies and procedures and their implementation, compliance oversight, and review of ESG investing practices and disclosures.

Staff Observations of Deficiencies

The Risk Alert provided a summary of Staff observations which highlighted instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks, such as:

- *Portfolio management practices inconsistent with disclosures about ESG approaches*. For example, portfolio management practices that differ from client disclosures (e.g., Form ADV Part 2A or offering materials).
- *Inadequate controls to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.* The staff noted weaknesses in policies and procedures governing implementation and monitoring of the advisers' clients' or funds' ESG-related directives.
- *Proxy voting practices inconsistent with advisers' stated approaches* such as inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices, such as public claims regarding clients' ability to vote separately on ESG-related proxy proposals, but clients were never provided such opportunities, and no policies regarding these practices were maintained.
- *Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.* The staff observed 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. The staff observed that some firms substantially engaged in ESG investing lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight.

[1] See https://www.sec.gov/files/2021-exam-priorities.pdf for the complete 2021 SEC Exam Priorities.

- 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.

Staff Observations of Effective Practices

The Risk Alert also provided examples of effective practices that set the tone for the industry, and provide examples of practices and policies that advisers should ensure are in place, such as:

- *Simple and clear disclosures regarding the firms' approaches to ESG investing*, such as disclosing that an adviser's ESG investing approach involves relying on unaffiliated third parties to conduct underlying ESG analysis, and explanations regarding how investments were evaluated using goals established under global ESG frameworks.
- *Maintenance of detailed investment policies and procedures that addressed ESG investing*, including specific documentation to be completed at various stages of the investment process (e.g., research, due diligence, selection, and monitoring).
- *Compliance personnel that are knowledgeable about the firms' specific ESG-related practices*. The staff observed that, where compliance personnel were integrated into firms' ESG-related processes and more knowledgeable about firms' ESG approaches and practices, firms were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents.

In summary, advisers should ensure they evaluate whether their disclosures, marketing claims, and other public statements related to ESG investing are accurate and consistent with internal firm practices. Additionally, firms should ensure that their approaches to ESG investing are implemented consistently throughout the firm where relevant and are adequately addressed in the firm's policies and procedures and subject to appropriate oversight by compliance personnel. Lastly, firms should also consider taking steps to document and maintain records relating to important stages of the ESG investing process.

About HighCamp Compliance

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