

April 13, 2021

SEC Staff Issues Risk Alert on ESG Investing

On April 9, 2021, the SEC Division of Examinations (the “Division”) issued a [Risk Alert](#) “to highlight observations from recent exams of investment advisers, registered investment companies, and private funds offering [environmental, social, and governance (‘ESG’)] products and services” (collectively, “firms”).

- The Risk Alert follows the Division’s standard format by describing, based upon examinations of firms, Division staff observations of (i) deficiencies and internal control weaknesses and (ii) commendable practices and reasonably designed internal controls.
- The Division staff’s observations are summarized below.

CONTEXT FOR THE RISK ALERT

A Risk Alert focusing on ESG investing should not come as a surprise. Among other things, at the March 2021 Mutual Funds and Investment Management Conference sponsored by the Investment Company Institute and the Federal Bar Association (the “ICI Conference”), Peter Driscoll, the Director of the Division, stated that the Division expected to issue a risk alert in the coming weeks summarizing its ESG-related examination findings to date. Furthermore, the SEC’s focus on ESG investing has been apparent for more than a year.

1. In the January 2020 Office of Compliance Inspections and Examinations (now the Division of Examinations) 2020 Examination Priorities (described in this Ropes & Gray [IM Update](#)), the Division announced that it would be focusing on the accuracy and adequacy of disclosures provided by investment advisers offering new or emerging investment strategies, including strategies that focus on ESG criteria.
2. In March 2020, the SEC requested comments on fund names and Rule 35d-1 under the 1940 Act (the “Names Rule”) (described in this Ropes & Gray [Client Alert](#)). Among the factors offered by the SEC as contributing to current challenges in applying the Names Rule, the SEC stated that the number of funds with investment mandates that require a qualitative assessment of certain issuer characteristics (such as ESG funds) had grown, and that these funds often include their mandate in their name. The SEC reported that the SEC staff had observed that “some funds appear to treat terms such as ‘ESG’ as an investment strategy (to which the Names Rule does not apply) . . . while others appear to treat ‘ESG’ as a type of investment (which is subject to the Names Rule).”
3. The ESG Subcommittee of the SEC Asset Management Advisory Committee (the “AMAC”), provided a written [update](#) to the AMAC in May 2020 and another written [update](#) to the AMAC in September 2020. In December 2020, the ESG Subcommittee presented its [Preliminary Recommendations](#) to the AMAC, which were debated at the AMAC’s March 2021 public meeting.
4. On March 3, 2021, the Division published its [2021 Examination Priorities](#) in which the Division stated that, to meet investor demand, firms are increasingly offering investment strategies “referred to by a variety of terms such as sustainable, socially responsible, impact, and ESG conscious.” Accordingly,

[t]he Division will review the consistency and adequacy of the disclosures RIAs and fund complexes provide to clients regarding these strategies, determine whether the firms’ processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.

5. On March 4, 2021, the SEC announced the creation of a Climate and ESG Task Force within the SEC's Division of Enforcement (the "Task Force") (described in this Ropes & Gray [IM Update](#)). The announcement stated that, in view of "increasing investor focus and reliance on climate and ESG-related disclosure and investment, the Climate and ESG Task Force will develop initiatives to proactively identify ESG-related misconduct." The announcement noted that the Task Force's initial focus will be to identify any material omissions or misstatements in issuers' disclosures concerning climate risks under existing rules. In addition, the announcement stated that the Task Force will analyze disclosure issues and compliance shortfalls in investment advisers' and funds' ESG strategies.
6. On March 15, 2021, Acting SEC Chair Allison Herren Lee delivered a [speech](#) titled "A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC." Acting Chair Lee stated that "climate and ESG are front and center for the SEC. We understand these issues are key to investors – and therefore key to our core mission."
7. On March 17, 2021, at the ICI Conference, Acting Chair Lee delivered a [speech](#) in which she noted, among other things, two key trends that necessitate updates to SEC rules and guidance regarding proxy voting: (i) the dramatic growth in the percentage of US households that own index funds and (ii) soaring demand for ESG investment products. She noted that the rise of index funds may operate to the detriment of corporate accountability – and on ESG matters in particular – given that SEC rules have not kept up with these developments. Acting Chair Lee explained that, although investors are demanding ESG investment opportunities, funds may not always reflect those preferences in their voting.

At the ICI Conference, Division Director Driscoll participated in a panel discussion of SEC examinations and enforcement. The panel included Adam S. Aderton, Co-Chief, Asset Management Unit, SEC Division of Enforcement. In his remarks, Mr. Driscoll discussed the Division's 2021 examination priorities. He noted the high level of interest and growth of assets in ESG products, and stated that the Division is focused on reviewing the consistency and adequacy of the disclosures provided by investment advisers and fund complexes to clients concerning ESG strategy, determining whether the firms' processes and practices align with their disclosures and reviewing fund advertising for false and misleading statements. Messrs. Driscoll and Aderton suggested that their focus in the first instance is considering whether firms' processes and practices match their ESG disclosures.

SUMMARY OF THE RISK ALERT

General. The Risk Alert confirms that the Division will continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures and practices that accord with their ESG-related disclosures. Examinations of firms claiming to engage in ESG investing will focus on three key areas: (i) portfolio management, (ii) performance advertising and marketing and (iii) compliance programs. Interestingly, the Risk Alert states that it uses the term "ESG" broadly, and calls out the following terms specifically as being within the meaning of ESG when used to describe factors that may be considered when making an investment decision: "socially responsible investing," "sustainable," "green," "ethical," "impact" and "good governance."

Deficiencies and internal control weaknesses observed by the Division staff:

- Portfolio management practices that were inconsistent with disclosures about ESG approaches.
- Controls that were inadequate to maintain, monitor and update firm clients' ESG-related investing guidelines, mandates and restrictions.

- Proxy voting that may have been inconsistent with advisers' stated approaches (*i.e.*, inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices).
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.
- Compliance controls that were inadequate to assure that ESG-related disclosures and marketing are consistent with the firm's practices.
- Compliance programs that did not adequately address relevant ESG issues (*i.e.*, firms that lacked policies and procedures regarding analysis, decision-making and compliance review and oversight).
- Compliance programs where compliance personnel had limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions.

Effective practices observed by the Division staff:

- Disclosures that are clear, precise and tailored to actual ESG practices. The Risk Alert highlighted clear and prominent disclosures to the effect that firms could satisfy the requirements of certain global ESG frameworks but, nevertheless, make investments that appear to be inconsistent with ESG investing.
- Detailed policies and procedures that address ESG investing, including specific contemporaneous documentation of the ESG factors considered at various stages of an investment.
- Compliance personnel who were integrated into the ESG process and knowledgeable about ESG practices and, therefore, in a position to (i) help avoid misleading claims in marketing materials, (ii) test the adequacy of policies and (iii) ensure appropriate documentation of adherence to client investment preferences.

COMMISSIONER PEIRCE'S STATEMENT

On April 12, 2021, Commissioner Hester Peirce issued a [public statement](#) in which she posited that ESG-based investment strategies raised no new questions under the federal securities laws. She stated that (i) the publication of an ESG-specific risk alert "should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners" and (ii) as with any investment strategy, "advisers and funds should not make claims that do not accord with their practices, and our examiners will be looking for that consistency between claims and practice."

Commissioner Peirce's statement is consistent with a March 4, 2021 [public statement](#) that she made jointly with Commissioner Elad L. Roisman regarding the SEC announcement of the creation of the Task Force. In their joint statement, the two commissioners asserted, among other things, that the SEC's "enhanced focus" on climate and ESG-related matters amounted to nothing new, and questioned whether "these announcements represent a change from current Commission practices or a continuation of the status quo with a new public relations twist."

OBSERVATIONS

As noted above, much of the message conveyed in the Risk Alert is not novel because the Division has regularly signaled in public statements that it will be looking closely to see whether firms' ESG investing practices are in fact consistent with representations to clients and investors. However, the Risk Alert does provide more concrete guidance than we have seen to date regarding the Division's expectations for effective compliance policies and controls in this area. Firms that engage in ESG investing and/or represent to clients or investors that they take ESG considerations into account in their

investment process would be well served to review their current compliance controls in light of the observations and recommendations summarized above.

About our Practice

Ropes & Gray has a leading ESG, CSR and business and human rights compliance practice. We offer clients a comprehensive approach in these subject areas through a global team with members in the United States, Europe and Asia. In addition, senior members of the practice have advised on these matters for more than 30 years, enabling us to provide a long-term perspective that few firms can match.

For further information on the practice, click [here](#).