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Legal Update

SEC Examinations Division Issues Risk Alert on ESG Products and Services

On April 9, 2021, the Division of Examinations of the US Securities and Exchange Commission ("Division" or "staff") issued a risk alert to highlight the staff's observations from its recent examinations of investment advisers, registered investment companies and private funds offering ESG products and services (Risk Alert).[1] The Risk Alert also provides observations of effective practices.

Noting that the US Investment Company Act of 1940, the US Investment Advisers Act of 1940 (Advisers Act) and the rules under those statutes do not define "ESG" or include ESG-specific provisions, the Division made it clear that its interest in the accuracy and adequacy of disclosures provided by advisers and funds offering clients ESG investment strategies is the same as it would be for advisers and funds offering any other type of investment strategy.

ESG investing has been an examination priority in both 2020 and 2021.[2] But that understates the matter. The SEC's new webpage titled "SEC Response to Climate and ESG Risks and Opportunities" says it much better:

> As investor demand for climate and other environmental, social and governance (ESG) information soars, the SEC is responding with an all-agency approach.

The webpage highlights no less than six recent SEC developments related to ESG regulatory matters. This Risk Alert is one of them.

Exam Observations

The first observation that the staff shared is highly charged: potentially ***misleading*** statements regarding ESG investing processes and representations regarding adherence to global ESG frameworks. The staff's follow-on observations were similarly serious:

- despite claims to have formal processes in place for ESG investing, a lack of policies and procedures related to ESG investing;
- policies and procedures that did not appear to be reasonably designed to prevent violations of law or that were not implemented;
- documentation of ESG-related investment decisions that was weak or unclear; and

- compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials.

The staff then shared additional details about its exam observations:

- **Actual portfolio management practices were inconsistent with ESG disclosures –** In addition to observing a lack of adherence to global ESG frameworks where firms claimed such adherence, the staff also observed fund holdings predominated by issuers with low ESG scores, —as measured, for example, by a sub-adviser's proprietary internal scoring system,—where such predominance appeared inconsistent with those firms' stated approaches.

  According to the staff, these inconsistencies (as well as certain observed unsubstantiated claims, discussed below) were due to a weakness in controls over public disclosures and client/investor-facing statements, a lack of documentation of ESG investing decisions and issuer engagement efforts, and failures to update marketing materials timely (e.g., an adviser continuing to advertise an ESG investment product or service it no longer offered).

As is the case with any investment strategy, verifying that actual practice and disclosed practice are consistent is paramount. The SEC has brought enforcement actions against advisers whose investment management processes or practices materially differed from their disclosures regarding the same.

- **Unsubstantiated or otherwise potentially misleading ESG claims –** The staff observed such claims in a variety of contexts, including, for example, in:
  - marketing materials for some ESG-oriented funds that touted favorable risk, return and correlation metrics related to ESG investing without disclosing material facts regarding the significant expense reimbursement they received from the fund-sponsor, which inflated returns for those ESG-oriented funds;
  - claims by advisers regarding their substantial contributions to the development of specific ESG products where, in actuality, their roles were quite limited or otherwise inconsequential; and
  - an unsubstantiated claim that the adviser only invested in companies with "high employee satisfaction."
- **Inadequate ESG mandate controls –** The staff saw weaknesses in policies and procedures governing implementation and monitoring of ESG mandates, guidelines and restrictions. For example, some advisers did not have adequate controls governing clients' negative screens. These weaknesses were particularly acute where the mandates were ill-defined, vague or inconsistent. The staff also observed advisers that:
  - did not have adequate systems to consistently and reasonably track and update clients' negative screens; and/or
  - had not yet implemented client preferences to favor certain industries or issuers because the adviser had challenges with implementing and monitoring those preferences, yet the adviser had touted in marketing materials its process for implementing those types of preferences (i.e., a positive screen).
- **Proxy voting inconsistent with stated approaches –** The staff observed inconsistencies between stated ESG-related proxy voting claims and internal proxy voting policies and practices (e.g., a claim that ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value, but internal proxy voting guidelines did not provide for a case-by-case analysis). The staff also observed claims that clients could vote separately on ESG-related proxy proposals, but clients were never provided with the opportunity to do that and no policies about these practices existed.[3]
- **Inadequate compliance programs –** The staff observed:
  - firms that engaged in ESG investing lacked policies and procedures addressing their ESG analyses, decision-making processes (e.g., adherence to global ESG frameworks, per the firm's public statements), or compliance review and oversight;

– a lack of policies and procedures to ensure firms obtained reasonable support for ESG-related marketing claims[4];
– inadequate policies and procedures regarding oversight of ESG-focused sub-advisers;
– firms that had difficulties in 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 (i.e., environmental, social, and governance), when relying instead on composite ESG scores provided by a sub-adviser;
– compliance programs that were less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses or limited oversight of ESG-related disclosures and marketing decisions;

In order to effectively perform as the chief compliance officer of a firm that is engaged in ESG investing for clients, the chief compliance officer needs to have sufficient knowledge and understanding of ESG matters, both generally and specifically as they relate to the firm's own processes. 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. The compliance personnel in these firms appeared to provide more meaningful reviews of firms' public disclosures and marketing materials; test the adequacy and specificity of existing ESG-related policies and procedures, if any (or assess whether enhanced or separate ESG-related policies and procedures were necessary); evaluate whether firms' portfolio management processes aligned with their stated ESG investing approaches; and test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences.

– ineffective compliance controls and oversight of reporting to sponsors of global ESG frameworks and responses to requests for proposals and due diligence questionnaires; and
– weaknesses in compliance controls regarding performance metrics included in marketing materials (such as risk, returns and correlation metrics) and a lack of compliance review of the data underlying those measures.

In terms of what the staff is looking for, the staff specifically mentioned as a positive observation 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). The staff observed that these types of detailed, comprehensive investment policies and procedures resulted in contemporaneous documentation of the ESG factors considered in specific investment decisions. In addition, where multiple ESG investing approaches were employed at the same time, specific written procedures, due diligence documentation and separate specialized personnel provided additional rigor to the portfolio management process.

Continuation of ESG Examinations

The staff stated that it will continue to examine firms to evaluate whether firms:

- are accurately disclosing their ESG investing approaches and
- have adopted and implemented policies, procedures and practices that are in line with their ESG-related disclosures.

If a firm *claims to engage in ESG investing*, the Division will focus on the following three main areas:

- **Portfolio management –** Citing to Advisers Act Section 206 and the SEC's fiduciary interpretive release,[5] the Risk Alert stated that the staff will review:

- the firm's policies, procedures and practices related to ESG and its use of ESG-related terminology;
- the firm's due diligence and other processes for selecting, investing in and monitoring investments (the staff will evaluate these processes in light of the firm's disclosures on ESG investing); and
- whether the firm's proxy voting decision-making processes are consistent with ESG disclosures and marketing materials.[6]

- **Performance advertising and marketing –** The staff will review the firm's:
  - regulatory filings;
  - websites;
  - reports to sponsors of global ESG frameworks (to the extent the firm has communicated to clients and potential clients a commitment to follow such frameworks);
  - client presentations; and
  - responses to due diligence questionnaires, requests for proposals and client/investor-facing documents, including marketing materials.

The Division noted that in December 2020, the SEC adopted amendments to the Advisers Act advertising rule.[7] The amended rule is effective on May 4, 2021, and has an 18-month transition period between the effective date and the compliance date.

Although the Division observed that some advisers might seek to comply with the new marketing rule before the compliance date, the SEC's Division of Investment Management has made it clear that an adviser may not choose to comply with only some of the marketing rule requirements before the compliance date while not complying with others (and instead continue to rely on the current rule and related staff positions).[8]

- **Compliance programs –** The staff also will review the firm's:
  - written policies and procedures and their implementation;
  - compliance oversight; and
  - ESG investing practices and disclosures.

Commissioner Peirce's Public Statement on the Risk Alert

Interestingly, on April 12, 2021, Commissioner Hester Peirce issued a public statement regarding the Risk Alert. In that statement, she made a number of points and offered her views on various matters, as summarized below:

- Firms are offering ESG products because it is lucrative to do so.
- Asset manager accountability in the ESG space is important. Firms that claim to be managing ESG strategies need to explain to investors what ESG means to them, and those firms' actual ESG management practices need to match their disclosures. In other words, a firm's disclosures should match reality.
- The above is true regardless of the name of or label on the strategy. Accordingly, the Risk Alert should not be interpreted as a sign that ESG investment strategies are unique from an examination perspective: "As with any other 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."

- Regarding proxy voting, she warned that voting "to reflect the investment adviser's views when they do not also reflect those of the client would be a violation of the adviser's fiduciary duty."
- Firms do not need to have "a separate set of policies and procedures for any investment strategy." Instead, she says that policies and procedures should be designed in light of the firm's investment strategies, whatever those happen to be.
- As is the case with any investment strategy, compliance personnel "should be familiar with the firm's business so that they can build and operate an effective compliance program for the firm, but they need not be experts in ESG . . ."
- "As with many other ESG-related matters, this risk alert raises questions of its own . . ."

Concluding Thoughts

At the end of the Risk Alert, the Division "encouraged" firms to:

- **evaluate** whether their disclosures, marketing claims and other public statements related to ESG investing are accurate and consistent with internal firm practices;
- **ensure** that their approaches to ESG investing are:
  - implemented consistently throughout the firm;
  - adequately addressed in the firm's policies and procedures; and
  - subject to appropriate oversight by compliance personnel; and
- **consider** taking steps to document and maintain records relating to important stages of the ESG investing process.

We recommend that firms do so as well. As we've said in the past, examination risk alerts serve as "fair warning" to firms. But in this case, our warning for firms is a bit stronger. Given the intense and increasing legal and regulatory focus on ESG investing and the continued exponential popularity and growth of ESG investing (including with retail, senior and other groups of investors mentioned in the examination priorities), we would call this the perfect storm. In fact, the staff called out the fact that the rapid growth in demand for ESG products and services, coupled with the absence of standardized and precise ESG definitions, presents risks such as investor (particularly retail investor) confusion, particularly where investment advisers and funds have not clearly and consistently articulated how they define ESG, how they use ESG-related terms and how they employ investment strategies consistent with the foregoing.

We have seen this over and over again in the past, whether on a firm-specific basis or related to an industry trend (e.g., target-date funds; alternative fund strategies): whenever there is a rush to offer an investment product, strategy or service, for whatever reason, the marketing "cart" is often put before the compliance and risk management "horse," which can have dire consequences. The past is prologue, and we hope the foregoing warnings are taken seriously when implementing an investment strategy and marketing campaign designed around a popular, shiny and fairly new object attractive to many retail and institutional investors.

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Endnotes

[1] The Risk Alert uses the term "ESG" in the broadest sense to encompass terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact," or "good governance" to the extent they describe environmental, social, and/or governance factors that may be considered when making an investment decision.

[2] See https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf and https://www.sec.gov/files/2021-exam-priorities.pdf See also our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2020/04/secs-ocie-risk-alerts-examination-focus-on-compliance-with-regulation-best-interest-and-form-crs and https://www.mayerbrown.com/en/perspectives-events/publications/2021/03/secs-division-of-examinations-2021-exam-priorities-investment-advisers-and-investment-companies

[3] See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5325 (Aug. 21, 2019) and Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5547 (July 22, 2020). See also our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/sec-publishes-guidance-on-the-proxy-voting-responsibilities-of-investment-advisers and https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/us-sec-issues-supplementary-proxy-voting-guidance-for-investment-advisers

[4] Under recently adopted amendments to the advertising rule under the Advisers Act, advisers may not include in an advertisement a material statement of fact that the adviser does not have a reasonable basis for believing it can substantiate upon demand by the SEC. See https://www.sec.gov/rules/final/2020/ia-5653.pdf

[5] See https://www.sec.gov/rules/interp/2019/ia-5248.pdf See also our Legal Update at https://www.mayerbrown.com/en/perspectives-events/publications/2019/06/sec-publishes-final-interpretation-of-investment-adviser-standard-of-conduct

[6] See our Legal Updates at https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/sec-publishes-guidance-on-the-proxy-voting-responsibilities-of-investment-advisers and https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/us-sec-issues-supplementary-proxy-voting-guidance-for-investment-advisers and blog posts at https://www.eyeonesg.com/2021/03/the-us-department-of-labors-non-enforcement-policy-on-recent-esg-and-proxy-voting-rules/#more-2487 https://www.fundsandim.law/2021/01/final-erisa-regulations-describe-fiduciary-duties-related-to-plan-proxy-voting/ https://www.freewritings.law/2020/07/amendments-to-proxy-rules/ https://www.usbenefits.law/2021/01/proxy-voting-erisa-regulations/ https://www.usbenefits.law/2021/02/2021-fiduciary-compliance-checklist/#more-2472, and https://www.usbenefits.law/2020/10/to-vote-or-not-to-vote-that-is-the-question/

[7] See our Legal Update https://www.mayerbrown.com/en/perspectives-events/publications/2021/02/what-is-the-fate-of-the-new-marketing-rule-for-investment-advisers

[8] See https://www.sec.gov/investment/marketing-faq

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