ALERT MEMORANDUM

SEC Staff Risk Alert Lays a Marker for Advisers on ESG Focus Areas

April 14, 2021

On April 9, 2021, the U.S. Securities and Exchange Commission ("SEC") Division of Examinations (the "Division") issued a risk alert (the "Risk Alert") describing observations from recent examinations of investment advisers that manage and offer environmental, social and governance ("ESG") investment options. The Risk Alert highlights observed deficiencies in several key areas that we expected the SEC staff to scrutinize using its traditional regulatory arsenal: advisers' practices inconsistent with ESG disclosures and unsubstantiated or potentially misleading ESG claims; inadequate controls governing implementation and monitoring of advisers' disclosed ESG practices and clients' ESG-related directives; proxy voting practices inconsistent with ESG disclosures; and inadequate compliance programs or policies in the ESG area, including compliance personnel with only limited knowledge of an adviser's ESG practices. Notably, the Risk Alert also identifies three observed "effective practices": disclosures that were clear, precise and tailored to advisers' specific ESG approaches; detailed compliance policies addressing advisers' ESG investing approaches and practices; and compliance personnel knowledgeable about advisers' ESG practices.

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The Risk Alert provides the clearest roadmap to date of the areas the Division staff will focus on when reviewing ESG investing and the ways the staff will use current regulatory tools and requirements to remind advisers of the SEC's expectations and shape their behavior. It also appears to raise the bar for advisers' compliance personnel, whom the staff expects to be knowledgeable about advisers' ESG investment analyses, practices, approaches and disclosures, as well as to be integrated and play an active role in overseeing advisers' ESG-related processes.

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Key Takeaways

The Risk Alert identifies three perennial focus areas that will be covered in future examinations: portfolio management, performance advertising and marketing, and compliance programs. These three areas were also discussed in the Division's 2021 Examination Priorities, on which the Risk Alert builds.[1] Below, we discuss these focus areas, along with other key takeaways.

— *Aligning practice with disclosures.* Advisers should take this opportunity to review their ESG disclosures for consistency with their actual portfolio management practices, including investment analysis and approval. In addition to the brochure, refreshing the content of client- and investor-facing documents, including offering materials, pitch decks and due diligence questionnaires in the ESG area on a regular basis will be important. We expect the Staff to continue to focus on issues such as whether (i) the number of ESG investments actually made or recommended aligns with expectations established in offering documents, (ii) proxy votes made by an adviser on ESG issues and the process used to arrive at that decision are consistent with policies as described in brochures and offering materials, and (iii) the methodology and source of information used by an adviser to score an investment's ESG credentials are implemented consistently with an adviser's ESG framework.

— *Performance advertising and marketing.* Whether an adviser's claims regarding ESG approaches are "unsubstantiated or otherwise potentially misleading" will be a focus of examinations, which will include a review of advisers' regulatory filings, websites, communications with investors and potential investors, marketing materials and due diligence questionnaires, among others. ESG statements and statistics in these materials should be held to the same level of internal compliance review and validation as performance data and similar information, and be supported and documented. For example, climate and environmental statistics in offering materials should be treated for recordkeeping and fact-checking purposes as if they are performance information. We expect advisers to face questions from the staff and need to substantiate qualitative and descriptive statements touting an adviser's comparative advantage or expertise in the ESG area. Compliance personnel should review data supporting ESG performance metrics included in marketing materials, with an eye towards adequate disclosure of the longer time horizons and different risk-return profiles of ESG investments relative to other investment types.

The Risk Alert cites the SEC's recently finalized Marketing Rule, which establishes new principles-based prohibitions on the content of advertisements, including a prohibition on using unsubstantiated statements of material fact.[2] Although the Marketing Rule is not yet effective, the Risk Alert does include an example of an observed unsubstantiated claim as a deficient practice: an ESG-oriented fund that touted favorable risk-return metrics related to ESG investing without disclosing the effect of expense reimbursements from the fund's sponsors, which inflated returns. To mitigate risk of including unsubstantiated claims, advisers should review policies and procedures to ensure they provide a mechanism to obtain reasonable support for ESG-related marketing claims.

— *Tailored and specific policies and procedures.* Examinations will include a review of advisers' policies, procedures, and practices related to ESG; their use of ESG-related terminology, due diligence and other processes for selecting, investing in, and

[1] See 2021 Examination Priorities (Mar. 3, 2021). For further discussion of the priorities, please see our client alert, Turning the Page: Highlights of the SEC's Division of Examination's 2021 Priorities.
[2] See Investment Adviser Marketing, Advisers Act Release No. IA-5653 (Dec. 22, 2020). For further discussion of the marketing rule, please see our client alert, SEC Adopts New Marketing Rule for Investment Advisers.

monitoring investments in view of an adviser's disclosed ESG investing approaches; and whether proxy voting processes are consistent with ESG disclosures and marketing materials.

The Risk Alert serves as a clear marker that the Staff expects advisers to update and tailor their policies and procedures, including proxy voting policies, to ensure an adviser's ability to implement, monitor and test the practices and approaches described in its disclosures. Monitoring and testing should be documented and retained in anticipation of an examination.

Advisers should take additional care to ensure that claims in marketing materials regarding portfolio management are properly implemented. For example, if an ESG fund's offering documents state that the fund will invest in companies with positive environmental impact, then the adviser's policies and procedures, including investment processes, should address how the adviser will measure and determine that investments meet that standard.

While the SEC's Compliance Rule does not require specific written policies and procedures in any particular area, private fund sponsors that are currently raising or marketing ESG-related funds should consider implementing ESG-specific policies and incorporating ESG considerations into proxy voting policies.

— *Role of compliance personnel.* Compliance personnel should have a seat at the table for an adviser's ESG activities. Through active participation with investment professionals, the investment committee and investors, compliance personnel can obtain the expected level of knowledge of an adviser's specific ESG-related practices and provide effective oversight over ESG-related disclosures and marketing decisions.

Experienced and integrated compliance personnel can help advisers avoid materially misleading claims in ESG-related materials, provide more meaningful reviews of those materials, test the adequacy and specificity of existing ESG-related policies and procedures or assess whether additional policies are necessary, evaluate whether advisers' portfolio management processes align with stated ESG investing approaches, and test the adequacy of documentation of ESG-related investment decisions.

— *Application of the fiduciary duty guidance.* Many of the Division's observations are grounded in the requirements set forth in the SEC's 2019 fiduciary duty guidance[3] for investment advisers. The Risk Alert confirms that—consistent with the Division's 2021 exam priorities—compliance with the guidance is a focus area of exams and signals a likely increase in enforcement actions based on failure to follow the guidance. Sponsors of ESG-focused private funds may face particular challenges in this area, given the implication in the Risk Alert that the Staff will highly scrutinize ESG-related disclosures for accuracy and for false and misleading statements or omissions. This is a stated priority not only of the Division, but also of the Enforcement Division[4] and of Commissioner Lee.[5]

With the absence of specific rules or clear guidance for ESG-related disclosures, the overarching guidelines for marketing materials for ESG-focused funds are the antifraud rules, the Advisers Act and the fiduciary duty guidance. In the ESG context, that means providing disclosure that is sufficiently "clear, precise and tailored" to an adviser's and its clients' specific ESG investment guidelines, mandates and restrictions. The Risk Alert is a potentially important first step by establishing a set of practices that the Division Staff expects to see—

[3] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. IA-5248 (June 5, 2019). For further discussion of the fiduciary duty guidance please see our client alert, SEC Adopts Best Interest Standard for Broker-Dealers and Fiduciary Duty Guidance for Investment Advisers.
[4] See SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021).
[5] See Statement on the Review of Climate-Related Disclosure (Feb. 24, 2021).

beyond the principles-based frameworks that currently applies.

— *Commission-wide efforts*. The Risk Alert suggests a doubling-down by the SEC's leadership under the Biden Administration in response to the critical—or at least cautionary—statements from Republican Commissioners and others about the SEC's tools to address ESG-related issues without additional study and rulemaking. Deputy Director Gibson, Commissioner Hester Peirce and now the Division are plainly confident that existing law and requirements for advisers give the SEC and the Enforcement Division the power and tools to regulate and enforce this area. We agree, and see this as a logical progression of the fiduciary duty guidance and "principles-based approach" of the Advisers Act generally, to make advisers walk-the-walk if they are going to talk-the-talk on ESG.

Specific Deficiencies Noted by the Division

— *Inconsistencies between portfolio management practices and disclosures about ESG approaches.* Advisers' portfolio management practices differed from client disclosures, advisory agreements, offering materials, responses to requests for proposals and due diligence questionnaires. For example, the staff noted lack of adherence to global ESG frameworks and fund holdings predominated by issuers with low ESG scores, despite claims to the contrary in disclosures, as well as unsubstantiated claims regarding investment practices and a lack of documentation of ESG investing decisions and issuer engagement efforts.

— *Inadequate controls to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.* Advisers had weak policies and procedures governing implementation and monitoring of advisers' clients' or funds' ESG-related directives, such as lack of adequate controls around implementation and monitoring of clients' negative screens (e.g., prohibitions on investments in certain industries).

— *Inconsistencies between proxy voting and advisers' stated approaches.* The staff observed inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices, such as public statements that ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value, while internal guidelines generally did not provide for such case-by-case analysis.

— *Compliance programs did not adequately address relevant ESG issues.* The staff noted a lack of policies and procedures to ensure that advisers obtained reasonable support for ESG-related marketing claims, and observed inadequate policies and procedures regarding oversight of ESG-focused sub-advisers. Advisers also had difficulties in substantiating adherence to stated investment processes and global ESG frameworks.

Staff Observations of Effective Practices

— *Simple and clear disclosures regarding advisers' approaches to ESG investing.* Advisers included clear disclosures in client-facing materials where clients were offered choices among standardized portfolios focused on particular ESG issues, or alternatively, customized separately managed accounts designed to accommodate particular client preferences.

— *ESG factors that could be considered alongside many other factors.* Advisers could still satisfy the requirements of certain global ESG frameworks while making investments that appeared to be inconsistent with ESG investing. Clear and prominent disclosures regarding such practices served to notify clients and investors that adherence to certain global ESG frameworks did not necessarily alter long-standing and seemingly contrary investment strategies.

— *Policies and procedures that addressed ESG investing and covered key aspects of an adviser's relevant practices.* The staff noted 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.

Conclusion

The Risk Alert provides the most specific guidance to date from the SEC and its staff as to their expectations for advisers in the ESG area. Coupled with the recent statements from Acting Deputy Director of Enforcement Kelly L. Gibson, who oversees the Enforcement Division's new Climate and ESG Task Force, it signals a clear intent by the staff to use current regulatory requirements and tools in support of the new Administration's focus on the ESG area and to demand increased—and better—disclosure and practices from advisers who pursue ESG investing.

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