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RESPONSIBLE INVESTING

ESG Risk Alert: Why the SEC Distinguishes ESG From Other Strategies and How to Prepare for a Potential Exam (Part One of Two)

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On April 9, 2021, the SEC's Division of Examinations (Examinations) issued an ESG-focused risk alert (Risk Alert) detailing, among other things, practices inconsistent with disclosures; inadequate policies and procedures; and ineffective compliance programs. At first glance, the Risk Alert seems to traverse well-trodden paths, but a closer look at ESG investing reveals certain properties that are unique to the strategy.

Given the slew of SEC announcements and statements about ESG investing earlier in the year, the Risk Alert serves as a guide to fund managers looking for clues about what the SEC is and will be focusing on in examinations, as well as enforcement generally. Further, CCOs would be well advised to review the Risk Alert in light of reports that Examinations is already taking a more focused approach to reviewing managers' ESG programs.

This first article in a two-part series describes the regulatory context in which the Risk Alert was released; why an ESG-focused risk alert addresses both familiar and unique issues; and how to use the Risk Alert as a roadmap for anticipated SEC enforcement efforts. The second article will dig into the details of the Risk Alert, providing nuanced advice on how to avoid the deficiencies set forth therein and establish the effective practices identified by SEC staff.

See our two-part series: "OCIE's Targeting of ESG Investing Practices in Recent Examinations and What It Means Going Forward" (Jan. 21, 2020); and "How Fund Managers Can Identify and Mitigate Risks From the SEC's Increased Focus on ESG Investing" (Jan. 28, 2020).

ESG Regulatory Environment

In February 2021, then-Acting Chair Allison Herren Lee created a Senior Policy Advisor for Climate and ESG role in the SEC and released a statement directing the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings.

That March, Examinations announced that its 2021 Examination Priorities would include an enhanced focus on climate-related risks, and the SEC announced an enforcement task force focused on climate and ESG issues. Commissioners Hester M. Peirce and Elad L. Roisman followed those announcements with a joint statement suggesting that current SEC guidelines on materiality, risk and antifraud

were sufficient without an additional focus on ESG investing.

See "SEC Division of Examinations' 2021 Priorities Track and Advance 2020 Priorities" (Apr. 27, 2021).

Later that March, Lee gave a speech in which she requested public comments on the possibility of a comprehensive ESG disclosure framework and potentially ESG-specific policies and procedures requirements.

Risk Alert

Shortly after the SEC released the Risk Alert, Peirce issued a statement that firms did not need a special set of policies and procedures for ESG and that compliance personnel need not be experts in ESG. Two days later, Peirce delivered a speech warning that government-set metrics and converging standards would drive and homogenize capital allocation decisions; constrain decision making; and impede creative thinking.

The rebuttal-like timbre of Peirce's statements might leave managers wondering how specific policies need to be or how knowledgeable its compliance staff should be. In a Democratic administration, however, the views of the appointed Chair and Democratic commissioners are a better predictor of how the SEC's Division of Enforcement (Enforcement) will proceed, suggested Jenner & Block partner Charles D. Riely, a former Assistant Regional Director for Enforcement. "Another way of looking at it is that there are certain things both sides of the aisle agree on as to ESG and the climate," he continued. "One is that investment advisers need to do what they say they will do when it comes to ESG and climate issues."

Although the SEC's examination priorities of 2020 and 2021 both mentioned ESG, the Risk Alert reinforces the growing significance of ESG matters in the SEC's eyes. "Issuing a whole risk alert about ESG puts energy behind the priorities," explained Victoria G. Hogan, president of NorthPoint Compliance and former SEC examiner.

See "The Convergence of ESG Regulatory Alignment and Corporate Responsibilities in the U.S. (Part One of Two)" (May 25, 2021).

Continuing Focus

SEC Chairman Gary Gensler testified before the House Financial Services Committee in early May 2021 that ESG disclosure rulemaking was one of his top priorities, leading many to believe the SEC will release a proposed rule on ESG disclosures this year.

Managers involved in ESG investing should also be on the lookout later this year for potentially another ESG-focused risk alert that sets out best practices identified in targeted ESG exams happening now, as well as an enforcement action to bring home the importance of compliance in the space, suggested Simpson Thacher partner Michael J. Osnato, Jr., former Unit Chief of the SEC's Complex Financial Instruments Unit and Assistant Regional Director of Enforcement. "Nothing changes behavior like an enforcement action," he pointed out. "The SEC will be looking for the right fact pattern to emphasize the consequences of telling investors one thing but doing something else behind the scenes."

See our two-part series: "Former SEC Staff Forecast the Biden Administration's Potential Impact on the Agency's Enforcement Efforts" (Dec. 1, 2020); and "Former SEC Staff Expect

Aggressive Private Funds Scrutiny to Be a Priority Under the Biden Administration" (Dec. 8, 2020).

Familiar Risk Alert Topics

Experts agreed that the fundamental message of the Risk Alert was that managers should do what they say they are going to do and ensure they can demonstrate that is the case. "The Risk Alert is in the guise of ESG, but it is actually 'Advisers Act 101,'" quipped Morrison & Foerster counsel Kelley A. Howes. "Ensuring sponsors are managing client assets in the way they have disclosed is not a new topic and can work for any type of investment strategy," Hogan agreed. "Even if an adviser is not considering ESG factors, the Risk Alert can still serve as a guide."

Although the message is not new, the focus on a distinct investment strategy is unusual. "I have seen risk alerts on different investment products, such as digital assets, but focusing on a particular strategy is not typical," Hogan said. The approach enables the SEC to emphasize it is treating ESG and climate issues as important and giving them as much attention as disclosures and representations about fees or conflicts, Riely added. "Given that the SEC has only recently given the area greater focus under the Biden Administration, it was somewhat surprising that the staff had already identified a number of issues," he noted.

See our two-part series on Examinations' risk alert on compliance: "Limited Staffing, Marginalized CCOs and an Overall Lack of Resources at Fund Managers" (Jan. 26, 2021); and "Inadequate Annual Reviews, Poorly Implemented Policies and Other Key Takeaways" (Feb. 2, 2021).

Reasons for a Separate ESG Risk Alert

The main takeaways of the Risk Alert may feel familiar to those versed in compliance with securities laws, but some aspects of ESG investing set it apart from other types of investment strategies. "To some extent, the Risk Alert addresses the same issues that would arise for any strategy," noted Arnold & Porter partner Ellen Kaye Fleishhacker. "The staff is also indicating, however, that doing what you said you were going to do is often not as easy in ESG investing as it is for other types of investing because ESG vehicles are often different in some significant ways."

Rising Popularity of ESG

One reason why the SEC may have felt the need to issue an ESG-specific risk alert is the intense and growing interest from investors and the general public about ESG investing, which can lead to managers making hastier decisions than usual.

"The SEC appears to believe that the temptation to describe something as an ESG fund – to overstate and to puff – is very high right now," explained Goodwin Procter counsel Danielle Reyes. "That is what makes ESG investing different, more so than the actual compliance obligations, which are applicable to all strategies. The SEC has found the deficiencies in the Risk Alert to be more prevalent in the ESG world – in a sense, the low-hanging fruit."

For more on the increased prominence of ESG investing, see "Significant PE Growth in 2019 and an Evolved 2020 Approach to ESG and Technology, Among Others" (Apr. 14, 2020).

Disparate Global Standards

For instance, the Risk Alert mentions global ESG frameworks nine times. "Most other investment classes generally do not have standards with which to comply, except perhaps the Global Investment Performance Standards," Fleishhacker pointed out. "With ESG, however, there are numerous global frameworks that could potentially apply, each of which is slightly different."

In light of that, managers with global funds that are grappling with different ESG regulatory regimes should operate to the lowest common denominator, Howes recommended. "If a manager is active in the E.U. and adheres to the E.U. regime, that is the framework it should follow in the U.S. as well," she clarified. "Over time, best practices are likely to be shaped by the larger players that are subject to more prescriptive regimes."

See "E.U. Sustainable Finance Initiatives: Exploring the Different Application Levels of the SFDR Based on a Firm's ESG Practices (Part Two of Two)" (Nov. 3, 2020).

Lack of Definitions

Another reason why compliance with general antifraud rules may be harder for ESG-focused managers is that ESG is such a broad and undefined area. "Sometimes statements to investors about ESG and climate strategies will be harder to implement because those issues are not as defined as, say, investing in high-yield bonds," Riely said. "Therefore, firms may struggle to translate their ESG pledges into action when it comes to portfolio management."

Part of the struggle is that ESG investing can involve different markets, like carbon-credit futures, Howes said. "It isn't like buying equity. It can take some time to understand how to navigate new markets." In addition, ESG investing continues to evolve at a rapid pace compared to non-ESG investing. "Guidelines, metrics and regulations are all changing when it comes to ESG," Fleishhacker said.

That lack of a universal definition of ESG can also be advantageous, however, as an adviser can describe what it means by ESG and how it plans to approach ESG investing, Howes explained. "If it does that well, it should not be a surprise that regulators will ask the adviser to show that its investments comport with its disclosed approach."

See "Survey Gauges Global Trends in Impact Investing, Anticipates Continued Growth Despite Pandemic" (Sep. 15, 2020); and "PELR Program Explores Current Issues and Trends in Impact Investing" (Jul. 16, 2019).

ESG Performance Reporting

A primary challenge with ESG investing is the additional performance reporting it requires. "ESG sponsors also need to think through and disclose impact or ESG returns, instead of only financial returns," Fleishhacker explained. "The ESG return is what makes ESG products fundamentally different from other products. The Risk Alert makes clear the SEC staff expects sponsors to treat the ESG component of their programs with the same discipline as they would the financial aspects. That can be tricky."

Investors want to know how sponsors define their ESG goals and, just as importantly, how they will measure achievement of those goals. "If, for example, a fund's ESG theme is financial inclusion and creating access to credit, measuring the impact of the investments made might

involve surveying the community served to determine how many people had access to credit before the investment and after," Fleishhacker suggested. "That is not as straightforward as setting out how much the fund spent to acquire an asset and how much the fund sold it for."

Measuring ESG returns is difficult. "Often the metrics need to be customized," Fleishhacker said. For example, a fund focused on clean water might invest in companies creating technology to purify water to drinkable levels, but there is no standard way to measure the impact of investment. "The fund might choose to present how many gallons of clean drinking water were produced and how many people were able to use that water, but those are just some possible measurements," she reasoned.

At the fundraising stage, sponsors should think through how they will measure and present impact to investors. They must be clear about how difficult it is to measure impact, the possibility that metrics will need to be created for the investment and the limits of what the metrics can capture, Fleishhacker advised.

See "Legal and Compliance Challenges for Global Asset Managers From Disparate ESG Regulations in the U.S. and Europe" (Feb. 23, 2021).

Preparation for Examinations and Enforcement

Current ESG Review of Advisers

Recently, the number of ESG-focused examinations of investment advisers has increased, according to multiple sources. The SEC's current approach to ESG exams, however, appears to be more focused than in the past. "Sometimes ESG-specific requests are bolted onto a broader exam, but my impression is that the approach is more surgical in current examinations. Managers in the exams are being asked to tell examiners specifically about their ESG programs," Osnato commented. "That feels different from past exams that may have included ESG requests as a secondary area of interest."

Anecdotally, the SEC seems to be focusing on sponsors with relatively prominent ESG platforms based on their assets under management. "From a risk-based perspective, that approach makes sense," Osnato said. It i s notable, however, that examiners appear to be using document requests very similar to those used in past ESG-focused exams, such as this sample from 2018. "There appears to be substantial overlap between the 2018 requests and the ones being used now," he confirmed.

See "SEC Officials Clarify the Commission's Stance on ESG Investing and the Role of Disclosure" (Aug. 11, 2020).

Examination Areas of Focus

The Risk Alert states that examinations will focus on portfolio management; performance and advertising; and compliance programs. Although those areas apply across all strategies, managers of ESG funds should exercise a heightened level of caution, Howes recommended. "ESG is where the money is going right now. Advisers need to be careful not to just jump on the bandwagon and instead should clearly define how they are going to invest ESG dollars."

Existing ESG Managers

Managers involved in ESG investing should prepare by exercising similar scrutiny to what the SEC would do in an exam, Osnato advised. "That means mapping what investors have been told about ESG investment protocols against what is actually happening with investment origination and approvals," he continued. As part of that exercise, managers should ensure that any public statements were accurate when made and that they remain accurate, Reyes added.

If examiners identify problems – especially disclosure issues – then the thresholds to refer those to Enforcement is likely to be fairly low, Osnato cautioned. "There is likely to be a slight presumption that meaningful gaps in disclosures should be referred to Enforcement given how important ESG is to the SEC. It is important to be buttoned up now because I don't think managers will have a second chance in an exam." Therefore, a pre-mapping exercise is valuable.

New ESG Managers

Managers contemplating or just starting out in ESG investing should build controls to ensure they adhere to what they have stated, and to ensure the personnel responsible have appropriate training and support.

See "A Guide to Pre- and Post-Investment ESG Considerations and Due Diligence" (May 7, 2019).

"I am seeing existing staff being asked to take new roles on ESG," Reyes said. "If it is the manager's first foray into the ESG space, its existing staff is less likely to have the appropriate training, knowledge and experience to do the job effectively. Managers must provide training and support in that situation."

An alternative – and highly advisable – approach for managers without existing in-house ESG expertise would be to hire someone (*e.g.*, additional staff or a consultant) who understands the nuances of putting an ESG program together, including how to define, measure and invest in ESG, Fleishhacker added.

Risk Alert As Road Map

Experts agreed that the Risk Alert is a helpful guide for reviewing compliance policies, procedures and controls, as well as preparing for potential examinations. "The Risk Alert is specifically tailored to investment advisers and offers a sneak peek of the SEC's playbook for examining the issues," Riely said. "Because it details actual failings the staff found, it provides an opportunity for compliance officials to use the Risk Alert as a checklist to assess whether any similar issues exist at their firms."

Due to the lack of specific regulations for investment advisers on ESG and climate issues, the SEC's primary enforcement mechanism is grounded in the antifraud rules – *i.e.*, advisers must do what they say they will do, Riely said. "The antifraud rules are the most flexible tool in the SEC's enforcement toolbox, so the SEC generally tries to use them to address new and emerging issues without the need to change any existing rules or regulations."

The SEC's standard examination playbook for reviewing disclosures on conflicts and performance will likely be applied to ESG a nd climate disclosures, Riely speculated. In short, the SEC will review what was said by investment advisers on ESG and climate issues to assess whether the statements match how the fund actually operated.

"In the past, there may have been an assumption that, as long as the manager provided returns to its investors, then it was less important whether or not it carried through on ESG and climate issues," Riely explained. "The Risk Alert signals, however, that regardless of the financial returns, the SEC will focus on whether the adviser did what it said it would do in terms of ESG issues."

Further, the experts highlighted some ways that investment advisers can control their risk exposures by:

- tailoring disclosures carefully and ensuring they can verify that they can do what they say they want to do in their representations to investors;
- clearly defining and explaining their ESG investment paradigms;
- operating in manners consistent with their ESG investment paradigms;
- implementing compliance programs that will demonstrate their consistent operations; and
- ensuring ESG policies remain consistent across the firms (*e.g.*, the investor relations team should be aligned with the portfolio management team).

The Risk Alert's repeated references to lack of controls and proper compliance frameworks stood out to Reyes. "Those are things that advisers must focus on and can fix if they dedicate their resources properly."

See "Five Steps for PE Sponsors to Establish ESG Policies at Their Portfolio Companies to Suit the Present Moment" (Nov. 17, 2020).