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RESPONSIBLE INVESTING

ESG Risk Alert: Inadequate Controls, Policies and Procedures Concern SEC About ESG Practices Inconsistent With Disclosures (Part Two of Two)

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An SEC priority has been ESG investing, as demonstrated by the regulator's appointment of a task force within its Division of Enforcement (Enforcement) and a special policy advisor, as well as the issuance of multiple statements from Commissioners. In May 2021, Chair Gary Gensler also testified before the House Financial Services Committee that ESG disclosure rulemaking was one of his top priorities, and Commissioner Allison Herren Lee delivered a speech that suggested a forthcoming climate-related disclosure framework.

Amid the speeches and statements, the Division of Examinations (Examinations) recently issued an ESG-focused risk alert (Risk Alert) detailing deficiencies and effective practices observed during examinations. Managers with ESG investing programs should review the Risk Alert with an eye toward unique aspects of ESG investing that may make it more difficult to meet standards they have applied in the past to other strategies.

This second article in a two-part series delves into the details of the Risk Alert, providing nuanced advice on how to avoid the deficiencies identified by the SEC staff and to establish effective ESG practices. The first article described the regulatory context surrounding the Risk Alert; the familiar and unfamiliar issues addressed therein; and ways to use the Risk Alert as a roadmap for anticipated enforcement.

See our two-part series on the 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).

Alignment of Practices and Disclosures

The Risk Alert states that portfolio management practices differed from client disclosures in regulatory filings (*e.g.*, Form ADV, Part 2A) and other investor-facing documents.

Update Disclosures

One possible reason why the staff observed discrepancies between practice and disclosure is that disclosures did not keep up with changes in portfolio management. For instance, managers tend to focus on keeping client-facing documents updated and accurate, but they may forget to do the same for regulatory documents, according to Morrison & Foerster counsel Kelley A. Howes. "One of the challenges of keeping Form ADV updated is that it is generally updated once a year."

See "Unexpected Traps for Filing Other-Than-Annual Amendments Using the Revised Form ADV and How to Avoid Them" (Jul. 13, 2017).

To avoid that issue, compliance teams should ensure there is a process in place to capture significant changes to the investment approach during the year, as well as a procedure in place to raise a flag as those changes arise. "The compliance team needs to be aware of when the firm's regulatory and investor documents diverge and when an off-cycle amendment to Form ADV is needed," Howes counseled.

Define ESG, Impact, Metrics and Limitations

Another possible reason why practice may diverge from disclosures is that certain key compliance considerations were not given enough weight when drafting disclosures – especially in terms of monitoring, testing and tracking.

Due to the popularity of ESG investing, managers may be tempted to overpromise or rush through the disclosure drafting process. Instead, disclosures should follow a careful consideration of what is achievable and how it can be documented. Other unique properties of ESG investing can also contribute to vague or unsupportable statements, such as the range of global frameworks and the lack of standard definitions.

Also, ESG fund disclosures should include descriptions of the expected ESG return, including how that is defined. "Offering documents always disclose the risk of not achieving the stated financial return goals. ESG funds should also clearly disclose how ESG or impact is defined and measured; any limitations on their ability to measure impact; and the risk that stated ESG goals may not be achieved," advised Arnold & Porter partner Ellen Kaye Fleishhacker. "They need to customize their policies and procedures so they are not just tracking the financial aspects of their investments but also whatever ESG goals and objectives they set."

See "Practical Tips and Considerations for Preparing PE Impact Investment Fund Offering Documents" (May 28, 2019).

Create "Simple and Clear" Disclosures

In a section describing effective practices, the Risk Alert recommended that disclosures be simple, clear, precise and tailored to the firm's approach to ESG investing. As an example, the staff pointed to an adviser that prominently stated that for separately managed client accounts its ESG investing approach relied on having unaffiliated advisers conduct ESG analysis and allocating client assets among ESG-oriented mutual funds managed by those advisers.

Specific Objectives

A simple and clear disclosure includes the sponsor's objectives, which could range in specificity. "The great thing about PE is that managers can fill very specific niches," Howes said. "Managers need to do what they say they are going to do, but they can narrow down what they are going to do to be very, very specific." Precision allows investors to find managers that match the investors' investment and broader ESG goals, she added.

Very specific disclosures may lead to higher expectations, however. "If disclosures are very specific, there is a greater onus to ensure money is actually managed in the way it is disclosed," cautioned Victoria G. Hogan, president of NorthPoint Compliance and former SEC examiner. "Although managers should accurately and clearly disclose investment methods without omitting anything material to an investor, at some point, they need to consider whether additional details are necessary."

It is worth noting that less-specific objectives can still be clear and precise. "The goal of defining what a manager means by ESG is to make clear to investors what its investment is going toward and to set a standard for compliance," explained Goodwin Procter counsel Danielle Reyes. A more specific objective could be, for instance, investing in companies where women are 50 percent of board members. Alternatively, a less specific objective might be to support the advancement of women on boards. "Adherence to the less specific objective is harder to prove," Reyes admitted. "But, as long as you can back it up, it's still a good objective."

See "How University Endowments Approach Diversity at Asset Managers and Racial Equity in Investments" (Feb. 9, 2021).

Clear Limitations

A simple and clear disclosure would include any limitations on the sponsor's ability to achieve or even measure the impact of its investments, Fleishhacker suggested. A fund with a goal of increasing opportunities for women in small business might set out how it plans to measure its impact, such as tracking the number of companies it invests in that are owned by women. It might also state, however, that it would be difficult to measure how investing in those companies might help other women.

Simultaneous Non-ESG Investments

The Risk Alert pointed out that firms could still satisfy the requirements of certain ESG frameworks while making investments that were inconsistent with ESG investing. With that in mind, managers should define exactly what role ESG issues will have in portfolio management, advised Jenner & Block partner Charles D. Riely, a former Assistant Regional Director for Enforcement. "For example, will emphasis on ESG be a determining factor or just a relevant factor to an investment? Does every investment need to be consistent with an ESG investment thesis?"

In some ways, the more weight ESG factors have in investment decisions, the higher the risk of regulatory scrutiny. "A fund that considers ESG as one of multiple factors when choosing investments may be held to a looser standard if the manager is saying that ESG is not the primary factor, versus a fund that holds itself out as primarily an ESG fund," Hogan counseled.

Inadequate Controls for Client Mandates and Marketing Materials

The Risk Alert observes that firms approach ESG investing in a variety of ways, including:

- considering ESG factors along others;
- focusing on ESG practices;
- taking into account ESG factors by applying negative, positive or norms-based screens;

- engaging with companies with a goal of improving specific ESG practices; or
- conducting impact investing.

The staff noted that advisers did not have adequate controls or systems in place to implement and monitor clients' ESG directives, specifically naming inadequate controls around negative screens. Negative screens are prohibitions on certain types of investments (*e.g.*, alcohol, tobacco or firearms) and can be challenging to maintain.

Negative screens should only be used if the manager is confident in its controls, Reyes advised. "Proving a negative is difficult. If the right controls are not in place to catch investments that are inconsistent with the stated ESG policy, the manager should not say it is using negative screens."

The staff also observed instances where positive screens – or client preferences for certain industries or issuers – were also not effectuated despite marketing claims touting processes for implementing them. "The SEC is asking for what it asks for in all cases – ESG or otherwise – which is to ensure a manager's marketing materials and other disclosures are accurate," Reyes explained.

Notably, where compliance personnel were integrated into a firm's ESG-related processes and more knowledgeable about the firm's approach and practice, the staff observed that firms were more likely to avoid materially misleading claims in client-facing documents.

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

Inadequate Policies and Procedures

The staff observed compliance programs that lacked policies and procedures directed at:

- addressing their firms' ESG investing analyses; decision-making processes; or compliance review and oversight;
- ensuring their firms obtained reasonable support for ESG-related marketing claims; and
- describing their firm's oversight of ESG-focused sub-advisers.

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

No Requirement for Separate ESG Policies

The Risk Alert includes assessing the necessity of "enhanced or separate ESG-related policies and procedures" in its section on effective practices.

Experts were quick to stress, however, that separate ESG policies and procedures are not required. "The SEC is not mandating that everyone have an ESG policy. It is reminding sponsors that they need appropriate policies and procedures in place to reduce risk," Hogan explained. "In light of the Risk Alert, sponsors need to evaluate the risk of not complying with their ESG policies and determine if their current controls and compliance program are adequate to reduce that risk."

Rather than a completely separate set of policies and procedures, sponsors need policies and procedures that include customizations needed for ESG strategies. "It can be an additional layer to existing policies and procedures," Fleishhacker suggested. "Advertising policies and procedures, for example, might be different for ESG because advertisements must not overpromise impact, which would not be an issue in other strategies."

Within a firm's policies and procedures, subsections may be needed to address ESG-specific issues, Howes agreed. "For example, if there's a section in the policies and procedures about portfolio construction, a firm with an ESG focus may want to include a subsection about ESG portfolio construction that includes items that ensure the portfolio reflects the stated ESG thesis."

Adherence to Claims and Frameworks

The Risk Alert also calls out firms that did not adhere to global ESG frameworks listed in their offering documents or substantiate their compliance with their stated investment processes. That includes, for example, claims made to clients that each fund investment had received a high score for each separate component of ESG, despite the firm actually relying on composite scores provided by a sub-adviser.

See "E.U. Sustainable Finance Initiatives: Preparing to Apply the Taxonomy Regulation and Other Proposed ESG Regulations (Part One of Two)" (Oct. 27, 2020).

Insufficient Documentation

The Risk Alert points out that one effective practice involved creating detailed investment policies and procedures that resulted in contemporaneous documentation of ESG factors considered in specific investment decisions, including at the research, due diligence, selection and monitoring stages.

"If a disclosure explicitly says that ESG and climate issues are part of how a portfolio manager makes investment decisions, compliance managers can review the record of actual investments to see if the firm would be able to demonstrate that to an examiner," Riely suggested.

See our two-part series on mitigating climate risk: "Advantages to PE Firms Pursuing Climate Risk Programs and Pitfalls to Avoid" (Jun. 30, 2020); and "Solutions for PE Firms to Develop a Physical Climate Risk Program" (Jul. 14, 2020).

Ineffective Compliance Programs

Knowledge, Not Expertise

The staff observed that compliance programs were less effective when compliance teams had limited knowledge of their firm's ESG-investment analyses or oversight over ESG disclosures and marketing decisions.

In the section on effective practices, the Risk Alert noted that "where multiple ESG investing approaches were employed at the same time, . . . [then] separate specialized personnel provided additional rigor to the portfolio management process." In her statement on April 12, 2021, however, SEC Commissioner Hester M. Peirce subsequently pushed back against any suggestion that the Risk Alert might mean compliance personnel should be experts in ESG.

As a result, sponsors might be excused if they wonder where their compliance officers' expertise should land between "limited knowledge" and "experts." "Firms don't necessarily need ESG specialists, but their compliance teams need to be well integrated; aware of how ESG processes are being represented to investors and reflected in the portfolio; and able to understand why and how an investment fits the fund's ESG thesis," Howes explained. Put differently, Fleishhacker suggested that a firm's CCO needs to be familiar enough with ESG to be able to identify any compliance holes.

A compliance staff's knowledge of its firm's ESG program can come from working closely with the portfolio management team handling the ESG fund. "What comes up often is a disconnect between the compliance function and the ESG team," Reyes observed. "Having the compliance team embedded in the investment management team is one way to do it. Even if they are separate, however, compliance should always be closely involved with overseeing disclosures, any public-facing statement and any third party the team relies on for its ESG obligations."

Poor Oversight of Third Parties

The staff observed inadequate policies and procedures regarding oversight of ESG-focused sub-advisers. ESG-focused sub-advisers can include third parties that create metrics and analytics for measuring impact or that provide ESG scoring systems. A third-party analysis of ESG impact may lend credibility to the results presented, but managers need to do their due diligence on those ESG scores.

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

"ESG seems to feature more opportunities to involve third parties," Hogan observed. "If a manager is relying on third parties, it must have proper oversight and the type of controls that would bring to light anything going wrong," Reyes added. "In that sense, it is not different from any other type of investment."

If a sub-adviser is used to conduct a negative screen, for example, managers cannot simply rely on the sub-adviser's statement that none of the prohibited types of businesses are involved in their funds. "The sub-adviser needs to be able to prove that, which is time-consuming," Reyes said. A sub-adviser should describe whatever tool they are using to ensure compliance with the negative screen and provide documentation backing up the claim of compliance, she advised.

"Ideally, the sub-adviser can demonstrate that the tool prevented an investment that would not have been consistent with the firm's ESG policy," Reyes said. "The SEC is saying that if a manager uses negative screens, it needs to be able to back it up. Reliance on a third party is not enough."

Lack of Effective Practices by Knowledgeable Personnel

The Risk Alert concluded by providing a representative list of effective practices performed by knowledgeable compliance personnel that were properly integrated into a firm's ESG-related processes, including:

- providing meaningful reviews of their firms' public disclosures and marketing materials;
- testing existing ESG-related policies and procedures, or assessing whether enhanced or separated policies and procedures are necessary;

- evaluating whether portfolio management processes align with stated investing approaches; and
- testing the adequacy of documentation of ESG-related investment decisions and adherence to client investment preferences.

See "How Fund Managers Can Identify and Mitigate Risks From the SEC's Increased Focus on ESG Investing (Part Two of Two)" (Jan. 28, 2020).