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Asset Management Takeaways From SEC Risk Alert On ESG

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Investors are increasingly requesting ESG-focused financial products and services, and investment advisers and fund sponsors are delivering.

Not surprisingly, this has prompted the U.S. Securities and Exchange Commission and its staff to direct resources toward ensuring that firms holding themselves out as being ESG investors continue to comply with the requirements of applicable securities laws.

This article reviews certain of the most recent guidance and statements from the SEC and its staff related to environmental, social and governance, or ESG, investing.[1]

On April 9, the SEC's Division of Examinations published a risk alert[2] summarizing its observations from recent examinations of investment advisers, registered investment companies and private funds engaged in ESG investing. The risk alert is the latest in a series of announcements from the regulator that demonstrate its focus on investor protection in connection with climate and ESG investing.

- On March 4, the SEC announced the launch of the Climate and ESG Task Force within the Division of Enforcement. The task force is led by Kelly L. Gibson, acting deputy director of the Enforcement Division, and is composed of 22 members from the division's specialized units, the SEC's headquarters and its regional offices.

- On March 3, the Division of Examinations released its 2021 examination priorities,[3] which emphasize an enhanced focus on climate-related risks.

Notably, the task force has committed to working closely with the Division of Corporation Finance, the Division of Investment Management and the Division of Examinations to access information across SEC registrants for purposes of identifying potential regulatory violations and insights.

The task force is also encouraging individuals to report compliance issues to the Office of the Whistleblower and intends to work with the Office of Market Intelligence to triage climate and ESG-related complaints, tips and referrals.

While it is too early to observe the modus operandi of the task force, the risk alert and recent remarks made by the Enforcement Division's Gibson and Commissioner Hester Peirce[4] provide a helpful overview of the SEC's approach to investment advisers offering ESG-focused investment products and financial services.

Key takeaways include:

1. Current ESG enforcement efforts will be based solely on existing SEC rules, regulations and guidance.

The laws governing ESG firms and the products they offer do not distinguish between firms that have adopted ESG strategies and those that have not. These laws include the Securities Act, the Securities Exchange Act, the Investment Advisers Act, the Investment Company Act and the respective rules and regulations promulgated thereunder.

ESG firms are subject to the same fiduciary duty to provide full and fair disclosure and advice in their clients' best interests as firms pursuing any other type of investment strategy. Although ESG investing strategies position a firm to generate positive societal impact, they do not pave the way for relaxed regulatory scrutiny.

2. Examinations of ESG firms will focus on deficiencies in portfolio management, advertising/marking and compliance practices.

ESG firms subject to SEC examination should expect the following to be key areas of focus for examiners:

- Portfolio management: Whether due diligence and other processes for selecting, investing in, and monitoring investments are consistent with the firm's stated ESG goals and commitments;

- Performance advertising and marketing: The accuracy of regulatory filings, marketing materials, due diligence questionnaire responses, and reports regarding compliance with ESG frameworks, such as the United Nations Principles for Responsible Investment, to which a firm claims to adhere; and

- Compliance programs: The breadth of written policies and procedures related to ESG and how they are implemented and enforced within the firm.

As further discussed below, clear and accurate documentation of ESG policies, procedures and performance is essential to avoiding exam deficiencies and enforcement actions.

3. Consistency is key.

The Division of Examinations staff observations outlined in the risk alert can generally be distilled down to a single message: Do what you say you're going to do. In the words of the Division of Examinations staff: "Actual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals."

To ensure such consistency, ESG firms should seek to:

- Implement clear policies and procedures for ESG investing and asset management reasonably designed to prevent violations of law (e.g., detail specific documentation to be completed at various stages of the investment process, such as research, due diligence, selection, and monitoring);
- Take affirmative steps ensure clients' ESG directives and investment preferences and prohibitions are met (e.g., impose negative screens);
- Thoroughly document ESG-related investment and other decisions;
- Tailor marketing materials and disclosures to the firm's specific approach to ESG investing — simple and clear is best;
- Update marketing and disclosure documents on a timely basis to ensure consistency with evolving ESG practices;
- Structure proxy voting policies and practices for consistency with communicated rights and processes;
- When relying on goals established under national or global ESG frameworks, provide clear and prominent disclosures regarding how investments are evaluated under such frameworks;
- Only make claims about ESG practices, experience, and successes that can be substantiated and retain copies of materials providing substantiation; and
- Ensure compliance personnel have the experience, competencies, and knowledge required to adequately conduct ESG analyses and oversight functions (e.g., with regard to investment risk, return and correlation metrics).

Conclusion

Increased investor demand for ESG-focused financial products and services has prompted a shift in the SEC's examination and enforcement priorities.

In an effort to protect investors against so-called greenwashing, the SEC has signaled that it will be dedicating significant resources to ensuring that companies, investment advisers and funds that hold themselves out as focused on ESG matters follow through with their promises to investors and do not use good intentions as an excuse for noncompliance with applicable law.

In addition to creating the task force, the SEC is encouraging investors and others to report ESG-related noncompliance through its Office of the Whistleblower. ESG firms should take the time to carefully review their existing operations, marketing materials, and policies and procedures and take steps to remedy any identified deficiencies or inconsistencies.

Clear documentation of investment decisions and other matters hinging on ESG factors can help to avoid issues by serving as substantiation for ESG-related claims.

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[1] As used in this article, "ESG" means "environmental, social, and governance," three central factors in measuring the sustainability and societal impact of an investment in a company or business. 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] https://www.sec.gov/files/esg-risk-alert.pdf.

[3] https://www.sec.gov/files/2021-exam-priorities.pdf.

[4] https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert.