



Insights: Alert

SEC Expands Focus on ESG-Related Products

June 8, 2021

Written by **Thomas B. Cain**, **Alexandra M. Fenno** and **Jeffrey T. Skinner**

On April 9, 2021, the SEC's Division of Examinations (f.k.a. OCIE) (the "Division") released a [risk alert](#) (the "Alert") highlighting observations from exams of registered investment advisers ("RIAs"), registered investment companies, and private funds recommending or offering environmental, social, and governance ("ESG") -related investment products and services.¹ The Alert, which was closely followed by a public statement regarding the Alert from SEC Commissioner Hester Peirce (the "Peirce Statement"²), is part of a flurry of recent SEC activity regarding ESG-related investment products that appears to have arisen in response to the rapid growth of investor demand for such products and a corresponding increase in the number of ESG investment products and services offered to investors.³ For example, as noted in our recent legal alert, [SEC Division of Examinations Releases 2021 Examination Priorities](#), the SEC has established a number of resources for firms and investors regarding ESG-related products, including a dedicated [webpage](#), and the Division clearly identified ESG-related recommendations and offerings as an examination priority in its [2021 Examination Priorities](#). Recognizing the marketing value stemming from appearing to sell an ESG or ESG-related product,⁴ this ESG-related guidance from the SEC—including both the Alert and the Peirce Statement—have stressed accountability of asset managers in the ESG space. Both the Alert and the Peirce Statement, in particular, focus on the importance of consistency between ESG-related disclosures made by firms (including statements in marketing materials) and those firms' actual ESG-related practices, emphasizing that firms "claiming to be conducting ESG investing need to explain to investors what they mean by ESG" and to actually "do what they say they are doing."⁵

We believe that the Alert will be particularly helpful for registrants and their compliance officers as the Alert not only signals the Division's continued focus on ESG issues, but also provides greater specificity regarding issues related to ESG products and services that the staff of the Division will prioritize in upcoming examinations. The Alert also identifies examples of both deficient and effective policies, procedures, and practices among previously examined registrants, which can be used by registrants and their compliance officers to assess and, where needed, reform their own ESG-related claims and practices.

Below, we provide a summary of the key observations and priorities highlighted in the Alert.

I. ESG-Related Priorities in Examinations of RIAs and Funds

In the Alert, Division staff stated that it will continue to examine registrants to evaluate whether they: (1) are accurately disclosing ESG investing approaches; and (2) have adopted and implemented policies, procedures, and practices that are consistent with the firm's ESG-related disclosures. In particular, the Alert indicates that examinations of firms claiming to engage in ESG investing will focus on:

- **Portfolio Management.** Division staff will review firms' policies, procedures, and practices related to ESG and ESG-related terminology as well as due diligence and other processes for selecting, investing in, and monitoring investments, to evaluate consistency with ESG disclosures. Examinations will also focus on whether firms proxy voting decision-making processes are consistent with ESG disclosures and marketing materials.⁶
- **Performance Advertising and Marketing.** Division staff will review regulatory filings, websites, reports to sponsors of global ESG frameworks (to the extent that the firm has communicated to clients and potential clients a commitment to follow such frameworks), responses to due diligence questionnaires and requests for proposals, and other client/investor facing materials (including marketing materials).⁷
- **Compliance programs.** Division staff will review firms' written policies and procedures and their implementation, compliance oversight, and ESG investing practices and disclosures.⁸

II. Staff Observations of Deficiencies

The Alert noted that, during examinations of RIAs, registered investment companies, and private funds engaged in ESG investing, Division staff observed: (1) potentially misleading statements regarding ESG investing processes and representations regarding adherence to global ESG frameworks; (2) issues with firms' policies and procedures, including a lack of policies and procedures related to ESG investing, policies and procedures not reasonably designed to prevent violations of law, and policies and procedures that were not implemented, weak, or unclear; (3) a lack of documentation of ESG-related investment decisions; and (4) compliance programs not reasonably designed to prevent inaccurate ESG-related disclosures and marketing materials.¹⁰ Specific examples of these deficiencies included the following:

- **Portfolio management practices that were inconsistent with disclosures about ESG approaches.** Division staff noted that some firms had portfolio management practices that differed from disclosures in client/investor-facing documents (e.g., Form ADV Part 2A, advisory agreements, offering materials). For example, Division staff noted that some firms failed to adhere to advertised global ESG frameworks.¹¹
- **Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.** In particular, Division staff provided examples of firms failing to control and update the implementation and monitoring of clients' negative screens (e.g., prohibitions on investments in certain industries or companies deemed to have negative ESG characteristics), leading to the risk that prohibited securities could be included in these clients' portfolios.¹²
- **Proxy voting may have been inconsistent with RIAs' stated approaches.** For example, Division staff observed that some firms advertised that ESG-related proxy proposals would be individually evaluated on a case-by-case basis, but internal guidelines did not provide for case-by-case analysis.¹³
- **Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.** Division staff observed that some ESG-oriented funds advertised favorable metrics related to ESG investing without disclosing significant expense reimbursement from the fund-sponsor, which inflated returns.

Division staff also noted RIAs touting substantial contributions to developing ESG products when, in actuality, the RIA's role was limited or inconsequential.¹⁴

- **Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.** Division staff observed that the inconsistencies between actual firm practices and ESG-related disclosures or marketing materials were often “because of a weakness in controls over public disclosures and client/investor facing statements.” Division staff also noted firms failing to document ESG investing decisions and failing to timely update marketing materials after discontinuing an ESG product or service.¹⁵
- **Compliance programs did not adequately address relevant ESG issues.** Division staff observed compliance programs that did not have policies and procedures to address adherence to advertised ESG policies and procedures, ensure reasonable support for ESG-related marketing claims, or oversee ESG-focused sub-advisers. Further, some firms also could not substantiate compliance with their stated ESG-related investment processes or claims.¹⁶
- **Compliance personnel had inadequate knowledge and oversight of ESG-related matters.** Division staff observed that compliance programs were less effective when compliance personnel had limited knowledge of relevant ESG investment analyses or oversight over ESG-related disclosures and marketing decisions.¹⁷

III. Staff Observations of Effective Practices

The Alert also described practices of firms examined by Division staff that accurately disclosed and advertised their ESG investing and firms that maintained effective policies, procedures, and practices with respect to their ESG investment approaches.¹⁸ Some effective practices highlighted in the Alert included the following:

- **Disclosures that were simple, clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices.** For example, Division staff noted effective disclosures where:
 - RIAs prominently stated that for separately managed client accounts, the RIA's ESG investing approach involved relying on unaffiliated advisers' underlying ESG analyses and allocating assets among ESG-oriented mutual funds;
 - RIAs clearly disclosed where clients were offered choices among standardized portfolios focused on particular ESG issues;
 - RIAs clearly and prominently disclosed practices where certain global ESG frameworks could be satisfied while making investments that were seemingly inconsistent with ESG investing; and
 - RIAs clearly explained how investments were evaluated using goals established under global ESG frameworks.¹⁹
- **Detailed policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices.** Division staff highlighted policies and procedures that included specific documentation throughout all stages of the investment process (e.g., research, due diligence, selection, and monitoring) for ESG investments, resulting in continuous documentation substantiating that investment decisions were made in compliance with advertised ESG-related investment approaches.

Division staff also noted that where firms employed multiple ESG investment approaches at the same time, each investment approach had specific written procedures, due diligence documentation, and separate specialized personnel to provide additional rigor to the portfolio management process.²⁰

- **Compliance personnel that are knowledgeable about the firms' specific ESG-related practices were less likely to have misleading claims in client-facing documents.** Division staff observed that these compliance personnel appeared to provide meaningful reviews of firms' public disclosures and marketing materials and tested the adequacy and consistency of firms' ESG-related policies, procedures, and practices.²¹

The Alert is the latest of many recent examples of how the SEC under the Biden administration is prioritizing climate and ESG-related risks and opportunities.²² In light of this increased focus, registrants who offer or advertise ESG products and services should expect Division examinations (which, as we discussed in our recent [legal alert](#), are becoming more common and should be expected, especially among new registrants and registrants who have not been recently examined) to assess whether the registrant's actual policies, procedures, and practices are consistent with disclosed or advertised ESG investing processes or investment goals. Thus, we encourage registrants and their compliance personnel to use the Alert as a guide in examining their current ESG-related practices, making reforms to policies, procedures, and practices as necessary, and to track new ESG-related guidance and news on the SEC's new ESG-focused [webpage](#), which highlights agency actions and other news related to climate and ESG investing.

If you have any questions about ESG-related issues, preparing for or responding to Division examinations, or about the regulation of RIAs, broker-dealers, and registered investment companies generally, please feel free to contact us.

Footnotes

¹SEC, Division of Examinations, The Division of Examinations' Review of ESG Investing (April 9, 2021), <https://www.sec.gov/files/esg-risk-alert.pdf> (hereinafter, "Alert").

²Hester M. Peirce, Commissioner, *Statement on the Staff ESG Risk Alert*, <https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert> (hereinafter "Statement on ESG Risk Alert").

³For example, the Forum for Sustainable and Responsible Investment's biennial "Trends Report" found that the total US-domiciled assets under management using "sustainable investing strategies" has increased 42% since 2018 to \$17.1 trillion as of the start of 2020, which represents roughly 33% of the total US-domiciled assets under management. Forum for Sustainable and Responsible Investment, *The US SIF Foundation's Biennial "Trends Report" Finds That Sustainable Investing Assets Reach \$17.1 Trillion* (Nov. 16, 2020), https://www.ussif.org/blog_home.asp?Display=155.

⁴Commissioner Peirce, in particular, noted that firms are "finding gold in the green" and "offering ESG products because it is lucrative to do so." Statement on ESG Risk Alert, *supra* note 2.

⁵*Id.*

⁶Alert, *supra* note 1, at 2. In the Peirce Statement, Commissioner Peirce reminded RIAs to also review the SEC's recent proxy voting interpretive releases (available [here](#) and [here](#)), which highlight that RIAs' proxy voting

authority is subject to such RIAs' fiduciary duty and must be undertaken in clients' best interest, recognizing that it is a violation of an RIA's fiduciary duty to vote to reflect the RIA's views when such vote does not also reflect those of the client. Statement on ESG Risk Alert, *supra* note 2.

⁷Alert, *supra* note 1, at 3.

⁸*Id.* at 3.

⁹Statement on ESG Alert, *supra* note 2.

¹⁰Alert, *supra* note 1, at 3-4.

¹¹*Id.* at 4. Notably, the Division repeatedly highlighted the failure of firms to adhere to global ESG frameworks despite claims to the contrary. However, the Division did state that some firms had effective disclosures that made it clear to clients that adherence to certain global ESG frameworks did not necessarily alter long-standing and seemingly contrary investment strategies. *Id.* at 6.

¹²*Id.*

¹³*Id.*

¹⁴*Id.* at 4-5.

¹⁵*Id.* at 5.

¹⁶*Id.*

¹⁷*Id.*

¹⁸*Id.* 5-6.

¹⁹*Id.* at 6.

²⁰*Id.* In the Peirce Statement, Commissioner Peirce clarified that the Alert does not impose new obligations on registrants, such as requiring "separate specialized [portfolio management] personnel." However, she also emphasized that a firm's disclosures about its personnel should match reality. Statement on ESG Risk Alert, *supra* note 2.

²¹Alert, *supra* note 1. Commissioner Peirce noted, however, that while compliance personnel in an ESG firm should be familiar with the firm's business in order to operate an effective compliance program, they need not be experts in ESG. Statement on ESG Risk Alert, *supra* note 1.

²²In the Peirce Statement, Commissioner Peirce stated that the issuance of an ESG-specific risk alert should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners, or that the SEC will assess whether any strategy is a good one. Rather, the SEC's focus is on ensuring that investors know what they are getting when they choose a particular adviser, fund, strategy, or product. Statement on ESG Risk Alert, *supra* note 2. However, the SEC and the Biden administration are clearly dedicating more time and resources to climate and ESG related issues, as evidenced by the Alert and other recent ESG-related guidance. See, e.g., Allison Herren Lee, Commissioner, *Living in a Material World: Myths and Misconceptions about "Materiality"* (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421?utm_medium=email&utm_source=govdelivery.

Related People



Jeffrey T. Skinner

t 336.607.7512

jskinner@ktslaw.com



Thomas B. Cain

t 336.607.7511

tcain@ktslaw.com



Alexandra M. Fenno

t 336.607.7426

afenno@ktslaw.com



Regan K. Adamson

t 336.607.7450

radamson@ktslaw.com



F. Daniel Bell, III

t 919.420.1834

dbell@ktslaw.com



Thomas W. Steed, III

t 919.420.1832

tsteed@ktslaw.com



Katherine A. McCurry

t 336.607.7359

kmccurry@ktslaw.com



Lauren B. Emanuel

t 336.607.7305

lemanuel@ktslaw.com