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The Division of Examinations Publishes Risk Alert with Observations from Its Exams of Investment Advisers and Funds Regarding ESG Investing

[33441]

April 12, 2021

TO: Chief Compliance Officer Committee
ESG Advisory Group
ESG Task Force

Internal Audit Committee RE: The Division of Examinations Publishes Risk Alert with Observations from Its Exams of Investment Advisers and Funds Regarding ESG Investing

Last Friday, April 9th, the SEC's Division of Examinations published its latest Risk Alert,[\[1\]](#) which contains observations from the Division's ESG examinations of funds and investment advisers.[\[2\]](#) As with all the Division's Risk Alerts, this one was published to provide registrants and others information about the most often cited deficiencies and weaknesses that the Division's staff observed in these examinations, which have been a priority for the Division for the past two years. As discussed in more detail below, in addition to identifying areas of concern, the Risk Alert also includes the staff's observations of effective practices and their plans for future examinations related to ESG.

Staff Observations of Compliance Deficiencies and Weaknesses

The Risk Alert identifies several compliance deficiencies and weaknesses the staff observed in its examinations focused on ESG. These included the following:

- Potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks;
- A lack of formal processes in place for ESG investing notwithstanding claims to the contrary;
- Controls that were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions;
- Controls that were inadequate to ensure that ESG-related disclosures and marketing are consistent with the firm's practices;
- Proxy voting that may have been inconsistent with advisers' stated approaches to

ESG investing;

- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches;
- Compliance weaknesses involving performance metrics included in marketing materials and a lack of compliance review of the data underlying such materials;
- Policies and procedures that did not appear to be reasonably designed to prevent a violation of law or that were not implemented;
- Weak or unclear documentation of ESG-related investing decisions;
- Compliance programs that did not adequately address relevant ESG issues to ensure the firm was operating consistently with its public disclosures about its ESG investing; and
- Compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials.

The Division's staff also observed that "compliance programs were less effective when compliance personnel had limited knowledge of ESG-investment analysis or oversight over ESG-related disclosures and marketing materials."

Staff Observations of Effective Practices

The Risk Alert also highlights effective practices observed during its ESG examinations. According to the Division, these effective practices were seen at investment advisers and funds that:

- Had in place disclosures that accurately conveyed material aspects of the firms' approaches to ESG investing;
- Maintained policies, procedures, and practices that appeared to be reasonably designed in view of their particular approaches to ESG investing;
- Used disclosures that were clear, precise, and tailored to the firms' specific approaches to ESG investing and that aligned with the firms' actual practices;
- Had policies and procedures that addressed the firms' ESG investing and covered key aspects of the firms' relevant practices; and
- Had compliance personnel that are knowledgeable about the firms' specific ESG-related practices and integrated into the firms' ESG approaches and practices.

The Risk Alert expounds on this last bullet about the significance of having compliance personnel who are knowledgeable about ESG. It notes that the compliance personnel in these firms appeared to: provide more meaningful reviews of firms' public disclosures and marketing materials; test the adequacy and specificity of existing ESG-related policies and procedures, if any; evaluate whether firms' portfolio management processes aligned with their stated ESG investing approaches; and test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences.

The Division's Ongoing Focus on ESG Investing

Notwithstanding publication of the Risk Alert, the Division's staff will continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches and have adopted policies, procedures, and practices consistent with such disclosures. Such examinations will focus on the following three areas, among others:

- **Portfolio Management** – *i.e.*, a review of the firms': policies, procedures, and practices related to ESG; due diligence and other processes for selecting, investing in, and monitoring the firm's ESG investments consistent with the firm's disclosure; and the firm's proxy voting decisions to ensure they are consistent with its ESG disclosures

and marketing materials.

- **Performance Advertising and Marketing** – *i.e.*, a review of the firms': regulatory filings; websites; reports to sponsors of any global ESG frameworks the firm has committed to follow; client presentations; and responses to due diligence questionnaires, requests for proposals, and client/investor-facing documents, including marketing materials.
- **Compliance Programs** – *i.e.*, a review of the firms' written policies and procedures and their implementation, compliance oversight, and review of ESG investing practices and disclosures.



The Division encourages market participants promoting ESG investing to evaluate whether their disclosures, marketing claims, and other public statements related to ESG investing are accurate and consistent with internal firm practices. Firms are also encouraged to ensure that their approaches to ESG investing are implemented consistently through the firm where relevant, adequately addressed in the firm's policies and procedures; and subject to appropriate oversight by compliance personnel. Firms should also ensure they are maintaining books and records documenting their ESG activities.

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endnotes

[1] See *The Division of Examination's Review of ESG Investing, Risk Alert*, SEC Division of Examinations (April 9, 2021), which is available at: <https://www.sec.gov/files/esg-risk-alert.pdf>. 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." The Risk Alert acknowledges that ESG and these terms "are not defined in the Investment Advisers Act of 1940, the Investment Company Act of 1940, or the rules adopted thereunder."

[2] The DoE's Examination Priorities for 2020 and 2021 included a focus on ESG investing. Even prior to publication of these Priorities, the Division has been focusing on ESG investing in its examinations.