

MEMO# 34509

December 7, 2022

SEC Charges Investment Adviser for Failing to Follow Policies and Procedures Relating to ESG Investments

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TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
ESG Advisory Group
ESG Fund Disclosure Working Group
ESG Public Company Disclosure Working Group
ESG Task Force
SEC Rules Committee SUBJECTS: Compliance
Disclosure
ESG
Litigation & Enforcement RE: SEC Charges Investment Adviser for Failing to Follow Policies and Procedures Relating to ESG Investments

In a settled enforcement action, the SEC sanctioned an investment adviser for failing to establish and follow established policies and procedures involving two mutual funds and one separately managed account strategy marketed as Environmental, Social, and Governance ("ESG") investments.[\[1\]](#) To settle the charges, the investment adviser agreed to pay a \$4 million penalty.[\[2\]](#)

Though the adviser neither admitted nor denied the violations, SEC's order found that, from April 2017 until February 2020 (the "Relevant Period"), the adviser had several policies and procedures failures involving the ESG research its investment teams used to select and monitor securities. The order found that from April 2017 until June 2018, the company failed to have any written policies and procedures for ESG research in one product, and once policies and procedures were established, it failed to follow them consistently prior to February 2020.

The SEC's order referenced one separately managed account strategy ("ESG SMA Strategy") and two mutual funds ("ESG Funds," and, together with the ESG SMA Strategy, the "ESG Investment Products") managed by the investment adviser. The order found that the investment adviser identified and screened out securities issued by companies

primarily engaged in certain businesses, such as casinos, distillers, tobacco producers, arms manufacturers, or other prohibited industries and excluded such securities from further ESG considerations. Then, investment teams undertook a supplemental ESG analysis of companies that were still being considered after step one, which included "conducting proprietary ESG research" in order to select securities for their portfolios.

Policies and Procedures Over the ESG Investment Process

The SEC's order stated that, in an attempt to consistently apply ESG research to the selection of securities for the ESG Investment Products, the investment adviser developed a common framework for the ESG investment process. This framework included a questionnaire, which contained a series of detailed questions covering ESG topics. The responses generated numerical scores for each ESG component, which were then weighted depending on the issuer's industry to generate an aggregated score. Although the investment adviser developed a common framework, the order found that during this time the investment adviser did not have written policies and procedures concerning its existing ESG two-step investment process for the ESG SMA Strategy.

The Investment Adviser's ESG Investment Process Practices

According to the order, for over a year, the investment adviser had not adopted written policies and procedures covering the ESG investment process for the ESG SMA Strategy. It found that once adopted, the investment adviser did not implement the policies and procedures for the ESG Investment Products during the Relevant Period. For example, the order found that the investment adviser's investment analysts did not complete all of the questionnaires until after the investment team had already selected securities for the initial portfolio for one of the ESG Funds. The order found that after more than two months, the investment analysts had completed questionnaires for fewer than half of the positions in that ESG Fund, and in some cases, questionnaires were not completed for an issuer for nearly six months.

The order also found that the investment analysts did not routinely complete questionnaires for new positions added to one of the ESG Funds, and found that the investment adviser did not use the questionnaires or ESG scores generated from the questionnaires to select securities or determine the size of positions in that ESG Fund during the Relevant Period.

With respect to the ESG SMA Strategy, the order found that despite describing in pitch books as early as February 2018 that the ESG SMA Strategy's investment team would use questionnaires as a part of its investment process, that team did not begin populating responses to the questionnaires for most ESG SMA Strategy positions until January 2020 and completed the work for the entire portfolio the following month.

According to the order, during the Relevant Period, the investment adviser did not provide its staff with sufficient guidance concerning the applicability and scope of the policies and procedures that covered the ESG investment process. The order indicated that the investment adviser staff's understanding of its obligations to complete questionnaires was inconsistent with the policies and procedures and marketing materials disseminated to third parties. For example, the order found that some investment adviser staff believed that completion of the questionnaire was optional, while others believed that the questionnaires could be completed sometime after the position had been added to the portfolio.

Violations, Sanctions and Remedial Efforts and Cooperation

The investment adviser consented to the Commission's findings that, as a result of the adviser's conduct, it willfully violated Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-7 under the Advisers Act. The investment adviser was ordered to cease and desist from committing or causing future violations of these provisions, censured, and ordered to pay a civil money penalty of \$4 million.

Joshua Weinberg
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Notes

[1] See SEC Press Release, SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments (November 22, 2022), available at <https://www.sec.gov/news/press-release/2022-209> and the order, In the Matter of Goldman Sachs Asset Management, L.P., Administrative Proceeding File No. 3-21245 (November 22, 2022), available at <https://www.sec.gov/litigation/admin/2022/ia-6189.pdf>.

[2] The respondent neither admitted nor denied the violations but consented to the entry of the order, agreed to a cease-and-desist order, a censure, and a \$4 million penalty.

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