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Risk Alert: SEC's Examination Division Issues ESG Risk Alert for Investment Advisers

19 April 2021

On April 9, 2021, the U.S. Securities and Exchange Commission's (the "SEC") Division of Examination Staff ("Exam Staff") published a [risk alert](#) providing observations from examinations of registered investment advisers offering funds or other advisory services involving an environmental, social and/or governance ("ESG") focus.

Key Exam Staff deficiency findings focused on inconsistencies between actual practices by investment advisers and disclosure to fund investors or advisory clients and related weaknesses in internal controls over ESG claims. Examples of such deficiencies or weaknesses in internal controls include the following:

1. Portfolio management practices were inconsistent with disclosures about ESG approach;
2. Inadequate controls to monitor and maintain client ESG directives;
3. Inconsistencies between public ESG-related proxy voting claims and an adviser's proxy voting policies and practices;
4. Unsubstantiated or otherwise potentially misleading claims regarding ESG approach;
5. Ineffective compliance practices to guard against inaccurate ESG-related disclosures and marketing materials; and
6. Lack of appropriately tailored compliance policies and procedures related to ESG investing for firms substantially engaged in ESG investing.

The Exam Staff noted it will continue to monitor advisers' ESG-related investing, with a focus on reviewing portfolio management, performance advertising and marketing, and compliance programs.

In light of these findings, advisers should continue to focus on adopting and implementing policies, procedures and practices that are consistent with ESG-related disclosures. In particular, Exam Staff cited the variability and imprecision of industry ESG terminology as a source of confusion for investors if advisers have not clearly articulated how they are using ESG-related terms, especially when offering products or services to retail investors. Accordingly, advisers should ensure its investor disclosures clearly identify how the adviser intends to define and implement ESG-related investment factors. The risk alert highlights other practices that advisers can implement to address the compliance issues listed above, including ensuring that policies and procedures address ESG investing in key aspects of the adviser's relevant practices (such as investment policies and contemporaneous documentation of ESG factors considered in specific investment decisions) and integrating compliance personnel into the adviser's ESG processes and practices to achieve a more comprehensive approach to ESG across the firm.

The risk alert notes that Exam Staff is not opining on the merits of ESG investing in general or on any particular ESG methodology and that its focus on disclosure of information related to ESG investment strategies is the same as for other investment strategies. While this echoes the sentiments of Republican-appointed Commissioners, Hester Peirce and Elad Roisman, that the SEC should not evaluate the merits of ESG investments, whether an investment strategy is consistent with an appropriate ESG approach or otherwise provide prescriptive ESG requirements, the SEC focus on ESG and climate-risk is expected to continue to grow under a Democratic majority of SEC Commissioners and the newly appointed Chairman Gary Gensler. To that end, the agency has begun soliciting public comment on a broad range of topics related to ESG oversight and establishing an ESG and Climate Task Force.

Disclosure requirements relating to ESG and climate-related risks are also gaining popularity outside of the US. In November 2020, the UK Chancellor of the Exchequer (head of the treasury), announced that it will mandate economy-wide disclosures in line with the Task Force on Climate-related Financial Disclosures ("TCFD") by 2025, going beyond the "comply or explain" approach. EU Regulators enacted a package of ESG-related reforms, including the EU Sustainable Finance Disclosure Regulation ("SFDR") which came into force in March 2021. Under this regulation, fund managers established in the EU, including U.S. fund managers who market in the EU, will be required to disclose how ESG risks are incorporated in their decision making and may also be required to make product-level disclosures for products that promote ESG objectives.

Our ESG & Impact Group contributing authors are [Alexandra N. Farmer](#), [Jennie Morawetz](#) and [Emilie A. Jones](#).

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