
The Division of Examinations' Review of ESG Investing

April 2021

On April 9, 2021, the SEC issued a [Risk Alert](#) ("Alert") discussing the Division of Examination's ("Division") review of Environmental, Social, and Governance ("ESG") investing.

This Alert underscores the SEC's heightened sensitivity around ESG-related investment products, born from a rapid growth in demand for ESG financial services and shifts in capital towards ESG investing.

Prior to this Alert, the SEC announced the creation of a Climate and ESG Task Force within the SEC's Division of Enforcement. The ESG Task Force will review and analyze disclosures to identify material gaps or misstatements and identify compliance issues relating to investment advisers' and funds' ESG strategies.

ESG has been on the list of exam priorities in 2020 and 2021. In March, then-Acting Chair Allison Herren Lee delivered two speeches featuring ESG topics. (March 15th [speech](#); March 17th [speech](#)). This Alert confirms the Division's commitment and echoes the comment by Herren Lee that ESG is "front and center for the SEC" based on increased investor demand for disclosure in this area.

ESG is not an official term whose definition is codified in regulations. The Division uses it broadly to encompass terms like socially responsible investing, sustainable, green, ethical, impact, or good governance, and includes themes of sustainability, climate, and faith-based investing.

Exam Focus Areas

According to the Alert, examinations of firms claiming to engage in ESG investing will focus on, among other matters:

- ESG-related policies and terminology;
- The due diligence process for selecting and investing in and monitoring investments in view of a firm's disclosed ESG investing approaches;
- Consistency of proxy voting decisions with ESG disclosures;
- Review of regulatory filings, websites, reports to sponsors of ESG frameworks, client presentations, responses to due diligence questionnaires, and other marketing materials; and
- Implementation of written policies, compliance oversight and review of ESG investing practices and disclosures.

Deficient Practices Observed During Examination

Among the observations made by the Division during examinations of investment advisers, registered investment companies and private funds engaged in ESG investing were:

- Portfolio management practices inconsistent with disclosures about ESG, which may be contrary to investment advisers' fiduciary duty and their obligation to provide full and fair disclosure of all material facts relating to the advisory relationship and to provide advice in the best interest of the client.

- Inadequate controls to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.
- Proxy voting that may have been inconsistent with advisers' stated approaches.
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches and inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices. Such claims may be contrary to antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act") and Marketing Rule provisions that provide that an adviser may not include any untrue statement of material fact or omit to state a material fact necessary to make the statement made not misleading.
- Compliance programs that did not adequately address relevant ESG issues and compliance personnel who had limited knowledge of ESG investment analyses. Such programs may be inconsistent with the Advisers Act requirement that advisers adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act.

Effective Practices Observed by Staff During Examination

In contract, the Division staff observed practices helpful in addressing the compliance issues identified above including:

- Disclosures that are clear, precise, and tailored to firm's approach to ESG investing and aligned with the firm's actual practice;
- Explanations regarding how investments are evaluated;
- Policies and procedures that address ESG investing and cover key aspects of the firm's relevant practices; and
- Compliance personnel who are knowledgeable about the firm's specific ESG practices.

Firms may mitigate risk during an SEC examination by: (1) evaluating disclosures and other materials to ensure accuracy and consistency with firm practices; (2) ensuring approaches to ESG investing are implemented consistently throughout the firm, addressed in firms' policies and procedures, and subject to appropriate oversight by compliance personnel; and (3) documenting and maintaining records related to important stages of ESG investing process.

While the SEC currently does not treat ESG activities differently than other strategies, then-Acting Chair Herren Lee hinted at the possibility of future changes in regulation including requirements for ESG-specific policies and procedures, Public Company Accounting Oversight Board standards on how auditors address ESG-related financial statements, and more transparency from credit rating agencies on how they consider ESG factors.