Simpson Thacher

Regulatory and Enforcement Alert

New SEC Risk Alert Focuses on ESG-Related Disclosures and Policies

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The Division of Examinations (the "Exam Division") of the U.S. Securities and Exchange Commission ("SEC") recently published a Risk Alert (the "Risk Alert")[1] highlighting deficiencies, internal control weaknesses and effective practices identified during recent examinations of investment advisers, registered investment companies and private funds (collectively referred to as "firms") related to environmental, social, and governance ("ESG")[2] investing. While the Exam Division's focus on ESG is nothing new,[3] the "rapid growth in [investor] demand [for ESG investing], increasing number of ESG products and services, and lack of standardized and precise ESG definitions" have prompted the Exam Division to sharpen its focus on firms' ESG-related policies, procedures, practices and disclosures.

The Risk Alert cautions firms that engage in ESG investing against the use of imprecise and inconsistent ESG definitions and terms that can lead to investor confusion and urges these firms to: (i) ensure that disclosure of ESG investment strategies, policies and practices align with actual practices; and (ii) implement appropriate ESG-related policies and procedures. Below is a summary of the deficiencies and effective practices identified in the Risk Alert and some key takeaways for firms engaged in ESG investing.

Key Takeaways

- The Risk Alert comes amidst the SEC's heightened focus on ESG. Last month, the SEC announced the creation of a new Climate and ESG Task Force ("ESG Task Force"), which is led by acting deputy director of the SEC's enforcement division, Kelly L. Gibson. The ESG Task Force consists of 22 specialists and has already begun focusing on the accuracy, or lack thereof, of firms' ESG disclosures.
- Firms that reference ESG in the marketing materials for their products or services should be prepared for the prospect that Exam Division staff will, during exams, scrutinize whether their ESG-related processes and practices align with their ESG-related statements in investor-facing documents, including their offering materials, marketing materials, due diligence questionnaires ("DDQs"), websites and periodic investor reports (*e.g.*, annual sustainability and impact reports). Given the SEC's overall posture and heightened

[1] *The Division of Examinations' Review of ESG Investing*, Risk Alert, SEC Division of Examination (April 9, 2021).

[2] The Risk Alert uses the term "ESG" broadly to cover: "'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." As the Risk Alert notes, neither the Investment Advisers Act of 1940 nor the Investment Company Act of 1940 defines the term "ESG."

[3] *See* the Exam Division's *Examination Priorities* for 2020 and 2021, both of which included a focus on ESG investing.

focus on ESG and climate-related issues, we believe meaningful exam deficiencies in this area are at greater risk of migrating to enforcement. Therefore, it is crucial that firms conduct a self-audit of ESG-related disclosures and ensure that they accurately reflect a firm's actual and current policies and practices.

- One point of emphasis in the Risk Alert is that compliance personnel at a firm engaged in ESG investing should have adequate knowledge of their firm's ESG investing approaches and practices and should exercise adequate oversight over their firm's ESG-related disclosures and marketing decisions.
- The Risk Alert provides firms that engage in ESG investing with a valuable window into the Exam Division staff's expectations, compliance concerns and exam focus areas on the topic of ESG investing. These firms should review their compliance policies and procedures in light of the deficiencies and effective practices identified in the Risk Alert.

Examinations of Firms

The Risk Alert indicates that when examining the policies, procedures and practices of firms that claim to engage in ESG investing, Exam Division staff will focus on three main areas: portfolio management, performance advertising and marketing, and compliance programs.

PORTFOLIO MANAGEMENT

The Risk Alert flagged that during examinations, Exam Division staff will look at a firm's policies, procedures and practices to: (i) ensure consistent use of ESG terminology and messaging; (ii) determine whether a firm diligences, selects and monitors its investments in a manner consistent with its ESG disclosures (including whether a firm's investment practices adhere to the global ESG frameworks or standards that the firm claims to voluntarily follow); and (iii) ensure that a firm's proxy voting processes are in line with its ESG disclosures and marketing materials.

PERFORMANCE ADVERTISING AND MARKETING

As noted in the Risk Alert, Exam Division staff will scrutinize all forms of disclosure (*e.g.*, a firm's website; regulatory filings; DDQs; reports to sponsors of ESG frameworks, as applicable; and other investor-facing documents and marketing materials). As with any investor-facing documents, firms should be careful not to make exaggerated, unsubstantiated or potentially misleading claims about ESG investing, and should regularly review their ESG-related disclosures to ensure accurate and up-to-date information is being presented. For example, during its examinations, Exam Division staff observed that certain marketing materials touted returns related to ESG investing, but failed to disclose significant expense reimbursement from the fund sponsor that resulted in inflated returns. The staff also observed failures to timely update marketing materials to reflect that a firm no longer offered a particular ESG product.

COMPLIANCE PROGRAMS

The Risk Alert flagged that examinations will also include a careful review of a firm's compliance program as it relates to its ESG investing policies, procedures, practices and disclosures. Firms engaging in ESG investing must ensure that their compliance programs contain adequate policies and procedures related to ESG investing and that these policies and procedures align with the firm's ESG-related disclosures. During examinations, the staff observed the lack of adequate policies related to ESG investing, including the lack of controls around the use of negative screens; the lack of policies pertaining to disclosed adherence to global ESG frameworks; and the lack of policies and procedures to ensure the gathering of reasonable support for ESG-related claims in marketing materials. Additionally, the staff observed the lack of, or weak, contemporaneous documentation of the ESG factors considered in investment decisions. The staff also observed that compliance programs were practically ineffective when there was insufficient compliance function knowledge and oversight over ESG-related disclosures, including in response to DDQs.

Effective Practices

The Exam Division staff also observed firm policies, procedures and practices that appeared, in the staff's view, to be reasonably designed in light of the firms' particular approaches to ESG investing. Specifically, the Risk Alert identifies the following examples of effective practices observed by the Exam Division staff: (i) disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices (including explanations regarding how investments were evaluated using goals established under global ESG frameworks); (ii) policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices; and (iii) compliance personnel that are knowledgeable about the firms' specific ESG-related practices.

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