

Regulatory and Enforcement Alert

ESG Scrutiny From the SEC's Division of Examinations

May 20, 2021

In the run up to the 2020 presidential election, we had predicted that a Biden administration would usher in an era of heightened SEC scrutiny. We also anticipated that ESG (environmental, social and governance) and SRI (socially responsible investing) would become a priority for the SEC's Division of Examinations (the "Exam Division"). For more on this priority shift, see Simpson Thacher, [The SEC Under New Management—Outlook for 2021 and Beyond](#).

Proposed Legislation and Regulatory Scrutiny. One way this shift has manifested is in proposed legislation. Last month, the Climate Risk Disclosure Act of 2021 was introduced by Senator Elizabeth Warren and Representative Sean Casten. The Act would direct the SEC to promulgate rules requiring public companies to disclose additional information about their greenhouse gas emissions and fossil fuel assets, and how climate change would affect their valuation. There has also been an increase in regulatory attention in this area. In March 2021, the SEC released a [request](#) for public comment on climate change disclosures. Also in March 2021, the SEC [announced](#) the creation of a Climate and ESG Task Force in the Division of Enforcement, with the stated initial focus on identifying material misstatements in issuers' disclosure of climate risks under existing rules, as well as to analyze disclosure and compliance issues relating to advisers' ESG strategies. In its announcement, the Task Force solicited tips and whistleblower complaints related to ESG. And earlier this month, SEC Chair Gary Gensler told the House of Representatives Financial Services Committee that he expected the SEC to propose new rules on corporate climate risk disclosures in the second half of 2021. Additionally, the Exam Division's April 9, 2021 Risk Alert highlights deficiencies, internal control weaknesses and effective practices identified during recent examinations of investment advisers, registered investment companies and private funds related to ESG investing. For more on this Risk Alert, see Simpson Thacher, [New SEC Risk Alert Focuses on ESG-Related Disclosures and Policies](#).

Targeted Review of ESG Practices. In the latest development, the Exam Division has initiated what appears to be a review of certain registered advisers seeking a broad range of information concerning ESG investing and disclosure practices. These inquiries offer advisers that engage in ESG/SRI investing, or plan to, a glimpse into the Staff's latest thinking in this area. The key lines of inquiry relate to:

Precise Internal Definitions. While ESG/SRI investing is not new, a number of the inquiries focus on the definition of ESG/SRI terms. This may indicate that the Staff recognizes that a lack of precision could lead to issues with adviser compliance, the SEC's ability to monitor advisers and confusion among investors. For

example, registrants have been asked for their internal definition of impact investing and any terms that relate to ESG/SRI that are also used in disclosure or marketing materials provided to prospective or current clients or investors. These inquiries also seek:

- A list and description for all ESG/SRI criteria that are utilized.
- Copies of any written policies and procedures relating to the application of ESG/SRI criteria to the investment process.

Industry Standards. The Staff also appears to be focused on understanding how registrants use industry metrics/standards. For example, registrants have been asked whether they adhere to any ESG/SRI industry standard (*e.g.*, UN Principles for Responsible Investment or Equator Principles). If so, the Staff requests written documentation of the registrant’s consideration of these standards in its investment selection, portfolio management processes and proxy voting/issuer engagement practices. Registrants have also been asked for details on third-party scoring systems based on ESG/SRI criteria, if in use.

Insight Into the Adviser’s Reasoning for Investment Recommendation Changes Based on ESG/SRI Criteria. For investments that were previously, but are no longer, recommended during the examination period and the preceding 12-month period, registrants have been asked to provide a list of the investments as well as a written explanation for why each one is no longer recommended. This concerns investments for which the registrant believes ESG/SRI criteria were “a determinative factor” with regard to the investment decision-making process. Registrants have also been asked to include or identify existing records that contain such explanations.

European Angle. The rise of ESG scrutiny in the U.S. mirrors recent developments in Europe. On March 10, 2021, the EU Sustainable Finance Disclosure Regulation (“SFDR”) became effective. The SFDR imposes sustainability-related disclosure requirements on financial services institutions including banks and investment firms.

Final Thoughts. We believe the recent requests from the Exam staff are the tip of the spear and that referrals to Enforcement staff of potential disclosure issues concerning ESG will likely soon follow. We encourage sponsors to consult with counsel and other external advisors to ensure that their disclosure and related fund documentation will measure up to this greater scrutiny in this area of growing prominence.

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