Chapman and Cutler LLP

Chapman Client Alert

April 14, 2021

Current Issues Relevant to Our Clients

SEC Issues Risk Alert on ESG Investing

On April 9, 2021, the Securities and Exchange Commission (the "*SEC*") Division of Examinations (the "*Division*") issued a Risk Alert highlighting observations made by the Division from recent examinations of investment advisers, registered investment companies, and private funds (collectively, "*firms*") offering products and services that incorporate environmental, social, and governance ("*ESG*") factors. According to the Division, the rapid growth in demand for ESG products and services and the lack of standardized and precise ESG definitions present certain risks, and the Risk Alert is intended to highlight risk areas and assist firms in developing and enhancing their compliance practices.

The Risk Alert is available here. The following is a summary of what is discussed in the Risk Alert.

Examination Priorities

ESG investing and its related risks were an Examination Priority for the Division in 2020, and as noted in this Chapman Client Alert and in a recent edition of Chapman Insights, the Division previously announced that its Examination Priorities for 2021 will continue to include ESG investing and related risks. The Division has examined, and will continue to examine, whether firms are accurately disclosing their ESG investing approaches and whether they have adopted and implemented policies and procedures that align with their ESG-related disclosures. During an examination of firms who offer ESG-related products, the Division focuses on:

- Portfolio management: including a review of a firm's practices related to ESG and the use of ESG-related terminology, as well as a firm's due diligence and the processes used to select, invest in, and monitor investments in light of a firm's disclosed ESG investing approaches.
- Performance advertising and marketing: including a review of a firm's website, regulatory filings, reports to sponsors of global ESG frameworks and client communications, including marketing materials.
- Compliance Programs: including a review of a firm's written policies and procedures, how these policies are implemented and reviewed, and compliance oversight.

Compliance Deficiencies

During examinations of firms engaged in ESG investing, the Division noted instances of firms making potentially misleading statements regarding their ESG investing processes and representations regarding adherence to global ESG frameworks. For example, for some firms that claimed to have formal processes in place for ESG investing, the Division observed a lack of policies and procedures related to ESG investing, policies and procedures that did not appear to be reasonably designed to monitor and prevent violations of law, and weak or unclear documentation of ESG-related investment decisions.

Additional observations by the Division included:

- Inconsistencies between portfolio management practices and disclosures to clients about ESG investing approaches;
- Inadequate controls to maintain, monitor, and update ESG-related investing guidelines, mandates, and restrictions;
- Inconsistencies between public ESG-related proxy voting claims and advisers' stated approaches to internal proxy voting policies and procedures;
- Unsubstantiated or otherwise potentially misleading claims regarding ESG investing, including misleading marketing materials;
- Inadequate controls to ensure that ESG-related disclosures and communications are consistent with a firm's practices; and
- Inadequate compliance programs to address relevant ESG issues, including a lack of procedures to address adherence to global ESG frameworks and compliance personnel that lacked knowledge of relevant ESG-related

investment analyses or had limited oversight over ESG-related disclosures and marketing materials.

Effective Practices

The Division also noted certain effective compliance practices they observed that may assist firms in developing and enhancing their compliance practices regarding ESG investing. Examples of these practices are listed below.

- Clear and precise disclosure tailored to a firm's specific approaches to ESG investing, and which aligned with a firm's actual practices, including:
  - Simple disclosure in client facing materials that outlined an investment advisers' approach to ESG investing;
  - Clear and prominent disclosure that ESG factors could be considered alongside many other factors in an investment strategy; and
  - Explanations regarding how investments were evaluated using goals established under global ESG frameworks (such as the U.N.-sponsored Principles for Responsible Investment).
- Policies and procedures that addressed ESG investing and covered key aspects of a firm's relevant practices, including detailed investment policies and procedures that addressed ESG investing and included specific documentation to be completed at various stages of the investment process (e.g., research, due diligence, selection and monitoring).
- Compliance personnel that are knowledgeable about a firm's specific ESG-related practices and are integrated into a firm's ESG-related processes, including personnel with adequate knowledge of relevant ESG-investment analyses and/or oversight over ESG-related disclosures and marketing materials.

Going Forward

The Division recommends investment advisers, registered investment companies, and private funds evaluate whether their disclosures, marketing materials, and other public statements related to ESG investing are accurate and consistent with their internal practices. Specifically, firms should ensure that their approaches to ESG investing are implemented consistently, are adequately addressed in relevant policies and procedures, and are subject to appropriate oversight by knowledgeable compliance personnel. The Division further noted that those offering ESG-related products should consider documenting and maintaining records relating to important stages of the ESG investing process.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management group, or visit us online at chapman.com.

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