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SEC Highlights Compliance Issues Related to Investment Advisers Offering ESG-Related Investment Products

On April 9, 2021, the SEC's Division of Examinations (the "Division") published a Risk Alert¹ highlighting observations of deficiencies and internal control weaknesses from recent examinations of investment advisers offering products, including private funds,² whose investment strategies incorporate environmental, social and governance ("ESG") factors. Increased investor demand for ESG products, the expansion of various approaches to ESG investing by investment advisers and private funds, the increased number of ESG products offered and a lack of standardized ESG terminology present a number of compliance risks for investment advisers. The Division's Risk Alert discusses the following:

- examination priorities, including whether investment advisers are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures and practices that accord with their ESG-related disclosures;
- compliance deficiencies, including potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks;³ inadequate policies and procedures related to ESG investing; weak or unclear documentation of ESG-related investment decisions; and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures or to prevent violations of law, or that were not implemented; and
- effective compliance practices, including disclosures that accurately conveyed material aspects of investment advisers' approaches to ESG investing and policies, procedures and practices that appeared to be reasonably designed in view of their particular approaches to ESG investing.

Below are more detailed summaries of the examinations priorities, compliance deficiencies and effective practices outlined by the Division.

Examination Priorities. The Division focused on, and will continue to focus on, the following areas during examinations of investment advisers offering ESG-related products:

- **Portfolio management:** due diligence and other processes for selecting, investing in and monitoring investments in view of the investment adviser's disclosed ESG investing approaches; policies, procedures and practices related to ESG and use of ESG-related terminology;
- **Performance advertising and marketing:** regulatory filings, websites, reports regarding global ESG frameworks (to the extent the investment adviser has communicated to investors or potential investors a commitment to follow such frameworks), investor presentations, and responses to due diligence questionnaires ("DDQs"), requests for proposals ("RFPs") and marketing materials; and
- **Compliance programs:** written policies and procedures and their implementation, compliance oversight, and review of ESG investing practices and disclosures.

Compliance Deficiencies. The Division noted the following compliance deficiencies during examinations of investment advisers offering ESG-related products:

- **Inconsistencies between portfolio management practices and ESG-related disclosures:** disclosures in Form ADV Part 2A, advisory agreements, offering materials, RFPs, and DDQs that differed from portfolio management practices; failures to adhere to global ESG frameworks to which an investment adviser claimed to be adhering;
- **Inadequate controls regarding ESG-related investing guidelines and restrictions:** inadequate controls around implementation and monitoring of investors' negative screens (*e.g.*, prohibitions on investments in certain industries, such as alcohol, tobacco or firearms); inadequate systems to consistently and reasonably track and update investors' negative screens;
- **Unsubstantiated or misleading statements regarding ESG approaches:** marketing materials for ESG-oriented funds that touted favorable risk, return and correlation metrics related to ESG investing without disclosing material facts regarding the significant expense reimbursement they received from the fund-sponsor (which inflated returns for those ESG-oriented funds); unsubstantiated claims by investment advisers regarding their substantial contributions to the development of specific ESG products, when, in fact, their roles were very limited or inconsequential;
- **Inadequate controls regarding consistency between ESG-related disclosures and practices:** weaknesses in controls over disclosures and investor-facing statements; failures to adhere to global ESG frameworks despite claims to the contrary; unsubstantiated claims regarding investment practices (*e.g.*, only investing in companies with "high employee satisfaction"); failures to document ESG investing decisions; failures to update marketing materials timely (*e.g.*, an investment adviser continuing to advertise an ESG investment product it no longer offered); and
- **Inadequate compliance programs:** inadequate policies and procedures regarding: (i) an investment adviser's ESG investing analyses, decision-making processes or compliance review and oversight; (ii) adherence to global ESG frameworks to which the investment advisers claimed to be adhering; (iii) substantiating ESG-

related marketing claims; (iv) oversight of ESG-focused sub-advisers; (v) substantiating adherence to stated investment processes, such as supporting claims made to investors that each fund investment had received a high score for each separate component of ESG (*i.e.*, environmental, social and governance), when relying instead on composite ESG scores provided by a sub-adviser; and (vi) compliance controls regarding performance metrics included in marketing materials (such as risk, returns and correlation metrics), and a lack of compliance review of the data underlying those measures. The Division also observed ineffective compliance programs due to compliance personnel having limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions.

Effective Practices. The Division also noted certain effective compliance practices that may assist investment advisers in developing and enhancing their compliance practices regarding ESG investing:

- **Tailored disclosures regarding approaches to ESG investing that aligned with actual practices:** simple and clear disclosures regarding the investment advisers' approaches to ESG investing; clear and prominent disclosures that ESG factors could be considered alongside many other factors (allowing such investment advisers to satisfy the requirements of certain global ESG frameworks while making investments that appeared to be inconsistent with ESG investing); explanations regarding how investments were evaluated using goals established under global ESG frameworks;
- **Comprehensive policies and procedures addressing ESG investing:** detailed investment policies and procedures that addressed ESG investing, including specific documentation to be completed at various stages of the investment process (*e.g.*, research, due diligence, selection and monitoring) and contemporaneous documentation of the ESG factors considered in specific investment decisions; where multiple ESG investing approaches were employed at the same time, specific written procedures, due diligence documentation and separate specialized personnel provided additional rigor to the portfolio management process; and
- **Knowledgeable compliance personnel:** where compliance personnel were integrated into investment advisers' ESG-related processes and were more knowledgeable about investment advisers' ESG approaches and practices, (i) such investment advisers were more likely to avoid materially misleading claims in their ESG-related marketing materials, and (ii) the compliance personnel were able to provide more meaningful reviews of investment advisers' disclosures and marketing materials; test the adequacy and specificity of existing ESG-related policies and procedures (or assess whether enhanced or separate ESG-related policies and procedures were necessary); evaluate whether investment advisers' portfolio management processes aligned with their stated ESG investing approaches; and test the adequacy of documentation of ESG-related investment decisions and adherence to investors' investment preferences.

Additional Takeaways. Investment advisers offering ESG-related products may consider evaluating whether their disclosures and marketing materials related to ESG investing are accurate and consistent with internal practices. Investment advisers may also consider evaluating whether their approaches to ESG investing are being implemented consistently throughout the firm, where relevant, and are adequately addressed in the investment adviser's policies and procedures and subject to appropriate oversight by compliance personnel. Lastly, investment advisers may consider taking steps to document and maintain records relating to important stages of the ESG investing process.

Finally, the SEC's Risk Alert should be understood within the context of recent SEC responses to climate and ESG risks,⁴ including the creation of a Climate and ESG Task Force in the Division of Enforcement, which has "already started working on plans and initiatives to look at potential materially misleading statements and omissions" by companies, investment advisers and private funds.⁵

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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¹ See [The SEC Division of Examinations' Review of ESG Investing](#).

² Although not discussed in this memorandum, the Division's Risk Alert also addressed compliance issues related to registered investment companies.

³ As part of an ESG strategy, an investment adviser may choose to adhere to one or more voluntary global ESG frameworks, principles, or standards for asset managers and financial institutions (e.g., the Equator Principles or the U.N.-sponsored Principles for Responsible Investment and Sustainable Development Goals).

⁴ For more on these recent developments, see our prior client alerts, [SEC Turns up the Heat on Climate and ESG Disclosures: 2021 SEC Examination Priorities for Private Fund Advisers](#); and [Acting SEC Chair Lee Discusses Additional Climate and ESG Initiatives](#).

⁵ See "[SEC's ESG Unit Chief Says Existing Regs Key To Enforcement](#)," *Law360* (April 9, 2021).