April 9, 2021

The Division of Examinations' Review of ESG Investing[*]

I. Introduction

Investor demand for investment products and financial services that incorporate environmental, social, and governance ("ESG")[1] factors has increased in recent years. In response to this demand, a range of investment advisers have offered several ESG investment options, including registered investment companies and pooled investment vehicles, *e.g.*, private funds (collectively, "funds"), and separately managed accounts. Today we are issuing this Risk Alert to highlight observations from recent exams of investment advisers, registered investment companies, and private funds offering ESG products and services (collectively, "firms").

The Division has observed that firms approach ESG investing in various ways. In making investment decisions, some advisers and funds consider ESG factors alongside many other factors, such as macroeconomic trends or company-specific factors like a price-to-earnings ratio, to seek to enhance performance and manage investment risks. Others focus on ESG practices because they believe investments with favorable ESG profiles may provide higher returns or result in better ESG-related outcomes. For example, some ESG funds select companies that have demonstrated a commitment to a particular ESG factor, such as companies with policies aimed at minimizing their environmental impact. Some advisers and funds take into account ESG factors by applying negative, positive, or norms-based screens to investments.[2] Others focus on engaging with companies with a goal of improving specific ESG-related practices. Certain

---

[*] The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by Division staff and is not legal advice.

[1] This Risk Alert uses the term "ESG" in the broadest sense to encompass terms such as "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. These terms, however, are not defined in the Investment Advisers Act of 1940 ("Advisers Act"), the Investment Company Act of 1940 ("Investment Company Act"), or the rules adopted thereunder.

[2] Negative screening excludes issuers that are deemed to have negative ESG characteristics; positive screening selects issuers that are deemed to have positive or best-in-class ESG characteristics; and norms-based screening, a sub-category of negative screening, excludes issuers if they fail to meet minimum standards based on international norms.

advisers and funds focus on a range or subset of ESG themes including sustainability, climate, and faith-based investing. Still others invest with a goal of generating measurable ESG-related benefits, known as impact investing.

In response to investor demand, investment advisers and funds have expanded their various approaches to ESG investing and increased the number of product offerings across multiple asset classes. This rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks. For instance, the variability and imprecision of industry ESG definitions and terms can create confusion among investors if investment advisers and funds have not clearly and consistently articulated how they define ESG and how they use ESG-related terms, especially when offering products or services to retail investors. Actual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals.

This Risk Alert provides observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing.[3] It also provides observations of effective practices from such examinations. The Risk Alert is intended to highlight risk areas and assist firms in developing and enhancing their compliance practices. In addition, the staff seeks to provide transparency regarding the Division's focus areas during examinations on this topic.[4]

II. Examinations of Investment Advisers and Funds

The staff will continue to examine firms to evaluate whether they are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices that accord with their ESG-related disclosures. Examinations of firms claiming to engage in ESG investing will focus on, among other matters, the following:

- *Portfolio management*. Examinations will include a review of the firm's policies, procedures, and practices related to ESG and its use of ESG-related terminology; due diligence and other processes for selecting, investing in, and monitoring investments in view of the firm's disclosed ESG investing approaches; and whether proxy voting decision-making processes are consistent with ESG disclosures and marketing materials.[5]

---

[3] The Division's Examination Priorities for 2020 and 2021 both include a focus on ESG investing.

[4] Different ESG approaches may entail investment, marketing, and compliance risks that are unique to those approaches. The staff does not opine on the investment merits of ESG investing in general or any particular ESG approach (*e.g.*, best-in-class, issuer engagement, or impact), whether any particular ESG methodology should be employed or avoided by advisers to satisfy their fiduciary obligations, or whether certain ESG practices should be encouraged or dissuaded. The staff also notes that neither the Advisers Act nor the Investment Company Act, or the rules adopted thereunder, have ESG-specific provisions. The Division's interest in the accuracy and adequacy of disclosures provided by advisers and funds offering clients ESG investment strategies is the same as it would be for advisers and funds offering any other type of investment strategy.

[5] Advisers Act Section 206 imposes a fiduciary duty on investment advisers to provide full and fair disclosure of all material facts relating to the advisory relationship and to provide advice that is in the best interest of the client. Investment advisers also have antifraud liability with respect to communications to clients and prospective clients under Advisers Act Section 206. *See* Commission Interpretation Regarding Standard of Conduct for Investment

- *Performance advertising and marketing*. Examinations will include a review of the firm's regulatory filings; websites; reports to sponsors of global ESG frameworks, to the extent the firm has communicated to clients and potential clients a commitment to follow such frameworks;[6] client presentations; and responses to due diligence questionnaires, requests for proposals, and client/investor-facing documents, including marketing materials.[7]

- *Compliance programs*. Examinations will include a review of the firm's written policies and procedures and their implementation, compliance oversight, and review of ESG investing practices and disclosures.[8]

III. Staff Observations

During examinations of investment advisers, registered investment companies, and private funds engaged in ESG investing, the staff observed some instances of potentially misleading statements regarding ESG investing processes and representations regarding the adherence to

---

Advisers, Release No. IA-5248 (June 5, 2019). Advisers Act Rule 206(4)-8 prohibits advisers to pooled investment vehicles from making false or misleading statements to existing or prospective investors in those pooled investment vehicles (*e.g.*, investors in a registered investment company or private fund).

[6] As part of an ESG strategy, an investment adviser may choose to adhere to one or more of these voluntary global ESG frameworks, principles, or standards for asset managers and financial institutions (*see*, *e.g.*, the Equator Principles or the U.N.-sponsored Principles for Responsible Investment ("UNPRI") and Sustainable Development Goals ("SDGs")). These frameworks are not uniform and some may apply only to very specific investment types. They can range in complexity from a set of aspirational principles to, for example, highly prescriptive financial industry benchmarks for assessing and managing environmental and social risk for infrastructure projects. Some sponsors of global ESG frameworks, such as the UNPRI, require signatories to report annually on their ESG investing practices by, for example, answering comprehensive questionnaires. Some of these reports are publicly available. The staff also noted that some firms engaged in impact investing may prepare annual sustainability and impact reports that are subject to review procedures conducted by an audit firm and which may be based on a framework, such as the SDGs. The staff is not taking a position with respect to the merit or efficacy of any of these frameworks.

[7] Advisers Act Section 206(4) and Rule 206(4)-1(a)(5) thereunder prohibit an investment adviser from, directly or indirectly, distributing advertisements that contain any misrepresentation of a material fact or are otherwise misleading. The staff notes that on December 22, 2020, the Commission finalized reforms to the advertising rule. *See* Final Rule: Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020). Among other prohibitions under the rule, an adviser may not include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading. The amended rule is effective on May 4, 2021, and has an eighteen-month transition period between the effective date and the compliance date. The staff anticipates that some advisers may seek to comply with the new marketing rule in advance of the compliance date. Investment Company Act Section 34(b) similarly makes it unlawful for any person to make untrue statements of material fact, or omit material information necessary to make other statements not misleading in registration statements, reports, and other documents filed with the Commission or otherwise provided to investors.

[8] *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release No. IC-26299 (Dec. 17, 2003). The Investment Company Act and Advisers Act require funds and advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws and the Advisers Act, respectively. *See* Investment Company Act Rule 38a-1 and Advisers Act Rule 206(4)-7.

global ESG frameworks. The staff noted, despite claims to have formal processes in place for ESG investing, a lack of policies and procedures related to ESG investing; policies and procedures that did not appear to be reasonably designed to prevent violations of law, or that were not implemented; documentation of ESG-related investment decisions that was weak or unclear; and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials. Below is additional information regarding these observations.

- *Portfolio management practices were inconsistent with disclosures about ESG approaches.* The staff observed portfolio management practices that differed from client disclosures in required disclosure documents (*e.g.*, Form ADV Part 2A)[9] and other client/investor-facing documents (*e.g.*, advisory agreements, offering materials, responses to requests for proposals, and due diligence questionnaires). For example, the staff noted lack of adherence to global ESG frameworks where firms claimed such adherence, and also observed fund holdings predominated by issuers with low ESG scores – as measured, for example, by a sub-adviser's proprietary internal scoring system – where such predominance appeared inconsistent with those firms' stated approaches.

- *Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions*. The staff noted weaknesses in policies and procedures governing implementation and monitoring of the advisers' clients' or funds' ESG-related directives. For example, the staff observed that advisers did not have adequate controls around implementation and monitoring of clients' negative screens (*e.g.*, prohibitions on investments in certain industries, such as alcohol, tobacco, or firearms), especially if the directives were ill-defined, vague, or inconsistent. Nor did advisers have adequate systems to consistently and reasonably track and update clients' negative screens leading to the risk that prohibited securities could be included in client portfolios. The staff also noted that client preferences to favor certain industries or issuers had not yet been effectuated because of challenges with implementation and monitoring, despite contrary marketing claims touting processes for implementing clients' positive screens.

- *Proxy voting may have been inconsistent with advisers' stated approaches.* The staff observed inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices. For example, the staff observed public statements that ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value, while internal guidelines generally did not provide for such case-by-case analysis. The staff also noted public claims regarding clients' ability to vote separately on ESG-related proxy proposals, but clients were never provided such opportunities, and no policies concerning these practices existed.

- *Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.* The staff observed unsubstantiated or otherwise potentially misleading claims regarding ESG investing in a variety of contexts. For instance, the staff noted marketing materials for some

[9] *See* Instructions to Form ADV Part 2A, including Item 8, regarding Methods of Analysis, Investment Strategies, and Risk of Loss.

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. The staff also observed unsubstantiated claims by advisers regarding their substantial contributions to the development of specific ESG products, when, in fact, their roles were very limited or inconsequential.

- *Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.* The staff observed inconsistencies between actual firm practices and ESG-related disclosures and marketing materials because of a weakness in controls over public disclosures and client/investor-facing statements. For example, the staff observed a lack of adherence to global ESG frameworks despite claims to the contrary, unsubstantiated claims regarding investment practices (*e.g.*, only investing in companies with "high employee satisfaction"), and a lack of documentation of ESG investing decisions and issuer engagement efforts. In addition, the staff observed failures to update marketing materials timely (*e.g.*, an adviser continuing to advertise an ESG investment product or service it no longer offered).

- *Compliance programs did not adequately address relevant ESG issues.* The staff observed that some firms substantially engaged in ESG investing lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight. For instance, the staff identified compliance programs that did not address adherence to global ESG frameworks to which the firms claimed to be adhering. The staff also noted a lack of policies and procedures to ensure firms obtained reasonable support for ESG-related marketing claims, and observed inadequate policies and procedures regarding oversight of ESG-focused sub-advisers. Firms also had difficulties in substantiating adherence to stated investment processes, such as supporting claims made to clients 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.

- The staff also observed that compliance programs were less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions. For example, compliance controls and oversight for reporting to sponsors of global ESG frameworks and responses to requests for proposals and due diligence questionnaires appeared to be ineffective. In addition, the staff noted weaknesses in 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.

IV. Staff Observations of Effective Practices

Although the staff observed compliance deficiencies and weaknesses relating to ESG investing during these examinations, the staff also observed that some investment advisers and funds had in place disclosures that accurately conveyed material aspects of the firms' approaches to ESG investing. Also, some firms maintained policies, procedures, and practices that appeared to be

reasonably designed in view of their particular approaches to ESG investing. Advisers and funds may find these practices helpful in addressing the compliance issues identified above.
Below are a sample of practices the staff observed.

- *Disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices.* More specifically, the staff observed:

    - *Simple and clear disclosures regarding the firms' approaches to ESG investing*, such as where advisers prominently stated, among other communications, that for separately managed client accounts, their ESG investing approach involved relying on unaffiliated advisers to conduct the underlying ESG analysis and allocating client assets among ESG-oriented mutual funds managed by those unaffiliated advisers. The staff also noted clear disclosures in client-facing materials where clients were offered choices among standardized portfolios focused on particular ESG issues, or alternatively, customized separately managed accounts designed to accommodate particular client preferences.

      ESG factors that could be considered alongside many other factors. For example, the staff observed that firms could still satisfy the requirements of certain global ESG frameworks while making investments that appeared to be inconsistent with ESG investing. Clear and prominent disclosures regarding such practices served to notify clients and investors that adherence to certain global ESG frameworks did not necessarily alter long-standing and seemingly contrary investment strategies.

    - *Explanations regarding how investments were evaluated using goals established under global ESG frameworks.* The staff observed, for example, investment statements posted on adviser websites, client presentations, and annual reports detailing how firms approached the U.N.-sponsored Principles for Responsible Investment or Sustainable Development Goals, including quantitative information on the local impacts of investments.

- *Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices*. In particular, the staff noted 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). The staff observed that these types of detailed, comprehensive investment policies and procedures resulted in contemporaneous documentation of the ESG factors considered in specific investment decisions. Furthermore, 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.

- *Compliance personnel that are knowledgeable about the firms' specific ESG-related practices.* The staff observed that, where compliance personnel were integrated into firms' ESG-related processes and more knowledgeable about firms' ESG approaches and practices, firms were more likely to avoid materially misleading claims in their ESG-related marketing

materials and other client/investor-facing documents. The compliance personnel in these firms appeared to: provide more meaningful reviews of firms' public disclosures and marketing materials; test the adequacy and specificity of existing ESG-related policies and procedures, if any (or assess whether enhanced or separate ESG-related policies and procedures were necessary); evaluate whether firms' portfolio management processes aligned with their stated ESG investing approaches; and test the adequacy of documentation of ESG-related investment decisions and adherence to clients' investment preferences.

V. Conclusion

The Division encourages market participants promoting ESG investing to clients, prospective clients, investors, and prospective investors to evaluate whether their disclosures, marketing claims, and other public statements related to ESG investing are accurate and consistent with internal firm practices. Additionally, firms should ensure that their approaches to ESG investing are implemented consistently throughout the firm where relevant and are adequately addressed in the firm's policies and procedures and subject to appropriate oversight by compliance personnel. Lastly, firms should also consider taking steps to document and maintain records relating to important stages of the ESG investing process.

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.