Lowenstein Sandler

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SEC Highlights Need for Improvements in Investment Adviser and Private Fund ESG Policies, Procedures, and Practices

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What You Need To Know:

- **The SEC recently examined investment advisers, registered investment companies, and private funds that offer ESG products and services.**
- **SEC examinations resulted in finding inadequate and inconsistent firm ESG-related approaches, but also examples of successful firm approaches to ESG investing.**
- **When implementing ESG-related investment practices, firms must be consistent, clear, and transparent regarding their ESG-related investment goals.**

On April 9, 2021, the U.S. Securities and Exchange Commission (the SEC) released results from its recent examinations of particular investment advisers, registered investment companies, and private funds (the firms) that purport to offer environmental, social, and governance (ESG) products and services. The SEC observed a large discrepancy between the ESG-related disclosures of these firms and their adopted and implemented ESG practices. The SEC examinations found that firms undertake ESG practices for a variety of reasons, often believing investments with favorable ESG profiles may result in higher returns. However, the SEC found that once they do implement such ESG-related approaches, the firms lack the necessary internal controls and compliance programs to achieve consistency between their stated approaches and actual adherence to such approaches. Consequently, this inconsistency results in making unsubstantiated or otherwise potentially misleading claims about their ESG approaches to the firms' clients. In its findings, the SEC provided valuable insight into avoiding the pitfalls of implementing misleading ESG-related practices by highlighting the ESG-related strategies of firms that maintained clear, precise, and consistent ESG policies, procedures, and practices.

I. Firms Respond to Growing Demand for ESG-Related Investing

The SEC found that in recent years, there has been an increase in investor demand for ESG-related investment products and financial services. Firms have responded by offering various ESG investment options, including registered investment companies and pooled investment vehicles (funds) that focus on incorporating ESG factors into their investment decisions. For example, the SEC found that some ESG funds select companies that have demonstrated a commitment to a particular ESG factor, such as minimizing their environmental impact, while other funds attempt to engage with companies with a goal of improving specific ESG-related practices. The SEC found that these firms have focused on various ESG themes, including sustainability, climate, and faith-based investing.

The SEC explained that one result of this rapid increase in investor demand for ESG-related investment products and financial services is increased diversity of ESG products and services. This diversity reduces standardization of ESG-related approaches and, consequently, enhances risks that clients and investors face when investing in such firms. In particular, the SEC found that firms may define the same ESG-related concepts differently, resulting in confusion for investors who may not understand the specific manner in which particular firms articulate ESG-related concepts and terms. The SEC explained that this confusion is exacerbated by inconsistencies between the firms' disclosed ESG investing processes or investment goals and their actual portfolio management policies, procedures, and practices.

II. SEC Examination Focus on Firm ESG Practices

The SEC has focused its examinations on the firms' ESG portfolio management, which includes firms' usage of ESG-related terminology, due diligence processes as they relate to the firms' disclosed ESG investing procedures, and proxy voting decision-making processes. Additionally, the SEC has reviewed the firms' advertising and marketing of their ESG policies, procedures, and practices, including without limitation a review of the firms' regulatory filings, websites, reports to sponsors of global ESG frameworks, and ESG-related communications to clients. Finally, SEC examinations have also entailed a review of the firms' compliance programs, including implementation of written policies and procedures, compliance oversight, and a review of ESG investing practices and disclosures.

III. SEC Examinations Have Resulted in Finding Inadequate and Inconsistent Firm ESG-Related Policies, Procedures, and Practices

In its review of the firms' ESG-related policies, procedures, and practices, the SEC found various violations of the Investment Advisers Act of 1940, as amended (the Advisers Act), including violations of Rule 206 of the act, which 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. More specifically, Rule 206(4) of the Advisers Act prohibits firms from misleading investors, such as by making false or misleading statements to existing or prospective investors in pooled investment vehicles. *The SEC found instances of potentially misleading statements regarding ESG investing processes, many of which resulted because firms falsely claimed to implement formal ESG processes when in reality they did not have any such ESG policies or procedures in place. The SEC highlighted these weak, unclear, and misleading practices, as well as a dearth of compliance programs to guard against misleading investors, in its findings listed below:

- Portfolio management practices inconsistent with disclosures about ESG approaches (e.g., lack of adherence to global ESG frameworks where firms claimed such adherence).
- Weak controls to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions (e.g., inadequate systems to consistently track and update clients' negative screens, leading to the risk that prohibited securities could be included in client portfolios).
- Inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices (e.g., ESG firms publicly stating that their 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).
- Unsubstantiated or otherwise potentially misleading claims regarding ESG investing in a variety of contexts (e.g., unsubstantiated claims by the firms regarding their substantial contributions to the development of specific ESG products, when in reality they had limited roles).
- Weak controls to ensure consistency between ESG-related disclosures and marketing of a firm's practices, and failures to make timely updates to marketing materials.
- Compliance programs that did not adequately address relevant ESG issues (e.g., compliance programs that did not address adherence to global ESG frameworks to which the firms claimed to be adhering).
- Weak compliance programs as a result of compliance personnel having limited knowledge of relevant ESG-investment analyses or minimal oversight over ESG-related disclosures and marketing decisions.

IV. SEC Examinations Resulted in Examples of Successful Firm Approaches to ESG Investing

The SEC found that some firms are successfully implementing ESG practices that could prove to be instrumental in addressing the compliance issues identified above. Below is a list of some of these successful ESG policies, procedures, and practices:

- Simple disclosures regarding the firms' approaches to ESG investing, including clear disclosures in client-facing materials.
- Ability to comply with requirements of certain global ESG frameworks while simultaneously making investments that could possibly be inconsistent with ESG investing.
- Evaluations of investments with global ESG frameworks.
- Clear policies and procedures that explicitly address ESG investing and cover key aspects of the firms' relevant practices.

*_See_ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019).

- Compliance personnel who are knowledgeable about the firms' specific ESG-related practices (e.g., an internal team to help firms avoid making misleading claims in their ESG-related marketing and to test the adequacy of existing ESG-related policies and procedures).

V. Takeaways

When implementing ESG-related investment policies, procedures, and practices, firms must be consistent, clear, and transparent regarding their ESG-related investment goals. They must strive to follow through in achieving these goals to raise investor confidence that their investments are being successfully managed by the firms. To avoid any discrepancy between their ESG-related disclosures and their implemented ESG practices, firms should consider adopting ESG-related strategies that are compliant with requirements of ESG global frameworks and employ internal monitoring systems, such as knowledgeable personnel who can monitor such compliance. For example, firms can consider the United Nations-supported Principles for Responsible Investment and the Sustainability Accounting Standards Board as bases for adopting successful ESG policies. Firms should also consider creating an ESG committee composed of personnel across departments at the firm to oversee the adoption of and compliance with the firm's ESG policies.

As the SEC made clear, ESG-related practices are becoming increasingly common with the rapid rise in investor demand for ESG-related investment products and financial services. Consequently, as the SEC recommended, firms that offer ESG investment options must ensure proper implementation of their ESG portfolio management, ESG-related communications to clients, and ESG compliance programs. When firms do implement such strategies, they should define their own metrics in their monitoring systems. For example, they should develop a framework to measure from both a general operating system perspective and an investment activity perspective whether a specific ESG policy was complied with. This framework should include clear and appropriately detailed instructions to employees for compliance with the firm's ESG policies.

Please contact one of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to designing and implementing effective ESG policies and disclosures.

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