

Regulatory Alert

Regulatory Insights



April 2021

SEC Examinations Risk Alert: Compliance issues in ESG investing

The release of this SEC Division of Examination Risk Alert dramatically increases the velocity with which compliance and controls must be expanded to cover ESG-related activity. Firms that engage in ESG investing should review their current compliance controls in light of the compliance weaknesses outlined by the SEC, with particular focus on the accuracy of ESG-related disclosures and marketing materials and their alignment with actual ESG investing practices. Consistent with the identified effective practices, firms may also want to consider establishing documentation and record keeping requirements at various stages of the investment process (e.g., research, due diligence, selection, and monitoring). As a general matter, firms should consider the Risk Alert as applying traditional core concepts such as accurate and meaningful disclosure, due diligence (including KYC and third-party oversight), and customer/investor protections in a new and increasingly prevalent area. Likewise, chief compliance officers must consider this alert as impacting the scope and nature—and accelerating the timeline of change—of the annual reviews under the Investment Company Act of 1940 and Investment Advisers Act of 1940.

KPMG is currently assisting clients with developing enhanced ESG-related compliance and controls and would welcome the opportunity to speak with you.

Key points

- The lack of standardized and precise ESG definitions and terms can create confusion among investors; SEC expects firms to clearly and consistently articulate how they define ESG and how they use ESG-related terms as well as to match their ESG claims with their ESG practices.
- SEC identified ESG investing as an examination priority in 2020 and 2021 with a focus on the consistency and adequacy of disclosures, consistency between disclosures and practices, alignment of proxy voting policies, procedures, and practices; and fairness of advertising statements.
- Deficiencies and internal control weaknesses observed in examinations of firms offering ESG products and services reflect a “disconnect” between ESG disclosures/claims and ESG practices.
- SEC states that it is not seeking to determine the merit of any ESG strategy but to ensure that firms adhere to their own ESG claims and investors understand what they are getting when they choose a particular adviser, fund, strategy, or product.

The Securities and Exchange Commission's (SEC) Division of Examinations has released a [Risk Alert](#) to

highlight observations, including deficiencies and internal control weaknesses, from recent examinations of investment advisers, registered investment

companies, and private funds (collectively, firms) offering ESG (environmental, social, and governance) products and services. The SEC states that the rapid growth in investor demand, increasing numbers of ESG products and services, and the lack of standardized and precise ESG definitions present “certain compliance risks.”

Examinations

The SEC’s examination priorities for 2020 and 2021 included a focus on ESG investing. Examinations are designed to evaluate whether firms are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices that are in accord with their ESG-related disclosures. Examinations of firms engaged in ESG investing focus on three broad elements:

- **Portfolio management**, including policies, procedures, and practices related to ESG and the use of ESG-related terminology; due diligence and other processes for selecting, investing in, and monitoring investments given the firm’s disclosed ESG investing approaches; and consistency between proxy voting decision-making processes and ESG disclosures and marketing materials.
- **Performance advertising and marketing materials**, including a review of regulatory filings; websites; reports to sponsors of global ESG frameworks (as appropriate based on a firm’s representations); client presentations; and responses to due diligence questionnaires, requests for proposals, and client/investor-facing materials.
- **Compliance programs**, including a review of written policies and procedures and their implementation, compliance oversight, and ESG investing practices and disclosures.

Observations

Deficiencies and weaknesses observed during examinations of firms engaged in ESG investing include:

- **Inconsistencies between portfolio management practices and disclosures about ESG approaches** in required disclosure documents and client/investor facing materials, such as a lack of adherence to global ESG frameworks where adherence was claimed.
- **Inadequate controls to maintain monitor, and update clients’ ESG-related investing directives**, resulting in prohibited securities being included in client portfolios (based on clients’ negative screens, such as a prohibition on investments in certain industries) or, alternatively, client preferences not

being effectuated (based on clients’ positive screens, such as favoring certain industries or issuers).

- **Inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices**, finding that the public claims were not supported by practice.
- **Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches**, such as overstating risk, return, and correlation metrics by not disclosing certain expense reimbursements.
- **Inadequate controls to ensure consistency between ESG-related disclosures and marketing materials and practices**, including failures to update marketing materials on a timely basis; findings of inconsistencies regarding adherence to global ESG frameworks; unsubstantiated claims regarding investment practices; and documentation of ESG investment decisions.
- **Inadequate compliance programs that do not fully address relevant ESG issues**, finding inadequately trained staff lacking relevant ESG knowledge and inadequate policies and procedures regarding: ESG investing analyses; decision-making processes; substantiation of stated investment processes; compliance review and oversight, including oversight of sub-advisers; and support for ESG-related marketing claims.

Effective practices

Observed compliance practices that the SEC believes may be helpful in addressing the identified deficiencies and weaknesses include:

- **Clear and precise disclosures tailored to a firm’s specific approaches to ESG investing and aligned to a firm’s actual practices**. Such disclosure also would include an explanation regarding how investments were evaluated using goals established under global ESG frameworks.
- **Comprehensive policies and procedures on ESG investing that cover key aspects of relevant practices**, including specific documentation requirements by investment stage (e.g., research, due diligence, selection, and monitoring).
- **Knowledgeable compliance personnel that are integrated into ESG-related processes**. Examiners found that more knowledgeable personnel appeared to: provide more meaningful reviews of public disclosures and marketing materials; test the adequacy and specificity of existing ESG-related

policies and procedures; evaluate whether 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.

SEC disclaimer

The SEC states that it does not opine on the merits of ESG investing in general or on any particular ESG approach, whether any particular ESG methodology should be employed or avoided to satisfy fiduciary obligations, or whether certain ESG practices should be encouraged or dissuaded. The SEC further states that its interest in the accuracy and adequacy of disclosure provided by advisers and funds offering ESG investment strategies is the same as it would be for offering any other type of investment strategy.

Commissioner's public statement

Following release of the Risk Alert, SEC Commissioner Hester Peirce issued a [public statement](#) characterizing it as "a useful tool for firms that sell ESG products and services and a useful protection for the investors that buy them." She highlighted the following points:

- The issuance of an ESG-specific risk alert should not be interpreted as a sign that ESG investment strategies are unique in the eyes of examiners.
- The SEC's role is not to assess whether any particular investment strategy is a good one, but to

ensure that investors know what they are getting when they choose a particular adviser, fund, strategy, or product.

- Proxy voting, when such authority is undertaken on behalf of the client, is subject to advisers' fiduciary duty and must be undertaken in the client's best interest.
- The staff's role is not to second-guess investment decisions through an SEC-created ESG scoring system; rather, it is to understand whether firms are adhering to their own ESG claims.

SEC's dedicated web page for the SEC response to Climate and ESG risks and opportunities, including announcements of its Climate and ESG Task Force in the Division of Enforcement, and Investor Bulletin on ESG Funds, is available [here](#).

For continued insight on ESG-related industry and regulatory developments, please visit our new [KPMG IMPACT website](#) and subscribe to our ESG Alerts.

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