ESG Issues Become Leading Concern for SEC and CFTC: SEC Warns Investment Advisers and Funds About ESG Disclosures

April 27, 2021

Recent initiatives by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) evidence the agencies' increasing intent to play significant roles in the ESG space.

On April 9, the Division of Exams (Exams) published an ESG Risk Alert (Risk Alert), describing areas where it is focusing in examinations of investment advisers' and funds' ESG products and services. Separately, on March 17, Rostin Behnam, Acting Chair of the CFTC, announced the establishment of the Climate Risk Unit (CRU) "to support the [CFTC's] mission by focusing on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy."

The SEC's Risk Alert is premised on its observation that, in recent years, investor demand has driven the offering of various ESG options, including registered investment companies and pooled investment vehicles, as well as separately managed accounts. The Risk Alert gives examples of what Exams considers to be deficient ESG-related compliance programs and disclosures by advisors and funds in connection with such offerings. Exams also provides examples of what they consider to be effective ESG compliance and disclosure practices.

The CFTC's CRU imitative, on the other hand, is not directed at any particular segment of CFTC registrants. Rather, it is meant to "accelerate early CFTC engagement in support of industry-led and market-driven processes in the climate — and the larger ESG — space critical to ensuring that new products and markets fairly facilitate hedging, price discovery, market transparency, and capital allocation."

Key Takeaway for SEC-Registered Funds and Advisers: Most of the observations in the Risk Alert are not unique or even new to ESG investing. Essentially, the messages in the Risk Alert are simple:

- Disclosures made by advisers and funds regarding investing should match their actual investment processes and practices; and
- Marketing materials should not contain false or misleading statements regarding ESG investing or otherwise.

As noted in the Risk Alert, "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 . . . . *Actual portfolio management practices of investment advisers and funds should be consistent with their disclosed ESG investing processes or investment goals.*"

The CFTC's CRU initiative follows publication of the CFTC's Market Risk Advisory Committee's Climate-Related Market Risk Subcommittee's September 2020 report on "Managing Climate Risk in the U.S. Financial System" (the Report). The publication of the Report marked the first time a US financial regulator released a report or statement that highlighted the risks of climate change from a financial stability perspective.[1]

Background

The Risk Alert follows a number of other ESG-focused initiatives by the SEC.

For example, on March 4, the SEC announced the creation of a Climate and ESG task force under the purview of the SEC's Division of Enforcement that will, among other things, "analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies." Also, on March 3, Exams identified ESG issues as a 2021 exam priority for investment advisers and investments.[2]

On April 12, SEC Commissioner Hester M. Pierce issued a public statement responding to the release of the Risk Alert, noting that "[a]s with many other ESG-related matters, this risk alert raises questions of its own . . . ." She also stated that ESG strategies are not unique in that "advisers and funds should not make claims that do not accord with their practices, and our examiners will be looking for that consistency between claims and practice. Our examiners are not—and will not be in this space—merit regulators. The SEC's role is not to assess whether any particular 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."

Deficiencies and Weaknesses Noted in the Risk Alert

In the Risk Alert, Exams provided the following as examples of weak or deficient practices, among others:

- **Portfolio management practices that were inconsistent with disclosures about ESG approaches.** This included firms saying they followed global ESG frameworks but did not actually follow the framework. Exams also found portfolio 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 that were inadequate to maintain, monitor and update ESG-related investing guidelines, mandates and restrictions.** Examples included advisers not having adequate controls to implement or monitor clients' negative screens (typical negative screens prohibit investments in certain industries, like alcohol, tobacco, or firearms). Exams observed that this was an issue, particularly where client directives were ill-defined, vague or inconsistent.
- **Proxy voting that is inconsistent with the advisers' stated approaches.** Exams is focused on proxy voting policies and procedures and will assess whether proxy votes align with an investment adviser's ESG strategies. In the Risk Alert, Exams called out firms for saying that "ESG related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value" when, in fact, their internal guidelines did not provide for a case-by-case analysis and for "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 potentially misleading claims regarding ESG approaches.** As an example, Exams pointed to "claims by advisers regarding their substantial contributions to the development of specific ESG products," where the firms' roles were, in fact, very limited or inconsequential.

1 https://katten.com/a-call-to-internalize-greenhouse-gas-cost-externalities-cftc-subcommittee-publishes-first-of-its-kind-report-regarding-climate-changes-impact-on-financial-markets

2 https://katten.com/esg-is-in-the-sec-house-sec-exams-enforcement-and-regulations-are-coming

- Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firms' practices. Exams pointed to firms not adhering to global ESG frameworks despite claims to the contrary and firms making unsubstantiated claims regarding investment practices, like saying they invest only in companies with "high employee satisfaction."
- Compliance programs that did not adequately address relevant ESG issues. Exams found that some advisers lacked policies and procedures to address their ESG investing analyses, decision-making processes, or compliance review and oversight. Examples included compliance programs that did not address adherence to global ESG frameworks, to which the firms claimed to be adhering, and inadequate policies and procedures regarding oversight of ESG-focused sub-advisers.
- Compliance personnel had limited knowledge of relevant ESG-investment analyses or oversight over ESG-related disclosures and marketing decisions. Exams referenced ineffective compliance controls and oversight for reporting to sponsors of global ESG frameworks and responses to RPPs and due diligence questionnaires.

Effective Compliance and Disclosure Practices in Risk Alert.

Some examples of effective practices identified in the Risk Alert were having:

- Simple and clear disclosures regarding, and tailored to, firms' approaches to ESG investing.
- Policies and procedures that addressed ESG investing and covered key aspects of firms' ESG investment practices, including specific documentation to be completed at various stages of the investment process (e.g., research, due diligence, selection, and monitoring), which results in contemporaneous documentation of the ESG factors considered in specific investment decisions. (Interestingly, the Risk Alert noted that, where multiple ESG investing approaches were employed at the same time, "separate specialized personnel provided additional rigor to the portfolio management process").
- Compliance personnel that are knowledgeable about firms' specific ESG-related practices.

The CFTC's CRU Imitative

The CFTC's CRU will be comprised of staff from across the CFTC's operating divisions and offices and "represents the [CFTC's] next step in response to what has become a global call to action on tackling climate change."
In addition to conducting research and engaging in outreach with relevant market participants and other stakeholders, the CRU may engage in discussions with exchange, clearinghouses and market participants related to new and emerging risks prompted by climate change and assist efforts to encourage the creation of "relevant and reliable climate-related market risk data resources."

What Funds and Advisers Should Do Now

The SEC's focus on ESG investing is clearly not going away anytime soon and will most likely intensify. Firms and their compliance professionals should carefully review, and revise as appropriate, their policies, procedures and practices, including ESG disclosures in marketing materials, Forms ADV, fund offering documents and advisory agreements, along with reviewing their ESG proxy voting practices.

The full SEC Risk Alert is available here.

The CFTC announcement regarding creation of its CRU is available here.

CONTACTS

For more information, please contact Katten's Financial Markets and Funds practice or any of the Katten attorneys identified on this advisory to assist your firm in these matters:

Mark D. Goldstein
+1.212.940.8507
mark.goldstein@katten.com

Henry Bregstein
+1.212.940.6615
henry.bregstein@katten.com

Wendy Cohen
+1.312.902.5372
wendy.cohen@katten.com

Gary DeWaal
+1.212.940.6558
gary.dewaal@katten.com

Jack P. Governale
+1.212.940.8525
jack.governale@katten.com

Allison Yacker
+1.212.940.6328
allison.yacker@katten.com

Lance Zinman
+1.312.902.5212
lance.zinman@katten.com

Katten katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

4/27/21