Private Equity Regulatory Update

May 27, 2021

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Industry Update

The SEC Division of Examinations Issues Risk Alert Regarding ESG Investing

Introduction

In a Risk Alert dated April 9, 2021, the SEC's Division of Examinations (the "**Division**") noted increasing investor demand for products that incorporate environmental, social, and governance ("**ESG**") values, while firms that offer ESG products and services vary in how they incorporate ESG considerations in their investment decisions. The Division noted that growth in consumer demand for ESG products, the corresponding increase in the number of ESG products offered, and lack of standardization in ESG definitions collectively present certain investing risks. For example, the lack of consistency with which firms use ESG terms can lead to confusion among investors.

Examinations of Investment Advisers and Funds

According to the Risk Alert, the Division has examined, and will continue to examine, how accurately firms disclose their ESG investing approaches. Such examinations include the following considerations:

- *Portfolio management*. Examinations will include a review of the firm's policies related to ESG, the firm's use of due diligence in selecting investments given its ESG policies, and whether a firm's proxy voting decision-making processes are consistent with its ESG disclosures.
- *Performance advertising and marketing*. Examinations will include a review of a firm's published information (including its regulatory filings, websites, and other sources), including its marketing materials.
- *Compliance programs*. Examinations will include a review of the firm's ESG policies and procedures and their implementation.

Staff Observations

During such examinations, the Division has observed instances of potentially misleading statements regarding ESG investing processes. Such observations included the following:

- *Portfolio management practices were inconsistent with disclosures about ESG approaches*. For example, some firms claimed in their marketing materials to adhere to ESG frameworks but the Division found that such firms did not indeed adhere to such frameworks. The Division also observed firms holding issuers with low ESG scores, despite stated investing approaches to the contrary.

- *Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions*. For example, some firms apply negative screens to investments: they exclude issuers that have certain negative ESG characteristics. However, the Staff observed that some of those firms did not have adequate controls to implement clients' negative screens (e.g., prohibitions on investing in alcohol, tobacco, or firearms industries), or to stay up to date on clients' changing screens. Notably, the Staff observed instances where firms had not yet implemented clients' positive screens (i.e., making certain investments with issuers that have desirable ESG characteristics), despite firms' marketing claims to the contrary.
- *Proxy voting may have been inconsistent with advisers' stated approaches*. For example, firms made claims that ESG-related proxy proposals would be internally evaluated on a case-by-case basis, but had no policies that provided for such analysis. Additionally, firms made claims that clients could vote separately on ESG-related proxy proposals, but offered no such opportunities.
- *Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches*. The Staff observed inflated returns for ESG-oriented funds and exaggeration of firms' contributions to the development of certain ESG products.
- *Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices*. For example, the Staff observed false claims of adherence to certain ESG investing practices, a lack of documentation on ESG investing decisions, and failures to update marketing materials in a timely fashion.
- *Compliance programs did not adequately address relevant ESG issues*. For example, the Staff noticed compliance programs that did not address a firm's adherence to ESG frameworks, despite firms' claims to the contrary. The Staff also noted firms' inability to substantiate ESG-related marketing claims and to oversee sub-advisers' activities.
- The Staff noted that compliance programs were less effective when compliance personnel had limited knowledge or oversight of ESG-related disclosures and decisions.

Staff Observations of Effective Practices

Some best practices that the Staff observed include the following.

- *Disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices*. The Staff observed some disclosures that were simple and clear, such as when firms prominently stated that their ESG investing approach involved relying on unaffiliated advisers to do the vetting, when firms offered choices among standardized ESG-friendly portfolios, and when firms disclosed clearly that some of their investments that appeared inconsistent with ESG directives could still satisfy global ESG frameworks. The Staff also observed some instances of clear explanations regarding how firms evaluated investments with regard to ESG objectives, including by publishing quantitative information regarding the impacts of their investments.
- *Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices*. When firms had ESG policies and procedures that dictated that specific documentation be completed at various stages in the investment process (e.g., research, due diligence, selection, and monitoring), the Staff noticed that it led to the creation of documentation and added rigor in the portfolio management process.
- *Compliance personnel that are knowledgeable about the firms' specific ESG-related practices*. When compliance personnel were more integrated into the firm's ESG-related investment

practices, firms were more likely to avoid materially misleading ESG-related claims in their marketing.

Conclusion

The Division encourages market participants to evaluate whether their public statements related to ESG investing are accurate. Firms engaged in ESG investing should ensure that their policies and procedures include such directives, are implemented consistently throughout the firm, and are subject to appropriate oversight. Finally, the Division encourages firms to strive to document important stages of the ESG investing process.

- **See a copy of the Risk Alert**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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