InteractiveBrokers

SPOTLIGHT ON

Discussion on the SEC's ESG RISK ALERT
released in April 2021.

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Earlier this year, the Division of Examinations released a Risk Alert discussing the Commission's observations which arose from examinations of investment advisers, registered investment companies, and private funds, offering environmental, social, and governance ("ESG") products and services.[1] First, this Spotlight will discuss the items that were highlighted in the Alert. Second, it will offer some general concepts that may guide investment advisers as they draft ESG disclosures and implement relevant policies.

Portfolio management—Adviser disclosures vs. actual practices.

The Division discovered that investment advisers' portfolio management practices are not always consistent with the advisers' ESG disclosures.[2] In other words, certain investment advisers express what they intend to do in practice, yet they do not actually manage portfolios in a manner that aligns with their ESG disclosures and marketing materials. Division staff found that advisers' Form ADV Part 2A, advisory agreements, offering materials, etc., claimed to comply with global ESG frameworks, when in fact, examinations identified practices that did not adhere to said frameworks.[3] Furthermore, the constant shift in climate-related risks that advisers consider as they manage portfolios may cause advisers to develop exhaustive ESG disclosures, however, the Division emphasized that advisers should implement simple and clear disclosures regarding the firms' approaches to ESG investing.[4] If the disclosures are extensive, firms should be prepared to show that its practices live up to the expectations they have memorialized. The Division offered the following examples of practices that were deemed to be simple and concise during examinations:

- Where advisers managed separately managed accounts, the advisers prominently stated that their ESG investing approach involved reliance on unaffiliated advisers to conduct the underlying ESG analysis and allocation of client assets among ESG-oriented mutual funds managed by those unaffiliated advisers.

[1] Risk Alert, The U.S. Securities and Exchange Commission, *The Division of Examinations' Review of ESG Investing* Apr. 9, 2021, https://www.sec.gov/files/esg-risk-alert.pdf.
[2] *Id*. At 2.
[3] *Id.* At 4.
[4] *Id*. At 6.

- Clients were offered choices among standardized portfolios focused on particular ESG issues, or alternatively, customized separately managed accounts designed to accommodate particular client preferences.

The Division found instances whereby firms maintained public facing materials stating that the firm's "ESG-related proxy proposals would be independently evaluated internally on a case-by-case basis to maximize value," however, such case-by-case analysis was generally not provided for internally.[5] Additionally, the Division observed public facing statements that clients would be able to vote separately on ESG-related proposals, yet clients were not actually provided the opportunity to do so, and worse, no internal policies existed on the topic.[6]

The uncertainty surrounding how to draft ESG disclosures arises from the fact that there are no ESG disclosure requirements to look to. While there are several reasons why the SEC has not promulgated ESG disclosures, one of the major factors that seems to be behind the hesitation to impose them, is the fact that ESG considerations are dependent on climate-related issues. Scientists' projections of the physical risks that climate-related issues pose on companies are changing at a speed that does not lend well to SEC rule-writing.[7] Generally, the rule-making process is quite slow. Therefore, by the time ESG disclosure requirements could potentially be instated, they would likely conflict with the state of environmental considerations. Consequently, investment advisers that monitor the SEC's commentary surrounding these issues will likely implement effective compliance programs despite the absence of ESG investment compliance requirements.

ESG strategy performance: advertising and marketing considerations.

ESG strategies are not frequently based on economic considerations, however, many companies believe that ESG factors do impact investment performance. For example, if companies pay more attention to environmental considerations, such companies may avoid environmental liabilities, litigation, or regulatory action.[8] These companies' reputations are likely to improve, impacting investment trends. These considerations are also shared by investment advisory firms. Some advisers may implement an ESG investment strategy that excludes certain investments considered environmentally unfriendly. Others may implement a strategy that aims to cause

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[5] *Id*. At 4.
[6] *Id*. At 4.
[7] Commissioner Elad L. Roisman, *Can the SEC Make ESG Rules that are Sustainable?* Washington, D.C. (2021), https://www.sec.gov/news/speech/can-the-sec-make-esg-rules-that-are-sustainable.
[8] Thomas P. Lemke & Gerald T. Lins, *Socially responsible investing*, *in* REGULATION OF INVESTMENT ADVISERS 158 (2021).

societal conditions to improve, whereby the firm monitors metrics that measure the non-economic benefits that arise as the strategy is implemented.[9] As advisers strive to convey how their strategy takes advantage of ESG considerations, they should err on the side of caution. Advisers should maintain well-documented records of how they measure the performance that arises from the impact of their ESG approach.

Some of the items that the Division's staff review during advisory firm examinations are: regulatory filings; websites; reports to sponsors of global ESG frameworks (if firms have conveyed to its clients that the firm intends to abide by such framework); client-facing materials; and responses to due diligence questionnaires. Advisers Act Section 206(4) and Rule 206(4)-1(a)(5) prohibit an investment adviser from, directly or indirectly, distributing advertisements that contain any misrepresentation of a material fact or are otherwise misleading. With that said, if an investment adviser firm notices that their ESG approach is the direct cause of an improvement in performance, they often wish to make consumers aware of such occurrence, in hopes of attracting more clientele. Where advisers fall short of complying with the SEC's marketing and advertising rules, is when they make such statements without:

- Stating the specific time periods that the performance results cover;
- Stating gross performance, without also presenting net performance subject to certain conditions; or
- Providing, or offering to provide promptly, the performance results of a portfolio in its entirety.[10]

Advertising that includes performance data, without more, is likely to be considered misleading because investors have little to look to as they consider the weight of such performance. If an advertisement's claim that performance of an ESG strategy has improved is not substantiated by other data that the marketing rules point to, i.e., a specific time-period, an investor may be misled to think that the advertised performance data is indicative of current or future performance.

By the same token, the Division discourages investment advisers from producing marketing materials which solely claim that an adviser firm's strategy considers ESG factors. The Division praised advisers that provide investment statements posted on adviser websites, client

[9] *Id*. At 158.

[10] This is not an exhaustive list of the marketing and advertising rules as they pertain to disclosing performance results. The amended marketing rule became effective on May 4, 2021, with a compliance date set for November 4, 2022, giving advisers plenty of time to become compliant with the amended rule. Advisers can adjust their practices to become compliant at any time following the effective date, even prior to the compliance date.

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.[11]. The crux to the Divisions' praise of implementation of such principles has to do with the idea that the SEC seeks to ensure that consumers are informed, thus bettering their opportunity to make sensible decisions prior to entering into an engagement with an adviser. By offering explanatory dialogue that examines adviser firms' practices and applicable U.N.-Sponsored Principles, firms ensure that consumers are provided with more information, enhancing their understanding of the firm's practices.[12] The Division observed that the inconsistencies between actual firm practices and ESG-related disclosures and marketing materials arose due to the lack of controls over client/investor-facing statements. Investment advisers are encouraged to implement procedures that require personnel to monitor marketing materials and to pull advertisements from the public eye when a particular ESG investment product ceases to actually be offered by the firm.[13]

ESG ELEMENTS OF COMPLIANCE PROGRAMS

The Division asserts that, although some firms take part in a considerable amount of ESG investing, they lacked policies and procedures addressing their ESG investing analyses, decision-making processes, or compliance review and oversight. The Division points out that firms' compliance programs should contain components dedicated to substantiating how the firm is adhering to global ESG frameworks if the firm has already stated that it shall adhere to such framework in client-facing materials, such as the Form ADV Part 2A, "Brochure."[14]

The Division staff also found that compliance programs were weaker where personnel had little knowledge of relevant ESG oversight.[15] In contrast, the staff observed that firms that prepare their compliance personnel to be well versed in their firm's ESG approach were more likely to avoid making materially misleading statements in ESG-related client-facing documents.[16]

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[11] Risk Alert, *supra* note 1, at 6.
[12] Although the Division mentions global ESG frameworks in its ESG Risk Alert, understand that the Division is not upholding any global ESG frameworks as rules that advisers must adhere to.
[13] Risk Alert, *supra* note 1, at 5.
[14] *Id*. At 5.
[15] *Id*. At 5.
[16] *Id*. At 7.

The Division highlighted firms that implement the following practices in their compliance programs:[17]

- 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;
- 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.

AT THE HEART OF THE MATTER

Those responsible for identifying how ESG factors are to be reflected in a firm's disclosures, investment strategy, or its compliance program, should not interpret the issuance of an ESG-specific risk alert as indicia that ESG investment strategies are somehow unique from an examiner's perspective.[18] Nor should a firm interpret the Risk Alert to impose an obligation to create a separate and distinct ESG compliance program.[19] Instead, investment advisers' policies and procedures should be crafted based on the firms' investment strategies, whether they have to do with ESG or not.[20] Once a firm determines how ESG factors are intertwined with their business model, the firm may draft its client-facing materials with certain concepts in mind. Such concepts are discussed below and should be applied throughout the drafting process no matter what the firm's strategy may entail.

MATERIALITY AS A GUIDEPOST

[17] *Id*. At 7.
[18] Commissioner Hester M. Peirce. *Statement on the Staff ESG Risk Alert*. (2021), https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert.
[19] *Id.*
[20] *Id.*

In developing any ESG related disclosures, investment advisers should continue to consider the historic approach to drafting any disclosure by considering the information that is material to an investment decision.[21] The SEC's instructions on how to draft a firm's Form ADV Part 2A, Brochure and Brochure Supplement direct investment advisers, as fiduciaries, to make full disclosure to their clients of all material facts relating to the advisory relationship.[22] SEC Rule 405 states that "[t]he term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." When an investment adviser seeks to draft disclosures that describe its ESG investment strategies, disclosing material information arising from the strategy should be the goal.

In the 1970s, the SEC considered requiring the disclosure of environmental issues and other societal concerns and underwent a review of many societal issues that were understood to be issues that investors took an interest in.[23] The SEC decided against requiring disclosure on any of the societal concerns at the time because "disclosure of comparable non-material information regarding each of these would in the aggregate make disclosure documents wholly unmanageable and would significantly increase the costs to all involved, without, in [its] view, corresponding benefits to investors generally."[24] However, the concept of materiality is meant to ensure that information required in a disclosure changes with time.[25] What may be considered material to an investor's decision-making process today, may not be considered material tomorrow. With that in mind, although ESG concerns may not have appeared worthy of disclosure in the 1970s, they certainly were by the time climate change gained attention in 2010.[26] The SEC did instruct companies to disclose information arising from climate-related issues at that point, if the information was considered material.[27]

PLAIN ENGLISH DISCLOSURES

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[21] Roisman, *supra* note 7.
[22] The Securities and Exchange Commission. *Uniform Requirements for the Investment Adviser Brochure and Brochure Supplement*: *General Instructions for ADV Part 2A,* at 1, https://www.sec.gov/about/forms/formadv-part2.pdf.
[23] Securities Act Release No. 5627, at 18 (Oct. 14, 1975).
[24] *Id.*
[25] *The Materiality Standard for Public Company Disclosure: Maintain What Works*, BUSINESS ROUNDTABLE 6 (2015), https://s3.amazonaws.com/brt.org/archive/reports/Materiality%20White%20Paper%20FINAL%2009-29-15.pdf.
[26] *Id*. At 7.
[27] *Id.* At 7.

No matter how common ESG investment strategies become, the SEC's instructions to use plain English in drafting an investment adviser's *Brochure* and *Brochure Supplement*, will remain the same. The SEC's instructions to draft an investment adviser's Form ADV Part 2 state that:

> in drafting [a firm's] brochure and brochure supplements, [a firm] should: (i) use short sentences; (ii) use definite, concrete, everyday words; (iii) use active voice; (iv) use tables or bullet lists for complex material, whenever possible; (v) avoid legal jargon or highly technical business terms unless [the firm] explain[s] them or [the firm] believe[s] that [its] clients will understand them; and (vi) avoid multiple negatives.[28]

Advisers should define terms that appear in their ESG disclosures, i.e., negative screening v. positive screening, and impact investing. Firms struggling to draft ESG disclosures in simple and concise terms, should look to the Office of Investor Education and Assistance's, Plain English Handbook (hereinafter the "Handbook"), for guidance. The Handbook's authors remind firms that writing in plain English does not mean ridding disclosures of technical information to make the document easier to grapple with. Investors are better prepared to make informed decisions if disclosure documents include complex aspects of an adviser's ESG investment strategy that are broken down and explained in plain English.[29] If an investment adviser adheres to an ESG framework that involves assigning ESG scores to investment products, then it is even more important to define each possible score under the applicable framework. Scoring is an aspect of various ESG frameworks, but scores vary greatly between frameworks, which ultimately confuses investors and decreases the level of insight that a score aims to provide.[30]

The SEC's Risk Alert on ESG Investing is one of six Alerts that have been issued this year. The Division of Examinations recognizes the ever-increasing demand for investment products that implement ESG factors. With such demand comes the risk that investment advisers use ESG-related terms inconsistently, leading to consumer confusion. The Division also highlighted effective practices that staff observed during examinations in order to assuage such confusion.

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[28] Commission, *supra* note 22, at 1, https://www.sec.gov/about/forms/formadv-part2.pdf.

[29] OFFICE OF INVESTOR EDUCATION AND ASSISTANCE, U.S. SECURITIES AND EXCHANGE COMMISSION, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 5 (1998), https://www.sec.gov/pdf/handbook.pdf.

[30] *What are the different ESG frameworks?* SOURCE INTELLIGENCE (Oct. 5, 2020), https://learningcenter.sourceintelligence.com/esg-frameworks.