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The SEC's ESG Risk Alert and the CFTC's New Climate Risk Unit

On April 9, 2021, the SEC's Division of Examinations (the "Division") published its [first risk](#) alert detailing deficient and effective practices among investment advisers and registered and private funds ("Firms") offering ESG strategies. The SEC is not alone in its focus on ESG matters as the CFTC and its [Climate Risk Unit](#) ("CRU") continue to assess the risks to U.S. financial stability posed by climate change.

The SEC Risk Alert

Based on Firm exams that began in 2019, the risk alert notes the "rapid growth in demand" for ESG services and products, the lack of "standardized" ESG definitions and terms and the wide variety of approaches to ESG investing that "can create confusion," particularly for retail investors. Generally, the guidance in the risk alert relates to the adequacy of compliance controls around ESG-related disclosures, marketing materials, and investment and proxy voting practices. *Exam Focus Areas* In its completed ESG-focused exams, and in those it will continue to conduct in keeping with its [2021 priorities](#), the Division's focus is on Firms' ESG-related:

- Portfolio management policies, procedures and practices, including terminology, investment due diligence and proxy voting.
- Performance marketing, including in regulatory filing disclosures, Firm websites, representations to global ESG framework sponsors, and client-facing materials.
- Compliance policies and procedures and whether they are adequate and effectively implemented and overseen.

Deficient and Effective ESG-Related Practices The shortcomings observed by the staff include inconsistency between Firms' public proxy-voting disclosures and actual proxy voting policies and practices. The staff also observed discrepancies between Firms' portfolio management and other practices and disclosures, marketing materials and other client-facing materials (such as offering documents, request for proposal responses and advisory agreements). On the other hand, the staff favorably observed Firms' clear and simple disclosures that aligned with Firm practices. Examples include reliance on third-party ESG scoring or investment analysis, the use of any global ESG framework, and consideration of ESG factors alongside other factors in investment decision making. The staff observed inadequate controls with respect to ESG-related investment "guidelines, mandates, and restrictions" and investment analyses, decision-making processes and compliance review and oversight, which may result from compliance personnel with limited knowledge of ESG investing. It also observed "unsubstantiated" and "potentially misleading" ESG claims, for example Firms inaccurately touting adherence to [UNPRI](#) or other global ESG framework principles or significant contributions to ESG product development. More approvingly, the staff highlighted Firms' detailed and comprehensive ESG-related investment policies and procedures that required documentation at each investment process stage. Similarly, the staff observed that knowledgeable compliance personnel well-schooled in Firms' ESG-related practices and approach were more likely to prevent misleading ESG-related claims, and also appeared to provide more meaningful reviews and testing of ESG-related policies and procedures and outward facing statements. In sum, as Commissioner Hester Pierce said in a follow-up [statement](#) to the risk alert, "Firms claiming to be conducting ESG investing need to explain to investors what they mean by ESG and they need to do what they say they are doing." Pierce also cautioned that 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."

The CRU

The new cross-division Climate Risk Unit at the CFTC will focus on "the role of derivatives in understanding,

pricing, and addressing climate-related risk and transitioning to a low-carbon economy." The March 2021 announcement of the CRU follows the September 2020 [report](#) of the Climate-Related Market Risk Subcommittee of the CFTC's Market Risk Advisory Committee. That report includes over 50 recommendations to mitigate the impact of climate risk on the financial markets. The CRU will tackle many of the report's recommendations, with an agenda that echoes the SEC's articulated ESG agenda and includes, among other potential action items:

- building "consistent standards, taxonomies, disclosures, and practices across derivatives products and markets;"
- developing and enforcing standards and policies; and
- accelerating "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."

Conclusion

These developments at the SEC and the CFTC preceded President Biden's [pledge](#) to halve U.S. carbon emissions by 2030. His announcement of the greenhouse gas reduction plan at the April 22-23, 2021 virtual [global climate summit](#) no doubt stokes the fire under the feet of the SEC and CFTC staffs. We'll keep you up to date as they keep moving.

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