Hedge Fund Law Report
An Acuris company

June 11, 2020

RESPONSIBLE INVESTING

OCIE's Targeting of ESG Investing Practices in Recent Examinations and What It Means for Hedge Fund Managers

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Environmental, social and governance (ESG) strategies are increasingly popular with investors and hedge fund managers. Thus, the SEC's Office of Compliance Inspections and Examinations (OCIE) stated that it plans to review ESG investing with "particular interest" as part of its 2020 Examination Priorities (OCIE Priorities).

In fact, OCIE's scrutiny of ESG investing may have already begun. A number of fund managers have reported receiving extensive document requests from OCIE – such as this sample version (Sample SEC Request) – about their ESG investing practices, including their disclosures, marketing, use of metrics, internal controls and other policies. In light of that scrutiny, fund managers must ensure that they know the risks associated with ESG investing and take steps to mitigate them.

To understand the scope of the SEC's efforts in this area to date and going forward, the Hedge Fund Law Report interviewed hedge fund practitioners advising managers with respect to recent OCIE exams that have covered ESG investing. This article analyzes the SEC's recent approach to ESG oversight, potential ESG-related risks for managers facing SEC scrutiny and steps managers can take to mitigate those risks in advance.

See "Focus Areas for Private Fund Managers From OCIE's 2020 Exam Priorities" (Feb. 27, 2020).

Adapting to ESG's Increasing Prominence

As record amounts of cash flow into ESG-focused strategies and new products proliferate, the SEC has been forced to acknowledge ESG's growing role in the investment landscape. "Unlike so many issues that arise in the U.S. and then get adopted elsewhere, it appears this issue is something that is being adopted in part by the SEC from what has already happened in Europe. As a result, we're seeing it develop quickly in the U.S.," opined Ropes & Gray partner Eva C. Carman.

Although ESG investing has undoubtedly increased in popularity, there has not been much enforcement in the area, as it is a relatively new focus of the SEC, according to Schulte Roth & Zabel partner Jennifer M. Dunn.

As part of ESG's growth, managers are gravitating to ESG frameworks, such as the United Nations Principles for Responsible Investing (U.N. PRI) or the Sustainability Accounting Standards Board (SASB). Although third-party guidance, standards and frameworks are important and good sources of information, Carman advised that the SEC may not expect managers to solely rely on them when designing and implementing their ESG policies.

"ESG is a front-of-mind topic for both public reporting companies and private fund managers, and it's no surprise that the SEC's examination function is looking at the potential risks created by the rising interest in that style of investing," said Akin Gump partner Peter I. Altman.

For more on the U.N. PRI or SASB, see "Regulators Are Focusing on Sustainable and ESG Investment" (May 7, 2020); and "Survey Identifies Drivers and Obstacles for Sustainable Investing" (Apr. 2, 2020).

SEC and ESG

The SEC mentioned investment advisers' ESG strategies as an area of emerging interest in its OCIE Priorities published in early January 2020. "OCIE has a particular interest in the accuracy and adequacy of disclosures provided by [investment advisers] offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate [ESG] criteria," according to the OCIE Priorities.

The SEC is trying to avoid advocating any particular brand of ESG investing. Instead, to better understand the state of ESG investing and ensure managers are being honest with their investors, OCIE is asking ESG-focused managers more questions about:

1. their ESG investment strategies;
2. related disclosures and marketing materials; and
3. their use of external standards and metrics.

By incorporating questions about ESG into its examinations, the SEC can address several goals at once, reasoned Proskauer partner Joshua M. Newville. OCIE can continue examining individual investment advisers, get a better handle on the state of ESG investing across the industry and look for problems that might be referred to the SEC's Division of Enforcement, he explained.

OCIE's biggest focus during examinations is likely to be on disclosures to investors, Newville posited. "The SEC's exam staff will primarily focus on what you've told clients you're going to do as far as responsible investing or ESG–focused strategies," he explained. "The second thing they will focus on is internal processes – whether you have sufficient policies, procedures and processes internally to monitor and adequately track internal decisions on ESG issues."

For general guidance, see "How Managers Can Navigate the Thin Line Between SEC Examinations and Enforcement" (Nov. 14, 2019).

Recent SEC Document Requests

Without taking a prescriptive approach to ESG, the SEC is trying to learn more about what investment advisers are actually doing in the space while also keeping an eye out for misleading or inadequate disclosures to investors.

"The examination process is being used by some offices at the SEC to see whether investment managers are doing what they're saying and saying what they're doing," observed Dechert partner Mark D. Perlow. "At the highest level, that's the thrust of the SEC document request letters."

In 2018 and 2019, the SEC issued a series of document requests to managers for additional information about their ESG practices and disclosures to investors. The document requests – reportedly coming from OCIE's office in Los Angeles – mix questions about ESG with more typical examination questions (*e.g.*, requests for an organizational chart; a list of current and former employees; etc.).

For additional background on SEC document requests, see our two-part series "Former OCIE Deputy Director Jane Jarcho Discusses the Relationship Between OCIE and Enforcement": Part One (Mar. 28, 2019); and Part Two (Apr. 4, 2019); and "How CCOs Can Use a Sample OCIE Information Request Letter to Improve Their Compliance Programs" (Jul. 25, 2019).

Focus on Definitions

The Sample SEC Request and other requests received by managers have asked several questions about how advisers define ESG or socially responsible investments (SRI) in the context of investments that were recommended to advisory clients.

Some of the SEC's requests regarding definitions include:

- the internal definition of any terms that relate to ESG or SRI that are also used in disclosure or marketing materials provided to prospective or current clients or investors;
- whether the adviser used a third-party definition for ESG or SRI;
- a list of each ESG or SRI factor used in investment decisions, with a description for each; and
- any written policies or procedures relating to how it weighed ESG or SRI factors before scoring or recommending an investment, along with any previous versions of those policies.

Those definitions can vary widely among ESG/SRI strategies, and organizations may differ on what investments they consider socially responsible. "ESG can encompass a variety of different things. Because of that, how it is applied in the private funds space – and especially by hedge funds in particular – can vary wildly from firm to firm," summarized Dunn.

See "Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of 'Doing Well by Doing Good'" (Mar. 21, 2019).

ESG Scoring, Benchmarks and Decisions

Recent document requests have included several questions about the benchmarks and metrics fund managers are using to guide ESG decisions, in addition to how those are manifesting in the actual ESG investments. Those include:

- whether managers are using proprietary or external benchmarks, as well as additional details related to their choices;
- whether managers pick investments based on any type of ESG scores, along with whether managers disclose those ESG scores to investors;
- how managers are ensuring compliance with their own internal compliance policies; and
- what are the profitability, impact and prestige results of the managers' ESG investments.

Internal Compliance

In addition to understanding a manager's ESG policy and how it is being applied, recent SEC document request lists have also included process questions about how managers are ensuring compliance with their ESG policies.

Items requested by OCIE in that category include:

- copies of periodic compliance or internal audit evaluations that assess the design or implementation of ESG/SRI investment policies;
- information about service providers that perform due diligence, screening or other services related to recommendations of ESG/SRI investments; and
- a list of ESG/SRI investments that were previously, but no longer, recommended, along with an explanation of why they are no longer recommended.

Profitability, Impact and Prestige

Finally, the SEC is asking about the results of ESG investments, including profits, impact statements and any ESG-related awards won by investment managers. Specifically, recent OCIE document requests have sought:

- a list of the three most profitable and three least profitable ESG/SRI investments offered to clients, along with relevant research and due diligence files;
- quarterly performance returns that quantify investment returns from ESG/SRI investments; and
- quantifiable non-financial performance metrics maintained by the manager (*e.g.*, carbon emissions reductions or quantifiable improvement in social or governance factors).

Questions about individual investments are unlikely to be used against a manager unless they reveal a disparity between the manager's results and what it tells its clients. "I don't think the SEC exam function is typically in the business of evaluating whether somebody made a good or a bad investment," opined Altman.

Instead, OCIE's evaluation will center around whether the manager invested in the types of investments in which it said it was going to invest. "You can imagine a scenario where somebody puts together an ESG fund and, for performance reasons, starts to drift away from that strategy in search of higher yields by moving into gray areas as to whether its investments fit within the disclosure it has previously given," explained Altman.

Finally, recent OCIE document request lists have also asked for examples of promotional materials related to ESG, including all pitch books, presentations and promotional materials that discuss ESG/SRI investments. In that vein, OCIE has also requested any awards or recognitions that managers have received related to ESG/SRI, as well as any communications to potential or current clients about those recognitions.

For more on measuring impact investments, see "The Death of Alpha: A True Challenge or a Poor Manager's Excuse? DMS Summit Discusses Alpha Generation, '2 and 20' Fees, AI and Impact Investing" (Apr. 12, 2018).

Implementing ESG Strategies and Associated Risks

Beyond the accuracy of their disclosures, hedge fund managers also face challenges when implementing ESG strategies. "Hedge fund managers are used to having broad mandates, and ESG, by its nature, requires you to narrow it. That can be a significant adjustment for a hedge fund manager," opined Dunn.

Managing Different ESG Strategies

More specifically, ESG strategies typically fall into three categories, and each carries its own disclosure-related risks:

1. negative screening (*e.g.*, refusing to invest in harmful industries);
2. factor-based approaches that weigh economic risk and opportunity; and
3. impact investing, which emphasizes non-financial goals.

For example, negative screening can seem simple on the surface, but implementation can raise a number of issues for fund managers to parse. That can include specifying clear processes for managers to evaluate investments that might fall into a grey area and considering if they have access to the necessary data to implement the desired screens.

Regardless of which ESG strategies they are pursuing, managers need to carefully craft their ESG policies and disclosures to leave themselves sufficient flexibility to make opportunistic investments, advised Newville. "Most managers want to have a decent amount of discretion," he observed. "Although you might have an ESG focus, you don't want to completely limit yourself so that every investment has to fit into a particular box."

Choosing the Right Metrics and Reporting

Metrics and benchmarks used for evaluating ESG investments are another risk area for managers. There are many competing frameworks for evaluating ESG factors, and the landscape continues to evolve. It is insufficient for managers to merely report their ESG efforts, as there are certain risks associated with how they position the impact of their investments. Managers should be careful about making claims that ESG factors will enhance returns or achieve a desired impact unless they are confident they have reliable data to back it up.

For hedge funds, there are numerous rating, data analytics and assessment tools that "provide managers with information to assess ESG factors at the companies they invest in," affirmed Carman. Dunn agreed and added that, even if a manager is using a rating agency, it needs to understand how the rating agency comes up with those ratings. Dunn also clarified that the manager needs to clearly explain how it takes a rating agency's rank into consideration and what it is doing with that data.

Providing Appropriate Disclosure

Because ESG definitions can be amorphous, managers must take extra care when describing their ESG strategies to current and potential investors. Although OCIE does not seem interested in prescribing a particular ESG approach, the SEC seems to want investors to be fully apprised of their managers' approaches to ESG.

Dunn clarified, "What the SEC focuses on is how have ESG strategies been explained to investors? Do investors understand what the manager is doing? And, are managers living up to their disclosures?" Managers need to "ensure that their disclosures match what they are actually doing."

Carman agreed and added that "it's important that a manager's policy reflect what is disclosed to the investors and that procedures be reasonably tailored to implement that policy." Also, Carman added that one way the SEC looks at mandates such as ESG investing is to assess whether managers "have made what the SEC considers to be any misrepresentations" in their disclosures.

Accessing ESG Data

Managers sometimes make investment decisions without the benefit of the detailed financial reporting that exists in public markets. Even where data exists, it may be hard to compare across investments, as ESG reporting may not be in the consistent format available for public companies.

For hedge funds that invest in public stocks, information is more readily available, and fund managers can generally rely on public disclosures, observed Newville. "People may disagree on this, but in my mind, unless there's some red flag or reason to question public statements, you can rely on them when deciding whether or not a particular investment fits within a strategy."

See our two-part series on ESG factors in hedge fund investing: "Past, Present and Future" (Nov. 10, 2016); and "Designing an ESG Investing Policy" (Nov. 17, 2016).

Takeaways for Managers

While ESG is a growing risk area in the SEC examination process, managers can use the Sample SEC Request as a compliance guide for future exams. Managers can protect themselves by being very clear with investors and taking steps to check their work before an SEC examination begins.

Managers should note that "there are a lot of other issues that the SEC is currently focused on as a result of the coronavirus pandemic disruption," observed Carman. ESG reviews "may take a bit of a backseat" during the current crisis, she added.

Tailor Policies and Procedures

"Building a compliance program that ensures compliance with ESG disclosures is crucial for fund managers," advised Dunn. Carman further advised managers to "work with counsel to develop appropriately tailored compliance programs that are aligned with their fund disclosures." During an ESG review, the SEC is likely to look "straight back to the policies and procedures and any fund disclosures."

Conduct Internal Audits

According to Dunn, managers should make sure that they are not only implementing their policies and procedures, but also revisiting them. Managers should periodically review their investment practices against their ESG disclosures and any external guidelines to which they subscribe to ensure they are reasonably aligned, advised Perlow.

In addition, managers that rely on external data – particularly external rating or scoring systems – should make an effort to understand the weaknesses or biases in the methodologies of those scoring systems, Perlow recommended. Managers should also be sure to communicate any limitations of external guidelines they use to their investors as part of their ESG disclosures, he advised.

"The SEC is looking at those," Perlow cautioned. "The Commission hasn't yet reached the phase where it is finding substantive problems, but that could very well be the next stage," he continued. "The way to get ahead of that particular set of issues is to ensure a reasonable level of material information about the scoring system is disclosed to investors, too."

Build on Existing Efforts

Although ESG is a relatively new priority for regulators, it is an area where the hedge fund industry has already been focused for some time and where many firms can leverage their existing ESG disclosures and practices during an examination.

"ESG is a trendy investment sector right now, but that's not to say it's new. There have been environmentally focused funds for a long time now," noted Altman.

Finally, it is worth noting that SEC examiners' questions in the area will likely have significant overlap with questions asked by investors or preexisting reporting frameworks (*e.g.*, the U.N. PRI). "The largest firms have very good disclosures and processes around them," noted Perlow. "They've been thinking about this issue for 10 years."

See "Four Essential Elements of a Workable and Effective Hedge Fund Compliance Program" (Aug. 28, 2014).

SEC Next Steps

Due to the lack of clear consensus on ESG investing in the U.S., there is a sense in the private funds industry that the SEC will move forward cautiously. Whatever course it takes in the future, the SEC will use its recent document requests for greater insight into the state of the hedge funds industry. Because the SEC has not announced a formal OCIE sweep of ESG issues, attorneys are unsure whether the regulator plans to issue a risk alert or other additional guidance to the industry in the near future. Risk alert or not, questions about ESG investing will remain for advisers in the space.