

# What is the Role of Compliance in ESG Investing?

---

By Beth Haddock



**About the Author:**

Beth Haddock is Managing Partner at [Warburton Advisers](#). She can be reached at [beth@warburtonadvisers.com](mailto:beth@warburtonadvisers.com).

## I. Introduction

The Securities and Exchange Commission (“SEC”) Division of Examinations’ (“DOE”), *Risk Alert: The Division of Examinations’ Review of ESG Investing* (Apr. 9, 2021) (“Risk Alert”) provides a strong starting point for firms involved in the Environmental, Social and Governance (“ESG”) investment process. Firms can benchmark their own programs to the strong and weak practices highlighted by DOE as they develop or refine their approaches to manage compliance risks related to ESG investments.

The Risk Alert is also an important signal to compliance officers that may risk potential personal liability and firm enforcement actions if they neglect developing ESG compliance policies and programs. For example, compliance officers can take this opportunity to adjust testing plans, if needed, to consider their firms’ compliance with ESG-related product, marketing and branding claims.

This article will cover two compliance officer practice management points: 1) how to design a risk-based compliance program (“Compliance Program”) to address this important priority and 2) how to approach a compliance testing program for firms that are either involved directly or indirectly in ESG investments.

## II. The Risk Alert

Understanding the practices identified in the Risk Alert should be a priority not only for ESG-focused firms, but also firms that offer third-party products such as ESG or impact funds, firms that seek to meet client investment profile requests for ESG sensitivity or targeted investment products and firms that brands their businesses as sustainable or impact-driven (collectively referred to as “ESG investing”). Each of these firms should consider the applicability of Sections II-IV of the Risk Alert with respect to (i) the role of compliance in monitoring the veracity of such ESG-related claims; and (ii) the risk that the designated chief compliance officer (“CCO”) will be vulnerable to personal liability if there is a “wholesale failure” to address ESG-fraud risks within the Compliance Program.<sup>1</sup>

Although hidden in a footnote of *Section II – Focus on Compliance Programs - 206(4)-7*, the Risk Alert highlights the importance of Compliance Programs and the DOE’s intent to review “written policies and procedures and their implementation, *compliance oversight*, and review of ESG investing practices and disclosures...” In *Section III – Observations about Compliance Programs and Compliance Officers*, the DOE appears to be directly linking the effectiveness of Compliance Programs to the adequacy of compliance officer knowledge of ESG investment processes.

The staff also observed that Compliance Programs were *less effective when compliance personnel had limited knowledge of relevant ESG-investment analyses* or oversight over ESG-related disclosures and marketing decisions. For example, compliance controls and oversight for reporting to sponsors of global ESG frameworks and responses to requests for proposals and due diligence questionnaires appeared to be ineffective.

Further, *Section IV - Observations of Effective Practices* identifies links between fraud prevention and compliance officer engagement in the ESG investment processes.

---

1. See NYC Bar Association [Committee Report: Framework for Chief Compliance Officer Liability in the Financial Sector](#); [WSJ article: Proposed Framework Aims to Guide Regulators in Decisions to Charge Chief Compliance Officers](#); [Litigation Opinions](#) (Personal liability of COO FINRA case upheld U.S Court of Appeals for DC on 10/23/2020); [Enforcement Manual](#).

The staff observed that, where *compliance personnel were integrated into firms' ESG-related processes* and more knowledgeable about firms' ESG approaches and practices, firms were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents.

As detailed below, this reference in Section IV is a helpful and timely reminder of the opportunity to distinguish the role of compliance with the aim to be *sufficiently engaged* to effectively provide regulatory advice and knowledgeable enough to test compliance, *but not to be so integrated* to create a conflict of interest and become an integral part of any operational investment processes. Compliance officers should be prepared to show sufficient independence if they are to effectively test and monitor adherence with a firm's policies and fiduciary duty to provide sound investment advice.

Compliance officers should be cautious when crafting their roles with respect to being integrated into any investment process as they may blur the important distinction between compliance and investment management and the well-known separate lines of defense.<sup>2</sup> For example, the importance of the distinction is highlighted in regulatory scrutiny of other investment processes such as the appropriate selection of mutual fund shares classes or private funds for investors or making a decision to show back-tested performance for an investment portfolio.<sup>3</sup> Likewise, the separation of functions and roles is considered when regulators and prosecutors assess the effectiveness of Compliance Programs.<sup>4</sup>

As shaped in part by the guidance provided in the Risk Alert and industry experience, the recommendations below are designed to assist compliance officers build effective programs to address ESG investment-related compliance gaps and/or to address concerns the investment team may not be able to achieve promised ESG performance.

### III. Compliance Program Design

Firms should consider adopting the following practices to help them assess whether their current programs adequately cover ESG investing and how to revise the programs, if warranted.

**Investment Committee, Product and Policies:** Compliance officers should consider whether their firms' investment policies and procedures adequately address this specialized investment class which suffers from inherent and well-known definitional and data credibility challenges.<sup>5</sup> Compliance officers could coordinate with the investment teams to better understand how they:

- determine whether they are qualified to provide ESG-investing advice vs. outsourcing and consulting with experts;
- conduct due diligence on ESG data providers, rating, scoring or other ESG-related technology and advisory service providers;
- document their initial and on-going assessments for ESG eligible investments;
- define ESG, impact and sustainable investing for clients of the firm whether it is using a private standard or standard set by the investment committee or board; and
- source and support claims in marketing and branding materials.

---

2. IIA Issues Important Update to Three Lines Model; Modernizing The Three Lines of Defense Model; Operational Risk White Paper.

3. Share Class Selection Disclosure Initiative; Private Fund Risk; SEC Adopts Modernized Marketing Rule for Investment Advisers; Interpretive Letter to Bradley J. Swenson, ALPS Distributors, Inc.

4. US Department of Justice Criminal Division Evaluation of Corporate Compliance Programs (Updated June 2020); DOJ Updates Guidance on the Evaluation of Corporate Compliance Programs; DOJ and SEC's Updated Guidance on Corporate Compliance Programs; The Role of the CCO – Empowered, Senior and With Authority; New Directions in Corporate Compliance: Keynote Luncheon Speech; and The Role of Chief Compliance Officers Must be Supported.

5. Improving ESG Data Quality and Frameworks.

**Compliance Manual and Training:** Compliance officers should consider whether it is helpful and prudent to add ESG investment-related examples to relevant sections of the compliance manuals such as sections covering 1) the purpose and duties of the investment committee and investment oversight procedures, 2) new product review processes, 3) portfolio guideline adherence and monitoring and 4) marketing standards.

Likewise, compliance officers should consider incorporating recent regulatory guidance such as the aforementioned SEC Risk Alert and/or financial news coverage to annual training content and the annual compliance report.

It is also important to consider the documentation to show that ESG investing constitutes an investment strategy which is owned by the investment experts and tested by compliance. By way of example, firms can adopt an ESG Policy Statement as required by some of the private ESG and impact standards.<sup>6</sup> Such policy statements should not be presented as compliance policies, just as an investment decision about recommending other products is not a compliance function. Rather, an ESG Policy Statement should be intended and designed to document investment expertise. Compliance's role, on the other hand, is to monitor and verify that the firm does what it says and says what it does.<sup>7</sup> Depending on the business model, compliance officers may want to explicitly highlight the distinction on delegation of duties charts, compliance manuals and/or codes of ethics.

#### IV. Compliance Risk Assessment and Testing Plan

**Risk Assessments:** Compliance officers are encouraged to review and explicitly cover ESG investing in assessments and testing plans. This is an opportunity to proactively manage a mock audit of a firm's ESG investing controls. Below are 7 recommended categories to consider in any such effort.

**Compliance Testing Plan:** Compliance officers should meet with the investment, finance, operations and marketing resources to consider accountability and support for any ESG investing claims, products and services. The 7 topics below can be used to start the conversation about accountability or to audit the strength of the firm's ESG-related internal controls.

1. *Written Policies:* Verify that the investment policies address ESG, impact and sustainability performance and service representations in product offering documents and client agreements. i.e., consider expansion of the investment committee process or best execution and proxy voting committee process to cover any such representations.
2. *Investment Process & Procedures:* Assess the relevance, completeness, reliability, neutrality and understandability of the investment procedures and designating a role for compliance to periodically test the correct application of the procedures as compliance may do for other investment topics such as best execution.
3. *Governance:* Assess, and designate if needed, specific accountability and ownership at the firm for defining, applying and enforcing the investment strategy and policies, i.e., consider adjustment to trade allocation, rebalancing practices and portfolio investment alert system for portfolio compliance.
4. *Financial Controls:* Verify the scope of covered assets managed within ESG investing mandates and confirm clear calculation of ESG and non-ESG regulatory assets under management (RAUM) to support any such claims.
5. *Disclosures & Conflicts:* Examine the integrity of the information and claims made in product and marketing materials including any conflicts between ESG investing claims

---

6. [Strategy, policy and strategic asset allocation; Impact Investing at IFC: What are the Impact Principles. The 9 Principles.](#)

7. [Statement on the Staff ESG Risk Alert.](#)

and business arrangements, operational and investment priorities and due diligence results for assets, partners and firm operations.

6. *Business Development*: Review a sample of marketing materials, requests for proposals (RFPs), client-requested certifications, firm annual reports & sustainability reports to affirm understanding of ESG representations made and then provide guidance based on the results to improve clarity of materials if needed.
7. *Firm ESG Claims*: Review any relevant branding efforts including representations that the firm is aligned with ESG principles and consider whether this is an opportunity to discuss compliance as an integral component of any assessment of the firm's governance efforts. For example, a firm asserting leadership in the "G" sector of ESG should reflect a firm that has not only strong board governance, but also a well-funded and supported Compliance Program.

In conclusion, compliance officers should also leverage the regulators' focus on ESG investing to engage with internal audit and/or ESG advisors as needed. Compliance officers may also want to inquire as to whether the firm has considered adopting a third party ESG-related standard such as the International Finance Commission (IFC) Operating Principles for Impact Management, United Nations Principles for Responsible Investment (UNPRI), Sustainable Development Goals (SDGs), Sustainable Account Standard Board (SASB) or Global Reporting Initiative (GRI). Compliance officers will then have the ability to research and become more knowledgeable about that standard benchmark as it applies to the business. This may be particularly helpful as the industry awaits for additional regulatory guidance. ■