

# SEC's 2021 Examination Priorities Address Climate and ESG-Related Risks

March 5, 2021



On March 3, 2021, the SEC's Division of Examinations ("Division") announced its 2021 examination priorities. The Division, which was formerly known as the Office of Compliance Inspections and Examinations, publishes its yearly priorities so that registered investment advisors ("RIAs") and Broker-Dealers can take immediate action to enhance their compliance programs. These priorities reflect the Division's analysis of the potential risks that may harm investors and the integrity of the U.S. capital markets. By focusing on these potential risks, market participants can help to mitigate them.

Although the Division has expressed concern about many of these risks before, the 2021 priorities have been influenced by the tumultuous events of the past year. These priorities have also been shaped by the new administration's concerns regarding climate change and socially responsible investing.

## ***Overview of the Division's 2021 priorities***

The Division's 2021 priorities include:

- Protecting retail investors, including seniors and those who are saving for retirement;
- Information security and operational resiliency;
- Financial technology and innovation, including digital assets;
- Anti-money laundering programs;
- The London Inter-Bank Offered Rate ("LIBOR") transition;

- Focus areas relating to investment advisors and investment companies, including compliance programs, registered funds, and RIAs to private funds;
- Focus areas involving broker-dealers and municipal advisors; and
- Market infrastructure.

Additionally, the Division warned that the risks arising from climate change should be considered as firms revise and improve their compliance programs.

### ***Business continuity plans and ESG investing***

Although business continuity plans (“BCPs”) have been on examiners’ radars for quite a while, the Division wants to ensure that firms are accounting for the growing physical and other relevant risks associated with climate change. As climate-related events intensify and occur more frequently, the Division will evaluate whether firms are implementing effective practices to help improve their response to large-scale disruptions.

In its 2020 examination priorities, the Division voiced its concerns regarding RIAs that offer clients novel investment strategies or investments in emerging markets. The Division cited strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (“ESG”) criteria. According to the SEC’s Acting Chair, Allison Herren Lee, the Division in 2021 will enhance its “focus on climate and ESG-related risks by examining proxy voting policies and practices to ensure voting aligns with investors’ best interests and expectations.” In the same press release, Division Director, Pete Driscoll, stated that the SEC’s priorities “reflect the complicated, diverse, and evolving nature of the risks to investors and the markets, including climate and ESG.”  
(<https://www.sec.gov/news/press-release/2021-39>)

### ***Information security, operational resiliency, and financial technology are high priorities***

The risks from cyber-attacks continue to be a high priority. The Division will analyze whether firms have taken appropriate measures to:

- Safeguard customers’ accounts and prevent intrusions, including verifying an investor’s identity to prevent unauthorized account access;
- Oversee vendors and service providers;
- Address malicious email activities, such as phishing or account intrusions; and
- Respond to incidents such as ransomware attacks.

In addition, the Division will continue to evaluate firms’ management of operational risks that arise when employees work at home because of COVID-19. The increase in remote operations due to the pandemic has raised issues involving endpoint security, data loss, remote access, use of third-party communication systems, and management of vendors.

Although there are many benefits derived from sophisticated financial technology and innovation, there are also risks that must be controlled. Examiners will analyze whether firms are handling customers’ orders in accordance with their instructions and will review compliance issues arising from trade recommendations made in mobile applications. Examinations will focus on whether firms are operating in a manner that is consistent with the representations they have made.

The Division will scrutinize participants engaged with digital assets and will evaluate:

- Whether these investments are in the best interests of investors;
- Portfolio management and trading practices;
- Safety of clients’ funds and assets;
- Pricing and valuation practices;
- Effectiveness of compliance controls and programs; and
- Supervision of representatives’ outside business activities.

It is not surprising that digital assets are a compliance priority. On February 26, 2021, the Division published a risk alert that summarizes findings from examinations of investment advisors, broker-dealers, and transfer agents involving the offer, sale, and trading of digital asset securities. Foreside's summary of that risk alert is available here <https://web.foreside.com/blog/risk-alert-digital-asset>.

### ***Additional examination priorities for firms to address***

As in prior years, examiners will focus on conflicts of interest and fiduciary duty. They will scrutinize whether broker-dealers and associated persons are complying with Regulation Best Interest. In 2021, the Division will expand the scope of its examinations to focus on assessing whether broker-dealers are making recommendations that they have a reasonable basis to believe are in customers' best interests and evaluating broker-dealers' compliance processes, as well as alterations made to product offerings. The Division will also conduct enhanced transaction testing as part of these examinations and will evaluate firms' policies and procedures that are designed to satisfy other elements of Regulation Best Interest, such as the recommendation of rollovers and the alternatives considered.

The Interpretation Regarding Standard of Conduct for RIAs, which was adopted in June, 2019, reaffirms and clarifies the scope of an RIA's fiduciary duty. The Division will continue to examine RIAs to assess whether RIAs' advice, including account or program types, are in the best interests of their clients. In addition to disclosure and mitigation of conflicts of interest, the Division will continue to focus on the risks associated with fees and expenses, complex products, and best execution. Examiners will also be on the lookout for undisclosed, or inadequately disclosed, compensation arrangements. Furthermore, examiners will determine whether broker-dealers and RIAs have complied fully with Form CRS requirements.

The Division's announcement provides detailed information regarding these and other 2021 compliance priorities. The SEC's 2021 compliance priorities are available at <https://www.sec.gov/files/2021-exam-priorities.pdf>.

### ***Conclusion***

The Division's priorities for 2021 are not exhaustive. There are other areas that will be addressed as part of examinations, risk alerts, and outreach. Although these priorities will primarily drive the Division's examinations, the scope of every exam is determined through a risk-based approach that includes an analysis of the entity's history, operations, services, products offered, and other risk factors.

According to Director Driscoll, the bedrock of the Division's examination program will not change. As always, the Division's goal is to promote compliance and protect investors.