SPOTLIGHT ON

Compliance Considerations for ESG and Socially Responsible Investing

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WHAT IS ESG AND HOW DOES IT APPLY TO INVESTMENT ADVISORS?

Environmental, social, and governance ("ESG") factors play a role in the business practices of corporations around the world, affecting each in a unique way. ESG concerns provide companies an opportunity to create new value - an ESG proposition or strategy. Although ESG factors have been growing in importance for companies and investors, there is little guidance or regulation on standardizing ESG strategy or compliance. The first step in understanding the factors and their application is by defining them.

Environmental: The environmental criteria include the energy a company takes in, the waste it produces, its carbon emissions, and contributions to climate change. The category includes any way a company affects living beings or the environment, which is unique for each business model and not limited to the criteria listed.[1]

Social: The social criteria cover the relationship a company has with people, including its employees, the communities it exists in, and all others affected by the business. For example, labor conditions in factories around the world would affect the social criteria for a company. Although environmental factors garner the most attention, surveyed investors claim social issues are equally important. [2]

Governance: The governance criteria measures a company's systems and processes on the ability to represent the best interest of long-term stakeholders. Governance is a company's ability to control its responsibilities and impact with the checks and balances necessary to ensure that all affected parties are considered. Some considerations are Board and labor force diversity, transparency in political donations, and corruption. A strong corporate governance system aligns the interest of all stakeholders.[3]

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[1] *ESG (Environmental, Social and Governance) – Overview, Example and Framework*, Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/other/esg-environmental-social-governance/ (last visited Mar 20, 2020).

[2] Jeff Faust, *Bigger than the Environment: New ESG Study Finds Other Social Issues have Equal or More Importance to Investors*, Businesswire (2019), https://www.businesswire.com/news/home/20190422005130/en/ (last visited Mar 21, 2020).

[3] Kelly Tang, *Exploring the G in ESG: Governance in Greater Detail*, S&P Global (2019), https://www.spglobal.com/en/research-insights/articles/exploring-the-g-in-esg-governance-in-greater-detail-part-i (last visited Mar 21, 2020).

RECENT ESG TRENDS

Since the 2008 financial crisis, the corporate world has increased its focus on ESG-related issues. The need to restore trust in the capital markets after the crisis led to a strong focus on governance issues in the first half of the 2010s, while the last half focused more predominantly on environmental and social issues.[4] For example, the RE100 Coalition (the "coalition") is an industry initiative by 229 large companies, including the likes of Coca Cola and Microsoft, with the goal of going "100% renewable" by 2050 at the latest. The coalition began in 2014 with only 13 member companies.[5] This focus is largely driven by companies recognizing that ESG factors will affect their businesses, instead of solely focusing on their external ESG impact.[6] Additionally, many corporations have adopted the United Nations Sustainable Development Goals, a list of 17 aspirational goals that bring attention to various ESG issues. The second driver of these changes comes from investor preference.[7]

A study done by the HEC Paris Business School, Toulouse School of Management, and MIT Sloan published in January 2020 reveals that investors valued companies that donated more to charity (donating one more dollar per share) $0.70 more than the average. At the same time, companies with negative social impact are valued $0.90 less than the average.[8] This preference has led to almost three thousand asset owners, investment managers, and service providers to become signatories to the United Nations Principles for Responsible Investing, including large institutions like Blackrock and Amundi.[9]

ESG issues also pose long-term risks for corporations, which require foresight and mitigation. These risks may include future regulation for pollution, social backlash, and litigation related to discriminatory practices (in cases with lack of diversity). This long-term risk of ESG factors negatively affecting business, investor preference for ESG focused investments, and the potential gains in efficiency lead corporations to take ESG more seriously. These three factors, if approached correctly, can influence a company's bottom line in a positive way. On average, companies that outperform peers on ESG-related issues also have higher valuation multiples and

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[4] Rodolfo Araujo and Kosmas Papadopoulos, *Top 10 ESG Trends for the New Decade*, FTI Consulting, Inc (2020), https://www.fticonsulting.com/insights/fti-journal/top-10-esg-trends-new-decade (last visited March 27, 2020).
[5] *RE100 Overview,* RE100, https://there100.org/re100 (last visited March 20, 2020).
[6] Libby Bernick, *2019 ESG Trends – What to Watch,* S&P Global (2019), https://www.spglobal.com/en/research-insights/articles/2019-environmental-social-and-governance-esg-trends-what-to-watch (last visited Mar 20, 2020).
[7] *Sustainable Development Knowledge Platform*, United Nations, https://sustainabledevelopment.un.org/ (last visited Mar 20, 2020).
[8] Jean-Francois Bonnefon, Et Al., *Do Investors Care About Corporate Externalities*?, 2–3 (2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3458447 (last visited Mar 20, 2020).
[9] Signatory Directory, *Principles for Responsible Investment*, https://www.unpri.org/signatories/signatory-directory (last visited Mar 20, 2020).

margins.[10] The rise in ESG prominence has led to over $12 trillion in sustainable investing in the US alone and raises important considerations for investors and investment advisors.[11]

INVESTMENT ADVISOR CONSIDERATIONS

Below are some areas that investment advisors should consider when planning to engage in ESG investing on behalf of their clients.

Operational and Strategic ESG

Investment advisory firms can adopt ESG policies, either operationally or strategically. When a firm ensures that its operations follow ESG policies, it is considered operationally ESG. When a firm's investment strategy focuses on ESG issues, it is said to be strategically ESG. The nature of running an operationally ESG advisory firm likely means that the advisor also implements an ESG investment strategy. To apply ESG policies to operations, firms must consider their own environmental, societal, and governance factors. These factors may include executive compensation, carbon neutrality, and appropriate ESG controls throughout the company. Firms may also apply ESG policies to only parts of its investment strategy and operations, creating a gradient of firms on ESG commitment.[12]

Although regulation on measuring the ESG compliance of investment advisors is undefined, many firms adopt the United Nations Principles of Responsible Investment and/or the standards issued by the Sustainability Accounting Standards Board to provide a basis for socially responsible investing.[13] Investment strategies are unique among each firm, making proper ESG disclosures vital for investors. For example, a firm may specifically focus on investing in renewable energies instead of broader ESG factors. In this case, how a firm decides on its strategy (and therefore investments) will be unique compared to firms that focus on other or broader ESG factors.[14] Like operational ESG firms, strategic ESG firms will require appropriate controls to guarantee socially responsible investments and proper disclosures to investors. A commonly used method of control is to use ESG scores as a basis for investment decisions.

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[10] Grant Freeland, *Being A Good Corporate Citizen Is Good For Your Bottom Line*, Forbes (2019), https://www.forbes.com/sites/grantfreeland/2019/08/05/being-a-good-corporate-citizen-is-good-for-your-bottom-line/#27d5bf6c7af6 (last visited Mar 20, 2020).
[11] Pippa Stevens, *Your complete guide to investing with a conscience, a $30 trillion market just getting started*, CNBC (2019), https://www.cnbc.com/2019/12/14/your-complete-guide-to-socially-responsible-investing.html (last visited Mar 20, 2020).
[12] Gwendolyn Williamson, *Investment Adviser ESG Policies and Compliance Measurement*, *Practical Compliance and Risk Management for the Securities Industry*, 3–4 (2018).
[13] Ibid, 3.
[14] Gwendolyn Williamson, *Compliance Issues in ESG Investing*, in 2019 Investment Adviser Compliance Conference.

Scoring and Choosing ESG Investments

Many ESG investment advisory firms and third-party vendors score companies on their ESG policies and impact. These scores provide guidance on making socially responsible investments, allowing firms to set thresholds for categorizing an investment as ESG. Each scoring system differs, which can dramatically influence how ESG is implemented into an investment strategy. On top of the various scoring systems, corporations report on some ESG factors and not others and on different metrics for those factors. This variance in scoring adds complexity to having an ESG-focused investment strategy, essentially making the scores subjective. For example, Bank of America was ranked "below average" by one rating company and "well above average" by another.[15] The lack of regulation around ESG scoring, again, leaves much of the required due diligence on each investment advisor and third-party vendor.

One popular third-party vendor, Refinitiv, provides financial market data and infrastructure. The company also provides ESG scores to aid investment managers in developing and following ESG investment strategies. The scores measure the ESG factors of over 7,000 companies around the world. The company ratings are relative to other companies based on 178 critical ESG measures across ten main themes, which are derived from 400 data points. The data points are collected from company reports, company filings, company websites, NGO websites, and media outlets. Refinitiv updates the data points, critical ESG measures, and overall ESG scores on a monthly basis[16]. The scores can then be used to develop both exclusive and inclusive screens, for thematic investing, and for individual investments. Exclusive screening, which has been prominent since the 1980s, requires excluding companies in industries deemed objectionable. For example, a clean energy exclusive screen would eliminate investment into any fossil fuel company. Inclusive screens, on the other hand, focus on investing in companies that practice best-in-class or strong ESG strategies.[17]

The changing nature of these scores, which pushes investments out of and into the ESG category, adds complexity to socially responsible investing and creates potential issues with regard to discretion and fiduciary duty.

Fiduciary Duty in Relation to ESG and SRI

Under the Securities Exchange Commission's (the "SEC") Fiduciary Duties Interpretation, an advisor has the obligation to understand a client's investment objectives. To provide investment advisory services to an individual, the advisor should understand a client's investment objectives,

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[15] Timothy Doyle, *The Big Problem With 'Environmental, Social and Governance' Investment Ratings? They're Subjective*, Investor's Business Daily (2018), https://www.investors.com/politics/commentary/the-big-problem-with-environmental-social-and-governance-investment-ratings-theyre-subjective/ (last visited Mar 21, 2020).

[16] *ESG data and solutions from Refinitiv*, Refinitiv, https://www.refinitiv.com/content/dam/marketing/en_us/documents/brochures/esg-research-brochure.pdf (last visited Mar 21, 2020).

[17] Robert Eccles and Svetlana Klimenko, *The Investor Revolution*, Harvard Business Review (2019), https://hbr.org/2019/05/the-investor-revolution (last visited April 13, 2020).

financial resources, risk profile, sophistication, and any potential ESG considerations.[18] The investment advisory agreement between the advisor and the client can set forth the terms of how ESG factors will be used in an overall investment strategy and even for specific investments in addition to the more traditional factors (i.e., objectives, risk profile). Since ESG policies are not standardized for investment advisors, the disclosure of how an individual investment advisor understands and implements ESG into its business is critical to fulfilling its fiduciary duty.

Even with proper and extensive disclosure, implementing ESG policies and strategies raises unique fiduciary issues for investment advisors. Without standardization across the industry, an investment advisor's ESG policy may contradict other aspects of fiduciary duty in specific unaddressed situations. To this point, some law professors believe that ESG investing complies with fiduciary duty only if the advisor reasonably concludes that the ESG investment improves risk-adjusted return without consideration for any externalized benefits, like carbon reduction or workplace diversity.[19] ESG scoring, although an attempt to crystalize ESG factors and investment decisions, raises its own issues. For example, consider that an investment advisor has invested with discretion in a company with a high ESG score based on the firm's ESG investment strategy. If the score drops and makes the investment non-ESG in regard to the investment advisor's policies or the investment management agreement, the firm would be required to divest. If the divesture simultaneously misaligns the client's portfolio with the client's objectives or risk profile, an issue of fulfilling fiduciary duty may arise.

Disclosure of ESG policies and strategy, therefore, does not address the full scope of an advisor's fiduciary duty in specific situations. Even if ESG focused investments on average outperform other investments, the fact that ESG investing is not standardized and may contradict other investment objectives (e.g., high returns, low risk) could pose issues for ESG compliance. In the example above, the investment advisor with discretion is faced with a decision that either way falls short of at least one aspect of its own strategy or the client's strategy. Generally, investment advisors must balance all considerations of a client's objectives, which increasingly will include ESG objectives.

Future Regulation

Lack of regulation around ESG investing leaves much to the interpretation of individual investment advisors. In recent examination document requests, the SEC has set forth some guidelines on ESG record-keeping, which provides some insight for investment advisors on developing ESG compliance policies. The SEC requests that advisors define their internal understanding of terms related to ESG and Socially Responsible Investing ("SRI") that are used in disclosures and marketing materials. The advisor must also state whether it adheres to the United Nations Principles for Responsible Investment and all the ESG investment strategies

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[18] Julien Bourgois, Jonathan Massery & Mark Perlow, *ESG Investing-- Considerations for US Registered Investment Advisers*, vol. 26 *The Investment Lawyer*, 3 (2019).
[19] Max Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee,* vol. 72 *Stanford Law Review*, 382 (2020).

recommended to clients. If the advisor uses its own proprietary scoring system, then it must provide a written explanation detailing the methodology and any documents related to the scoring system. If the advisor uses a third-party vendor for scoring, then the advisor must provide the reasons for choosing the particular third party, how the scores are used, and all the scoring reports used during the examination period.[20]

SEC regulation may bring clarity to the world of ESG investing. Currently, the nuanced approaches across the industry cause confusion for both advisors and their clients. By developing standard ESG definitions, disclosures, and reporting requirements, the SEC could assist advisors to better understand ESG investing and convey their ESG strategies to clients.[21]

International ESG Regulation

Internationally, the European Union and the United Kingdom have made progress with regulatory initiatives in the sustainable investing world. The European Union has put forth an action plan to address issues surrounding sustainable finance, titled the European Commission's Sustainable Finance Action Plan (the Plan).[22] Published in March 2018, the Plan aims to establish a green economy through the financial sector by introducing four primary measures: creating a standard EU classification system to determine if an investment is environmentally sustainable, improving disclosure regulations for asset managers, adjusting benchmark regulations to add uniformity to low-carbon benchmarks, and amending previous legislation to help investment firms to incorporate ESG factors into the advisory process.[23] A proposed Delegated Regulation would require investment firms to take into account client preferences on ESG when providing investment advice and portfolio management services to clients and would require a mandatory assessment of a client's ESG preferences, which should then be considered as part of any services subsequently provided. [24]

In July 2019, the United Kingdom published the Green Finance Strategy (the Strategy) with the aim to accelerate the growth of sustainable investing and to aid in reaching carbon neutrality by 2050. The Strategy is built on three strategic initiatives. The first, "Greening finance," involves integrating financial opportunities and risks from ESG factors into mainstream financial markets, which requires more disclosure from public companies and asset managers. The second, "Financing green," aims to increase the flow of private finance to investments supporting the

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[20] "Examination Initial Document Request", SEC (2018).
[21] Mark Schoeff, *Advisers welcome potential regulatory scrutiny of ESG investing*, InvestmentNews (2020), https://www.investmentnews.com/advisers-welcome-regulatory-scrutiny-esg-investing-175900 (last visited Mar 20, 2020).
[22] David Berman, Et Al., *Sustainable Finance and Climate Change Risk in Financial Services*, Latham & Watkins, 5-7 (2020), https://www.lw.com/thoughtLeadership/sustainable-finance-and-climate-change-risk-in-financial-services (last visited April 13, 2020)
[23] Caitlin McErlane, Et Al., *ESG Regulatory Reform: Impact on Asset Managers*, Baker McKenzie, 6-11 (2019), https://www.bakermckenzie.com/-/media/images/insight/publications/2019/07/esg-regulatory-reforms/esg-reforms--implications-for-asset-managers.pdf?la=en (last visited April 13, 2020).
[24] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=PI_COM:Ares(2018)2681500&from=GA

UK's carbon targets and other environmental ambitions by, for example, improving accessibility to finance for green companies. The last is to capture the commercial opportunity, which includes new green financial products and services and to turn the United Kingdom into a global green finance hub.[25]

Investment Advisor ESG Compliance Program

Although ESG compliance is currently not standardized by regulation, investment advisors can still implement effective ESG compliance programs. An established ESG compliance measurement framework should help coordinate ESG efforts across the firm, including aligning the actions of executive management with ESG policies and creating controls to ensure all advertising and disclosures are accurate. If possible, the firm could start a committee to oversee ESG policies and to hold itself accountable for implementation and for any mistakes.[26]

Investment advisors must also be sure to disclose ESG policies and investment strategies to clients in the advisory agreement. It would be best for the agreement to explicitly explain how ESG factors will be used by the advisor and the associated risks of an ESG strategy. If the advisor uses a third-party vendor for ESG scoring data, the advisor should disclose why it chooses that specific vendor and how it uses the data. Whether the advisor uses a third-party or creates scores in-house, the advisor should establish a due diligence process to ensure the ESG data is accurately measuring the factors important for the investment strategy. In case of any dispute or issue surrounding an ESG investment, advisors should document each ESG investment, including any ESG score or other reason for the investment. [27]

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[25] David Berman, Et Al., *Sustainable Finance and Climate Change Risk in Financial Services*, Latham & Watkins, 8 (2020), https://www.lw.com/thoughtLeadership/sustainable-finance-and-climate-change-risk-in-financial-services (last visited April 13, 2020)
[26] Gwendolyn Williamson, *Investment Adviser ESG Policies and Compliance Measurement*, *Practical Compliance and Risk Management for the Securities Industry*, 3 (2018).
[27] Julien Bourgois, Jonathan Massery & Mark Perlow, *ESG Investing-- Considerations for US Registered Investment Advisers*, vol. 26 *The Investment Lawyer*, 3-5 (2019).