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ESG Investing—Considerations for US Registered Investment Advisers

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After having been a focus of some European institutional investors and asset managers, Environmental, Social and Governance (ESG) investing appears currently to be having a breakout moment in the United States. It is gaining more attention in the US asset management media, and it is widely perceived as popular with US millennial investors, among many other groups. US Securities Exchange Commission (SEC)-registered investment advisers (advisers) are currently introducing new ESG-related products and modifying existing investment strategies to include ESG elements. Nonetheless, the current phenomenon of ESG investing in the United States has been years in the making, and it is a complex phenomenon.

While ESG investing is growing in popularity in the United States,[1] there is not a single definition of what it means in practice. For example, a simple Internet search for the acronym elicits countless hits, describing a wide variety of investment factors and strategies, but importantly there is no single legal or regulatory definition. In addition, many sources and studies on, as well as much expertise related to, ESG investing comes from outside the United States, and it is not always clear whether non-US-market concepts neatly transfer to the US regulatory framework. Moreover, among the authorities and studies that directly relate to ESG, there are conflicting opinions, with some touting its benefits for investors, as well as the environment, humankind, and corporate governance, while others question ESG investing's reliability, its wisdom, and whether it is consistent with potential duties to seek to maximize investment returns and capitalist principles.[2] An SEC Commissioner recently openly questioned the merits of ESG investing.[3] Given the number of prominent and differing views on ESG investing, it is no surprise that advisers may be asking themselves questions about how they should approach ESG investing, whether they already have embraced it, are starting to see market demand or are simply curious to understand the trend and how it affects their traditional duties and obligations.

This article addresses some legal, regulatory and compliance considerations advisers may want to consider in connection with ESG investing.

Background

While there is no single legal or regulatory definition of either ESG investing or related investment approaches, at a very high level ESG and related investment approaches such as socially responsible investing (SRI) or corporate socially responsible (CSR) investing (collectively, hereafter referred to as, ESG investing, for ease of reference), generally are understood as investing with the goal of long-term performance and risk management while promoting positive outcomes in the world outside financial

returns. In one sense, it is not a new concept. Various types of ethical and responsible investing approaches can be traced back for millennia.[4] The modern ESG investing movement, however, began to develop in the United States in the 1960s as an outgrowth of larger social movements, including but not limited to anti-war, environmental, and social welfare movements, as investors who supported such causes actively sought opportunities to invest in equity and debt markets in a manner better aligned with their personal beliefs. Early ESG investing products generally involved the use of simple negative screens to exclude the types of investments that certain investors found personally objectionable, for example, weapons of war, tobacco, alcohol, fossil fuels, etc.[5] Over time, however, ESG investing has developed to encompass a broad variety of strategies, from investment products utilizing negative screens to more complex strategies that use sophisticated ratings in an effort to invest in issuers believed to contribute to positive impacts on the world, as well as strategies that seek to fully integrate consideration of ESG factors into more traditional return-maximizing and risk-management-based investment strategies.[6]

The significant growth of ESG investing in the last 50 years has been primarily driven by the interaction of a number of developments, such as (1) growing investor demand; (2) evolving industry and regulatory thinking about how ESG considerations interact with the financial considerations underlying portfolio management and the fiduciary duties of advisers; (3) improvements in the amount and quality of CSR data publicly disclosed by companies; and (4) (in some places), government prodding. Certain ESG investing products have been publicly offered in the United States for decades,[7] and prominent commentary has suggested that consideration of ESG factors generally is consistent with advisers' fiduciary duties, at least in certain circumstances.[8] It does not necessarily follow that ESG considerations can be simply incorporated into every legacy investment strategy or product, without further consideration, in a manner that is automatically consistent with an adviser's fiduciary duties to its clients. Client consent to the change also may be necessary in certain circumstances.

Reconciling an Adviser's Fiduciary Duties: A Conceptual Framework for Designing an ESG Investment Program

Because ESG investing generally is marked by differences of opinion and values, as well as the absence of clear regulatory definitions, the burden of ensuring that an ESG investment strategy is consistent with an adviser's fiduciary duties largely falls to each adviser when designing and offering such strategies to clients. While the SEC has not issued specific detailed guidance related to ESG investing, the SEC's recently issued interpretive guidance relating to advisers' deemed fiduciary duties under the Investment Advisers Act of 1940, as amended (the Advisers Act),[9] which generally is applicable to all of an adviser's strategies and client relationships (the Fiduciary Duties Interpretation),[10] provides a useful framework for addressing key considerations when designing and implementing an ESG investment strategy. Such considerations might include, among others, which additional terms should be included in relevant advisory agreements, what disclosures need to be made in relevant offering materials, how to design a due diligence process for selecting and reviewing ESG data providers, and what additional compliance policies and procedures will need to be implemented in relation to a contemplated ESG strategy. Where a change to an investment strategy is material, client consent may be necessary.

The Fiduciary Duties Interpretation clarifies[11] the SEC's view that all advisers owe each of their clients a fiduciary duty under the Advisers Act to act in the best interests of the client at all times, and that this fiduciary duty should be viewed in the context of the agreed-on scope of the relationship between the adviser and the client.[12] Significantly, the SEC specifically noted that an adviser's "fiduciary duty

follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[13]

While drafting full and fair disclosure and obtaining informed consent from clients with respect to new investment strategies and products that incorporate ESG considerations is a relatively straightforward exercise, advisers who seek to incorporate ESG standards into an existing investment advisory relationship, strategy or product should give particular consideration to whether doing so is consistent with the "best interest" of the relevant client as described in legacy agreements, offering documents, and marketing materials. In particular, if an existing client's best interest in legacy documents traditionally has been understood to be the best economic interest of the client, in terms of investment return, an adviser carefully should consider what agreements and other materials may need to be revised in order to fully and fairly explain its new ESG-related investment proposition to a client and gain such client's consent prior to embarking on a modified strategy that now includes ESG considerations.

Key Fiduciary-Duty-Related Questions for Advisers Considering an ESG Investment Strategy

What Are My Client's Investment Objectives?

The SEC states in the Fiduciary Duties Interpretation that an adviser has an obligation to reasonably understand a client's investment objectives. For the firm providing tailored advisory services to individual and institutional clients through separately managed accounts or similar products, understanding a client's investment objectives means having a clear picture of the client's investment goals, financial resources, risk profile, and investment sophistication in order to assess whether and to what extent consideration of ESG factors are consistent with an investment strategy that serves such client's best interest.

For the firm serving as an adviser to legacy pooled investment vehicles, for example, an investment company or private fund, and considering whether to modify an investment strategy to include ESG considerations, an understanding of the fund's investment objectives can be based on the investment mandate of the client as set forth in its governance documents, offering materials and/or relevant agreements, as applicable, in order to assess whether and to what extent consideration of ESG factors are consistent with such client's best interest and the terms of the existing strategy. For the firm serving as adviser to a new pooled investment vehicle, the adviser may want to consider the same concerns to assure that full and fair ESG disclosure is included in the relevant fund documents prior to launch.

Should My Advisory Agreement with a Client Memorialize How ESG Factors Will Be Used in Seeking to Achieve the Client's Investment Objective?

When providing tailored investment advice to individual or institutional investors through separately managed accounts or similar products, it will support the adviser's position that it is acting in the best interest of the client to explicitly set forth in the advisory agreement or other documents forming the basis for the terms of the investment advisory relationship whether and how ESG factors will be used by the adviser, as well as their risks. For agreements with pooled investment vehicles, such as investment companies and private funds, offering materials rather than the investment advisory agreement may be the most appropriate location to memorialize the specific contours of how ESG factors are utilized when making investment decisions on behalf of such clients and related risks. Given the wide range of ESG standards and definitions available to advisers, it will be important to define what an adviser understands by its ESG strategy, as well as how the

adviser incorporates such strategy into its services and related considerations.

Do My Relevant Offering Materials and Disclosure Documents Clearly, Completely, and Accurately Disclose the Material Aspects of an ESG Investment Strategy and the Related Risks, As Well As Any Actual and Potential Conflicts of Interest That I Have with Respect to Clients and Investors?

To provide accurate disclosure concerning how ESG factors will be used in relation to a particular investment strategy, which as discussed above also serves as good evidence of client consent to a strategy, advisers can consider whether to include enough detail for investors to be able to clearly understand, among other material aspects of an ESG strategy, the methods by which the adviser: (1) performs its own ESG analysis; (2) relies on ESG data vendors to perform screening and/or other investment-related judgments; or (3) utilizes some combination of its own analysis and ESG scores or other analysis provided by third-party data vendors. Regardless of which of these or other methods the adviser uses, the adviser should take steps to reasonably assure that it clearly discloses the types of underlying ESG data that is relied on for analysis, risks associated with the ESG strategy and conflicts of interest that the adviser may have.

Practical Considerations Related to ESG Strategies

Consistent with good practice, the design of an adviser's ESG investment program should be a collaborative process that involves all of an adviser's relevant teams, for example, investment management, compliance, risk management, information technology, marketing and legal to assure organizational consistency and accountability. At the outset of designing any ESG investment program, an adviser organization should first clearly define what it means by ESG in the context of its investment program and consider to what extent various parts of its organization also should take that definition into consideration while performing their specific tasks.[14] An adviser should also decide whether ESG considerations will be the core aspect of a strategy or one component of a broader investment strategy.

Considerations Related to ESG Data and the Use of Third-Party ESG Vendors

Because there are not uniform data standards for how companies publish data that form the basis for ESG classifications, it is largely up to each potential portfolio company (based on local disclosure standards) to consider what and how to report. For example, two companies with substantively similar employee health and safety records may report vary different employee health and safety data depending on the reporting methodology each company uses. The lack of agreed standards presents significant challenges in forming consistent ESG analyses across issuers.

In addition, there are a multitude of third-party ESG data providers,[15] each with different research, data, sourcing, and scoring methodologies, practices, and standards. ESG vendors vary with respect to the factors that they consider to be material to their analyses, the assumptions that they use to fill in gaps in ESG reporting data, and the ways that they aggregate and weight available data, among others. This variation creates the potential for advisers to obtain different and contradictory ESG analyses of the same issuers, depending on which third-party ESG vendor is relied on. So, if an adviser will obtain ESG data and/or analysis from a third-party provider, it may want to develop a due diligence process that is reasonably designed to both select data providers and periodically assess whether the ESG data and analysis being provided is effectively measuring the types of ESG factors that the adviser seeks to measure under a particular ESG investment strategy.

Similar to the due diligence process that advisers use when evaluating the recommendations provided by advisory firms or research analysts in other areas, advisers evaluating a third-party ESG data provider may consider that it is helpful to evaluate what data the provider relies on, the methodology the vendor uses to analyze such data, the vendor's process for identifying and addressing potential errors in the data, potential weaknesses or limitations of the vendor's analytical methodology or processes, the quality of vendor's relevant personnel and technological infrastructure, and the vendor's ability and willingness to provide sufficient information to enable the adviser to evaluate and monitor the accuracy and usefulness of the data.

Lessons from Recent SEC Examinations

Advisers with an ESG strategy also may want to consider the themes in recent ESG-related SEC examinations. We understand that, to date, the SEC Staff's ESG-related examination inquiries have focused on the following: how an adviser defines ESG and related terms; the role that ESG factors play in the adviser's selection of investments; whether an adviser seeks to adhere to certain industry standards, such as the PRI Standards;[16] how the adviser uses third-party ESG data providers and/or scores, if at all, in its investment process; and whether and the extent to which an adviser engages in shareholder activism with respect to portfolio companies. Not surprisingly, the SEC Staff generally focuses not on the merits of an ESG view, but rather on whether the adviser is acting based on a reasonably informed view, consistent with its disclosures to investors in offering documents, marketing materials, websites, Form ADV other relevant materials, and in a manner consistent with its duties. These ESG-related examinations also have included common diligence requests, including requests to review relevant compliance policies and procedures, to examine proof of adherence to relevant principles and controls, and to audit records supporting performance results, ESG rankings, and awards cited in marketing materials.

Designing and Implementing Relevant Compliance Policies and Procedures

In general, under Rule 206(4)-7 of the Advisers Act, as well as under Rule 38a-1 of the Investment Company Act of 1940, as amended (the 1940 Act), with respect to any investment companies, an adviser is required to adopt and implement compliance policies and procedures reasonably designed to comply with relevant federal securities laws. Given the SEC scrutiny described above, of particular importance for the oversight of ESG investment program are policies and procedures related to: (1) investment oversight and governance controls; (2) review of offering documents and marketing materials; and (3) books and records.

Investment Oversight and Governance Controls

The more complex an ESG strategy is, the more carefully an adviser may want to consider establishing express ESG criteria or provisions within its existing investment oversight structure and procedures. The goal should be: (1) to create effective oversight to reasonably assure that the intended ESG criteria are being implemented as intended, for example, by periodically reviewing ESG investment methods for consistency with relevant disclosures and vice versa, testing actual investments for consistency with ESG assumptions, investment methods and relevant disclosures, testing ESG scoring methods, and periodically reviewing all of the above for reasonability and to determine if any changes are necessary; and (2) to reasonably assure effective communication between all of the relevant teams within an adviser, for example, portfolio management, compliance, administration, marketing and legal, so that strategies, performance and other relevant information are being described accurately and consistently across all of an adviser's offering documents, marketing materials and other external communications. Establishing specific ESG investing oversight provisions and/or

procedures may be especially helpful in structures where the adviser is supervising a sub-adviser who is engaged in the day-to-day management of an ESG strategy.

Review of Offering Documents and Marketing Materials

An adviser offering ESG strategies also may want to consider the disclosures that it should make in relevant prospectuses, other offering documents and communications, and/or the adviser's Form ADV (and soon Form CRS). The particular disclosures to be made or that are otherwise appropriate will vary based on the role that ESG considerations performs in relation to an investment strategy and the type of product being offered, among other factors.

Each adviser offering an ESG strategy should take reasonable steps to assure that its relevant offering materials accurately describe the specific ESG methodology that it uses to make investment decisions and any unique risks associated with its ESG investments, including but not limited to: potential limitations of its ESG processes; potential inaccuracies within data sets or other ESG metrics; and risks that the adviser's ESG processes may yield different results than other advisers with similar processes. Similarly, when designing and implementing policies and procedures related to the review and oversight of marketing materials, each adviser offering an ESG strategy may want to establish and implement a process for its compliance or legal staff to review all marketing materials prior to publication. For example, marketing materials should only claim adherence to various standards, for example, PRI standards,[17] where such adherence actually is the case in practice. In addition, the marketing of any awards or recognition related to ESG investing should be reviewed to reasonably avoid any suggestions to investors that could be potentially misleading. Similarly, whenever referencing marketing studies regarding ESG and its impact on performance, the adviser should consider including disclosures describing the limitations of such studies, as well disclaimers clearly stating that such studies are not indicative of the future performance of the relevant ESG strategy.

Books and Records

Applicable books and records requirements under Rule 204-2 of the Advisers Act (as well as under Rule 31a-1 of the 1940 Act, with respect to any investment companies) generally require advisers to maintain governance, compliance and other operational records, as set forth in the applicable books and records rule(s) for a period of at least five years after the end of the fiscal year in which the documents were provided, and the first two years in an easily accessible place. Advisers offering ESG strategies should pay particular attention to developing effective processes to produce and maintain sufficient backup materials to support the adviser's rationale for using ESG considerations in relation to an investment strategy, as well as all material ESG-related claims made in marketing materials and offering documents.

Conclusion

As ESG investing grows in popularity, advisers will continue to consider specific factors that apply when offering ESG strategies to their clients. They will need to consider how to reconcile fiduciary standards and regulations that were not formed with ESG in mind. But they will find that, with a reasonable approach, they can offer ESG investing without materially increasing compliance risks.

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NOTES

1 *See, e.g.* US SIF, *Report on US Sustainable, Responsible and Impact Investing Trends* (2018), available at *https://www.ussif.org/blog_home.asp?display=118* (Claiming that by its metrics, by the end of 2018, US asset managers considered ESG criteria when

making investment decisions with respect to approximately $11.6 trillion in assets under management (or approximately 25 percent of the total of approximately $46.6 trillion of assets under professional management in the United States at the end of 2018), which also represented a 44 percent increase from the $8.1 trillion in ESG-related US assets under management, as measured two years earlier at the close of 2016).

2 *See e.g.* William Sanders, "Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing," *Pace Law Review*, Vol. 35, Issue 2 at 567-572 (Dec. 2014) (Arguing that Socially Responsible Investing is generally inconsistent with US registered investment advisers' fiduciary duties, unless specifically authorized by a client via contract or a similar mechanism).

3 *See* SEC Commissioner Hester M. Peirce's Speech, Scarlet Letters: Remarks before the American Enterprise Institute (June 18, 2019), available at *https://www.sec.gov/news/speech/speech-peirce-061819*.

4 *See* Mateo Bidoggia, *et al.*, "SRI ESG Investments," *SIPA Columbia University*, at 3 (2016) (Discussing that SRI's origins can be traced back to biblical times. The organization traces SRI to the Torah and Quran in directing those of Judaism and Islam on how to invest.); *see also* Blaine Townsend, From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing, at 3 (2016) (Discussing how the roots of socially responsible investing trace back two millennia).

5 *See* Mateo Bidoggia, *et al.*, *supra* n.4 at 3, 7.

6 For example, the Global Sustainable Investment Alliance (GSIA), a collaboration of membership-based sustainable investment organizations around the world, classifies the current range of impact investing strategies into seven (not necessarily mutually exclusive) categories: (1) negative/exclusionary screening: the exclusion of particular sectors or companies based on specific criteria related to ESG; (2) positive/best-in-class screening: selecting the companies to invest based on positive ESG performance relative to peers; (3) norms-based screening: only selecting the companies that fulfill minimum standards based on international rules; (4) integration of ESG factors, *i.e.* systematic and explicit inclusion of ESG factors into financial analysis; (5) sustainability-themed investing: investing in topics or assets related to sustainability; (6) impact/community investing: investments where the financing is provided with a clear social or environmental purpose; and (7) corporate engagement and shareholder action: using shareholder power to influence corporate behavior. *See* GSIA, *2018 Global Sustainable Investment Review,* at 7, available at *http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf*.

7 For example, the Dreyfus Third Century Fund was launched in 1972, with a prospectus disclosure that "stated it was looking for companies that 'show evidence in the conduct of their business, relative to other companies in the same industry or industries, of contributing to the enhancement of quality of life in America'." *See* Blaine Townsend, From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing, at 6 (2016). The Dreyfus Third Century Fund is now named the BNY Mellon Sustainable U.S. Equity Fund, Inc. (the Fund), and continues to offer an ESG investment strategy, with a prospectus that states, "the fund normally invests at least 80 percent of its net assets, plus any borrowings for investment purposes, in equity securities of US companies that demonstrate attractive investment attributes and sustainable business practices and have no material unresolvable environmental, social and governance (ESG) issues." *See* the Fund's current effective registration statement on Form N-1A, as of the date of publication, available at *https://www.sec.gov/Archives/edgar/data/30167/000003016719000015/lp1-035.htm.*

8 *See, e.g.,* Freshfields Bruckhaus Deringer, "A legal framework for the integration of environmental, social and governance issues into institutional investment," *UNEP Finance Initiative*, at 6 (Oct. 2005). (A report by the London-based law firm Freshfields Bruckhaus Deringer that was commissioned by United Nations Environment Programme (UNEP) to address whether, under relevant laws of seven of

the most developed countries (*i.e.,* France; Germany; Italy; Japan; Spain; the United Kingdom; and the United States), the integration of ESG considerations into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) is voluntarily permitted, legally required or hampered by law and regulation. The report concluded that, "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.")

9 *See* Fiduciary Duties Interpretation at discussion in and around *supra* n.14.

10 *See Commission Interpretation Regarding Standard of Conduct for Investments Advisers,* Release No. IA-5248 (June 5, 2019).

11 *See* Fiduciary Duties Interpretation at 5, 29 (noting that while the Fiduciary Duties Interpretation contains additional detail on certain matters than prior SEC statements, it is intended to reaffirm and clarify, certain aspects of an adviser's fiduciary duty under the Advisers Act and not to establish new fiduciary duties).

12 *Id.* at 5-9.

13 *Id.* at 9.

14 As noted above and discussed in more detail below, there are a multitude of third-party definitions of each term to choose from, the adoption of which provide the potential benefits of ease and impartiality. If, however, definitions prepared by third parties do not fully capture an adviser's view, it may wish to tailor its own definitions.

15 *E.g.* MSCI, Bloomberg ESG Data, Dow Jones Sustainability Indices, ISS ESG Ratings and Rankings, Morningstar and Sustainalytics. *See* also Betty Moy Huber and Michael Comstock, Davis Polk & Wardwell LLP, "Harvard ESG Reports and Ratings: What They Are, Why They Matter," (Jul. 27, 2017) (Summarizing ESG rating scales and methodologies by several prominent third-party ESG data providers), available at *https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/*.

16 In 2006, UNEP partnered with the finance industry to launch a framework that would, in time, help encourage issuers to increase the amount of CSR data available to market: the United Nations Principles for Responsible Investment (PRI). PRI is a voluntary initiative whereby institutional investors are invited to pledge to incorporate PRI's six organizing principles into their investment programs. *See* PRI, PRI Reporting Framework 2017: Snapshot Report, p.2 (2017), available at *https://app.powerbi.com/view?r=eyJrIjoiZjA2OTA5MWUtMzc4OC00MTZhLWIyZDYtYTc3NDMzOGE1OGFjIiwidCI6ImZiYzI1NzBkLWE5OGYtNDFmMS1hOGFkLTEyYjEzMWJkOTNlOCIsImMiOjh9*.

17 *See supra* n.16.