Investment Adviser ESG Policies and Compliance Measurement

By Gwendolyn A. Williamson

Environmental, social, and corporate governance (ESG) investing is not a new trend, but its meaning is evolving and the practice is growing. Investment advisers have long included ESG factors in their proxy voting guidelines, and ESG-focused strategies abound as retail and institutional investors alike seek out "sustainable" and other "socially responsible investments."[1] Much has been said about measuring the impact of ESG investment strategies and policies on investment performance,[2] and under the federal securities laws public companies are required to disclose material ESG topics in their offering materials and annual and other reports.[3] But, best practices have yet to emerge for assessing compliance with ESG policies adopted at the adviser level. This article identifies compliance issues that can arise with adviser-level ESG policies, and suggests how advisers who have adopted such policies, or are seeking to do so, might work with legal counsel to fold the policies into existing compliance programs.

Advisers managing funds and other client accounts (collectively, accounts) pursuing ESG strategies typically employ exclusionary (negative) or inclusionary (positive) "screens" that filter out investments that do not align with an account's ESG strategies or policies or target certain ESG-focused investments. Advisers also manage accounts following activist ESG-based strategies. The universe of potential ESG investment themes is as broad and multi-faceted as society itself. Whether passive or active, an account's ESG-based approach might require it to invest primarily or only in companies that use solar energy, do not trade in fossil fuels, promote civil rights, encourage gender equality, foster diversity, do not tolerate sexual harassment, increase access to education, embody religious principles, and/or do not manufacture guns; it might steer the account's investments toward investments to foster innovation, achieve space exploration or public wellness goals, protect data and privacy, reward robust audit and risk management governance practices, and/or bolster a resilient national infrastructure.[4] Some accounts might, alternatively, employ a human "vice" strategy, investing in tobacco, alcohol, gambling, and other so-called "sin" stocks.[5] Regardless of the realm(s) that it covers, an ESG policy might impose mandates or factors for consideration, or it might merely make suggestions or set a tone.

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Advertising and Other ESG Compliance Concerns

Advisers may adopt ESG policies whether or not the accounts that they manage follow ESG strategies, and adviser-level ESG policies can function to establish or reinforce a firm's brand or mission statement.[6] For example, in January 2018, speaking about his views as Chief Executive Officer of BlackRock on "fiduciary responsibility and the wider landscape of corporate governance," Laurence D. Fink urged that, "to prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."[7] Implying that BlackRock would favor investing in companies that "benefit all of their stakeholders, including…the communities in which they operate," Fink said that BlackRock continues to "emphasize the importance of…[b]oards with a diverse mix of genders, ethnicities, career experiences, and ways of thinking."[8]

The New York Times reports that Fink's "is a refrain that we're hearing more and more from various pockets of the business community," with "company leaders…taking stands on issues like immigration policy, race relations, gay rights and more."[9] Online clothing retailers branding themselves as "global citizens" advertise their belief that "advocacy through industry" can be used as "a revolutionary way to harness the power of business to create social change," to help people "live better lives" by creating "equal access to the global marketplace."[10] Gun manufacturers and retailers, appealing to a different swath of the political spectrum, center their public communications on "the Second Amendment, which confers a fundamental right, expressly provided in the Bill of Rights, to keep and bear arms" and do "not take political positions with which consumers of [their] products do not agree."[11]

Under the federal securities laws public companies are required to disclose material ESG topics in their offering materials and annual and other reports.

In this environment of increasingly prevalent ESG ideology, advisers have begun posting their ESG policies online and delivering periodic ESG-themed reports and other marketing materials to investors. And, at the operations level, their chief compliance officers (CCOs) are faced with discerning how to best measure and test their firms' adherence to stated values and principles that can be hard to qualify and quantify, given the relative complexity of ESG due diligence generally.[12]

So that their interaction with the federal securities laws is appropriately monitored, advisers' ESG polices should be housed within their compliance programs adopted pursuant to Rule 206(4)-7 under the Investment Advisers Act of 1940 (Advisers Act). Given advisers' fiduciary duties, their ESG policies must not conflict with the best interests of clients and should generally not contradict any strategies used in managing client accounts unless the adviser-level ESG policy is tailored to permit differentiation.[13] And, considering the anti-fraud and advertising rules under the Advisers Act, ESG compliance measurement should be a part of the CCO's annual compliance review, especially when ESG policies are used in a firm's branding and other marketing efforts.[14] Indeed, as socially responsible investing has become more popular, some have questioned the authenticity of adviser-level ESG policies. As one commenter explains,

> it used to be that asset owners could identify which investment managers "got" ESG investing principles simply by asking whether they had a written ESG policy. Today, most investment managers have something to say about ESG issues, and written ESG policies are becoming ubiquitous. Yet, as anyone who has ever looked at investment managers' ESG policies can attest, the existence of a written document is not [necessarily] a reliable indicator of a firm's commitment to or performance on sustainable long-term goals.[15]

Perhaps more importantly, the Office of Compliance Inspections and Examinations at the Securities and Exchange Commission has advised repeatedly that it will pursue enforcement action against advisers that: do not fully adhere to their written policies; have compliance programs that do not "take into account important

individualized business practices such as the adviser's particular investment strategies" and policies; and/or make inaccurate or misleading statements in their Form ADV and other public disclosures, including advertisements that make claims of compliance with voluntary standards.[16]

Tools for ESG Compliance Measurement

Advisers' ESG policies can vary immensely depending on their targeted client base, geographic and industry focus, and other factors. For some, the goal might be to run a fully integrated ESG shop, making investments on behalf of clients and managing the firm's own operations in alignment with articulated ESG values. Others might apply their ESG policies to only a portion of their investment and/or operational activities. Many have used the United Nations' Principles of Responsible Investment (UNPRI) and/or guidance from the Sustainability Accounting Standards Board (SASB) as the foundational basis for their ESG policies.[17] The American Investment Council (formerly the Private Equity Growth Capital Council) has also published guidelines for ESG investing in the private equity context.[18]

Whatever the origin of an adviser's ESG policies, and regardless of its particular ideological bent, under the Advisers Act the firm will need to evaluate adherence to its ESG policies at least annually. Advisers should work with counsel to develop appropriately tailored ESG compliance measurement structures covering their general operations and their investment activities.

ESG Compliance in General Firm Operations

An adviser should consider having its ESG compliance assessments measure how the firm's overall operations support or detract from its ESG policies. In addition to other factors unique to the business of the firm, an adviser's ESG compliance measurement framework might seek to ensure that:

- ESG efforts are generally coordinated across the behaviors of the firm and its employees, including with respect to executive compensation and other human resource issues;
- adviser-level ESG policies are consistent with the firm's proxy voting guidelines and account-level ESG investment strategies, if any;
- executive management acts in accordance with the firm's ESG policies and any other advertised ESG stance(s);
- controls are in place to ensure the accuracy of ESG-related claims and commitments included in marketing content, financial reporting, verbal and written employee public statements (including those made on social media), Form ADV disclosures and other SEC filings, and management agreements and other contracts;
- ESG-related reputational and other risks are successfully identified and mitigated or remediated;
- ESG compliance failures are identified, addressed, and disclosed in a timely manner;
- employees are given clear and appropriately detailed guidance on complying with the firm's ESG policies, including in managing client accounts; and
- as appropriate given the scope of its ESG policies, the firm:
  - has an ESG committee or other governing body responsible for overseeing the ESG policies and/or developing ESG initiatives;
  - has engaged, or has an articulated rationale for not engaging, ESG specialists and/or consultants;
  - holds itself accountable for implementation of stated ESG goals; and
  - reflects its ESG policies in its investment activities, whether proprietary or on behalf of clients.

These various considerations may apply not only where an investment adviser adopts an ESG policy but also where a single client engages the adviser to manage an ESG strategy. An adviser first considering managing an ESG account may wish to put it through the same processes as it does for any new line of business.

ESG Compliance in Specific Firm Investment Activities

Advisers that have adopted ESG policies should also have in place a framework for measuring how their investment activities, whatever the investment focus is outside of ESG considerations, comply with both firm-level and account-level ESG policies. As with ESG compliance tests covering general adviser operations, a mosaic of data

points should inform a CCO's consideration of how the firm's investment activities comply with its ESG policies. The following example, based on certain common healthcare and environmental ESG policies, illustrates the myriad inputs around which a methodology for measuring ESG investment compliance might be framed.

An adviser focused on socially responsible investing in the healthcare sector might adopt firm-level ESG policies that generally limit investments to companies that:

- endeavor to protect employee safety and respect human rights;
- seek to protect the health of the natural environment;
- are intentionally positioned to beneficially address the needs of the aging US and global populations;
- pro-actively work to expand access to quality healthcare;
- ensure the quality and integrity of their products and services;
- price and market their products and services fairly and ethically;
- employ best disclosure and accounting practices; and
- embrace corporate governance principles intended to instill ethical business practices.

To facilitate and provide for oversight of its compliance with these policies, the adviser might invest only in companies following ESG policies aligned with the policies of the firm and/or its accounts. The adviser might also require that documentation be submitted to the CCO for review on each investment's contribution to, or exception from, the firm's ESG policies. Before making a new investment, periodically throughout the holding period as appropriate given the nature of the account and the investment, and upon exit, investment professionals might rate the company on each ESG factor, looking to publicly available information such as the company website, media reports, and SEC filings, as well as due diligence materials requested from the company such as financial statements, marketing materials, board meeting minutes, and other working papers. Such documentation could be produced internally or with the assistance of a third-party vendor and should be tailored to the type of account and the adviser's business generally. With respect to the socially responsible healthcare-focused ESG policies described above, it would equip the CCO with vital information regarding portfolio companies' practices around, respectively:[19]

- incentivizing excellence in patient outcomes (as evidenced by the company's executive compensation policies) and employee safety and compensation (as evidenced in the company's occupational health and safety policy/ employee handbook and records regarding time lost to injuries, accident investigations, and related matters);
- limiting any negative operational impact on the environment (as evidenced by the company's statistics regarding energy consumption attributable to "clean" energy like wind and solar power, water withdrawal from water-stressed regions, reuse/recycling/donation of devices and supplies, and incorporation of environmental and human health considerations in product lifecycles);
- developing new healthcare products and service delivery methods and other technologies designed for the needs of those 65 years old and above;
- allocating corporate resources and activities to education regarding and, reduced-fee offerings of, preventative and early intervention healthcare;
- compliance with the guidance, regulations, and approval process of the US Food and Drug Administration (FDA) (as evidenced by any recalls involving products manufactured by the company, the inclusion of company products on the FDA's MedWatch Safety List Alerts for Human Medical Products (Medical Devices) or any similar such list, and any data regarding company products, particularly any disclosed fatalities, included in the FDA's Adverse Event Reporting System);
- fair, ethical, and access-expanding pricing (as evidenced by the ratio of the company's weighted average rate of net product/service price increases to the US Consumer Price Index, policies limiting the negative impact of downward fee pressure and cost containment on consumers, plans incorporating revenue opportunities generated by expanding access to products or services, and disclosures regarding fees charged to individual customers versus group purchasing organizations) and fair, safe, and ethical advertising (as evidenced by any regulatory fines incurred

or any legal settlements regarding false marketing claims, including off-label marketing violations of the Food, Drug, and Cosmetic Act prosecuted under the False Claims Act, and any related remedial action);

- disclosure and accounting practices that comport with the Health Care Standards adopted by SASB; and
- the prevention of corruption and bribery (as evidenced by the company's code of ethics and an absence of any regulatory fines incurred or any legal settlements involving corruption, kickbacks, or other unethical business practices, including but not limited to violations of the Foreign Corrupt Practices Act).

Using these inputs, the adviser's CCO should be able to gauge the extent to which the firm's aggregate investment activity comports with its ESG policies for socially responsible investing in the healthcare sector. Advisers with all types of ESG investment mandates and policies should work with counsel to structure the ESG policy compliance-assessment process most appropriate for their businesses and to identify the best ways of informing their CCOs' ESG policy compliance assessments.

Looking Ahead: Normalization of ESG Compliance Measurement

Compliance measurement in the ESG context differs from traditional compliance testing primarily due to the subject matter involved. As opposed to relatively simple rules-driven adviser policies and procedures, ESG policies are often more nuanced and can relate to some of society's most firmly held, and politically sensitive, beliefs. Still, advisers and their CCOs should adjust their tried-and-true compliance programs to require testing of how the firm satisfies its ESG policies, from both a general operating perspective and an investment activity perspective. ESG compliance measurement should evolve along with ESG generally and become easier, not harder, as best practices and benchmarks emerge in step with the growth of socially responsible investing in the United States and abroad.

Advisers managing funds and other client accounts (collectively, accounts) pursuing ESG strategies typically employ exclusionary (negative) or inclusionary (positive) "screens" that filter out investments that do not align with an account's ESG strategies or policies or target certain ESG-focused investments.

ENDNOTES

* Gwendolyn A. Williamson's 15 years of experience in the asset management industry includes work with: registered fund launches and liquidations; fund and adviser compliance and vendor oversight programs; SEC registrations, examinations and investigations; annual compliance and risk assessments; routine and special shareholder disclosures; conflict of interest issues; cybersecurity oversight and monitoring; annual fund contract renewals and independence evaluations; large-scale fund and adviser changes in control; applications for exemptive relief; reporting under the federal securities laws; and negotiating advisory agreements, fund selling and servicing agreements, credit facilities, securities lending arrangements and other contracts germane to the asset management industry.

[1] For example, the Vanguard FTSE Social Index Fund, which launched in 2000, "seeks to track a benchmark [the FTSE4Good US Select Index] of large- and mid-capitalization stocks that have been screened for certain social, human rights, and environmental criteria." The Calvert Balanced Fund, launched in 1982, "is guided by The Calvert Principles for Responsible Investment, which provide a framework for considering environmental, social and governance ("ESG") factors that may affect investment performance." Roughly a quarter of total global assets under management (more than $22 trillion) are currently invested in strategies based on "the premise that environmental, social, and governance (ESG) factors can materially affect a company's performance and market value." (Sara Bernow, Bryce Klempner, and Clarisse Magnin, "From 'why' to 'why not': Sustainable investing as the new normal," McKinsey & Company (Oct. 2017), available at *https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal*). *See also* the January 10, 2018 announcement made by the Mayor and Comptroller of New York City that the New York City Employees' Retirement System and New York Teachers' Retirement System would begin a staged five-year plan of divesting from approximately $5 billion in fossil-fuel related investments in over 200 companies (available at *http://www1.nyc.gov/office-of-the-mayor/news/022-18/climate-action-mayor-comptroller-*

trustees-first-in-the-nation-goal-divest-from#/0). Pension funds were in fact among the first ESG investors, investing in projects to provide housing benefits for union workers and employ union labor as far back at the 1950s, although some attribute the concept of socially responsible investing to 18th century religious movements such as Methodism and the Religious Society of Friends (Quakers). (*See http://www.the-ethical-partnership.co.uk/historyofethicalinvestment.htm*).

2 As industry observers have pointed out, "Researchers continue to explore the relationships between ESG performance and corporate financial performance, and between ESG investment strategies and investment returns. Several studies have shown that sustainable investing and superior investment returns are positively correlated. Other studies have shown no correlation. Recent comprehensive research (based on more than 2,000 studies over the last four decades) demonstrates sustainable investing is uncorrelated with poor returns." (Bernow, Klempner, and Magnin, supa n.1).

3 *See* Rule 408 under the Securities Act of 1933 and Rule 12b-10 under the Securities Exchange Act of 1934.

4 See, e.g., recently filed registration statements for ETFs with strategies designed to empower women and minorities (Impact Shares YWCA Women's Empowerment ETF and Impact Shares NAACP Minority Empowerment ETF), support efforts to reduce global warming (Procure Advanced Global Warming ETF), and encourage the development of space-related entities (Procure Space ETF), participate in medical marijuana legalization trends (Alternative Agroscience ETF). These ETFs will join the approximately 65 existing ESG ETFs in the market, including the largest ESG ETF, the MSCI KLD 400 Social ETF, which has approximately $985 million iShares and an investment strategy that "screens out both military weapons and civilian firearms makers." (Lara Crigger, "Clients Asking for Gun-Free ETFs," ETF.com (Mar. 7, 2018), available at http://www.etf.com/sections/features-and-news/clients-asking-gun-free-etfs?utm_source=newsletter&utm_medium=email&utm_campaign=dailynewsletter).

5 See, e.g., the USA Mutual Vice Fund (which invests in "companies that derive a significant portion of their revenues from a group of vice industries that includes the alcoholic beverages, tobacco, gaming and defense/aerospace industries") and the AdvisorShares Vice ETF (which invests in securities of "companies that derive at least 50% of their net revenue from tobacco and alcoholic beverages and companies that derive at least 50% of their net revenue from the marijuana and hemp industry or have at least 50% of their company assets dedicated to lawful research and development of cannabis or cannabinoid-related products").

6 The ethos of social values-based investing can swell in connection with current events. For example, investor interest in ESG strategies that screen out gun-related stocks might rise in connection with news of a school or other mass shooting.

7 https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

8 Id.

9 Andrew Ross Sorkin, "BlackRock's Message: Contribute to Society, or Risk Losing Our Support," N. Y. Times (Jan. 15, 2018), available at https://www.nytimes.com/2018/01/15/business/dealbook/blackrock-laurence-fink-letter.html.

10 https://www.apolisglobal.com/about/.

11 Response of American Outdoor Brands Corporation to the Questions Raised in BlackRock's Letter dated March 1, 2018, available at http://ir.aob.com. *See* Andrew Ross Sorkin, "Big Investors Have Clout. They Can Use It With Gun Makers," N.Y. Times (Mar. 5, 2018), available at https://www.nytimes.com/2018/03/05/business/dealbook/investors-gunmakers.html. *See* also https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-distributing-firearms.

12 The topic is outside the scope of this article, but advisers should work with counsel to craft their ESG policies with the greatest level of clarity and specificity possible.

13 The SEC has explained that advisers' fiduciary duties prevent them from "engag[ing] in any activity in conflict with the interest of any client." (https://www.sec.gov/divisions/investment/advoverview.htm).

14 Section 206(4) of the Advisers Act makes it unlawful for an adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative," and Rule 206(4)-1 under the Advisers Act specifies advertising practices that "constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4)."

15 Michael Cappucci, Senior Vice President of Harvard Management Company, Inc. "The ESG Integration Paradox," Harvard Law School Forum on Corporate Governance and Financial Regulation (July 26, 2017), available at https://corpgov.law.harvard.edu/?s=esg+paradox.

16 *See* "The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers," OCIE National Exam Program Risk Alert, Volume VI, Issue 6 (Sept. 14, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf ; *See* also "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers, OCIE National Exam Program Risk Alert, Volume VI, Issue 3 (Feb. 7, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

17 The six UNPRI call for asset managers to: incorporate ESG issues into investment analysis and decision-making processes; be active investors and incorporate ESG issues into ownership policies and practices; seek appropriate disclosure on ESG issues from portfolio companies; invest in companies that promote acceptance and implementation of the UNPRI within the investment industry; work together to enhance effectiveness of implementation of the UNPRI; and report on activities and progress towards implementing the UNPRI. (*See* https://www.unpri.org/about/the-six-principles). The SASB "is an independent, private-sector standards setting organization...[that] develops and maintains sustainability accounting standards—for 79 industries in 11 sectors—that help public corporations disclose financially material information to investors in a cost-effective and decision-useful format." (*See* https://www.sasb.org).

18 *See* http://www.investmentcouncil.org/?s=esg+guidelines.

19 *See* generally the sustainability accounting metrics identified by the SASB as germane to the healthcare industry.

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