Board iQ

Opinion

Do Your Advisers Consider Material ESG Risks?

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More fund groups are offering funds that adhere to environmental, social and governance investment standards than in years past, and as result, many independent directors have become familiar with the related concepts and principles.

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However, it's not just directors overseeing ESG products who need to be aware of sustainable investing principles and developments. Everyone overseeing funds should understand the implications of the Sustainability Accounting Standards Board's recently issued compendium of industry-specific standards for corporate issuers. It calls for disclosure of sustainability- and ESG-related risks, including those tied to greenhouse gas emissions, energy and water usage, engagement with neighboring communities, security and human rights impacts, indigenous rights, and labor relations.

Here's what fund directors need to know about the new SASB standards and why they are relevant to board oversight of advisory services provided to their funds.

Why SASB Standards Are Relevant

The SASB is an independent nonprofit that develops reporting standards to help businesses identify, manage and communicate financially material sustainability information to their investors. The standards are voluntary but are supported by numerous institutional investment advisory firms that helped develop and craft them, including **BlackRock**, **Vanguard** and **State Street Global Advisors**. This support implicitly reflects the conclusion of those advisory firms that the sustainability and ESG risks identified by the SASB are material to the investment decision-making process.

Generally, Securities and Exchange Commission rules do not impose specific requirements related to disclosure of sustainability- and ESG-related risks by corporate issuers. This remains the case, even though public interest groups, public pension funds, state treasurers and mutual fund groups have filed petitions urging the adoption of rules imposing broader and more robust disclosure of these matters.

Under current rules, corporate issuers must disclose data regarding sustainability- and ESG-related risks associated with their businesses only if they determine these risks are "material." However, the SASB standards may be viewed as establishing standards of materiality that fund directors should not ignore.

What That Means for Fund Directors

Mutual fund directors have a fiduciary duty to represent the interests of the funds they serve and their shareholders. They must act with due care and exercise reasonable business judgment. This means they must be fully informed of and consider all pertinent facts in supervising the affairs and operations of their funds.

Investment advisers also have fiduciary duties and must act with due care in managing the portfolios of their clients. Implicit in the duty of care is the obligation to investigate. In this regard, the SEC staff has stated that advisers have a responsibility to make a reasonable investigation to determine that their recommendations are not based on materially inaccurate or incomplete information.

In light of these duties and the new SASB standards, independent directors should understand whether and how their funds' adviser considers sustainability- and ESG-related risks in managing investment portfolios, regardless of whether those funds adhere to ESG investment principles.

Questions to Ask

Some questions independent directors might want to ask fund advisers related to consideration of sustainability and ESG risks include:

- Does the adviser consider the risks identified in the SASB standards to be material?
- Are these risks, or other sustainability and ESG risks, considered when the adviser makes investment decisions?
- Does the adviser only consider disclosures made by issuers, or does it conduct independent research and analysis in evaluating sustainability and ESG risks?

- What affirmative steps are taken to obtain material sustainability and ESG risk information as part of the investment process? Do they involve engagement with issuers?
- Does the adviser analyze how the sustainability-and ESG-related practices of issuers may impact their financial performance?

A number of shareholder proposals have been filed for the 2019 annual meeting season calling for issuers to provide disclosures compliant with SASB standards. Independent directors should ask their funds' advisers to explain how they intend to vote on these proposals when they're included in issuers' proxy statements and why.

Mutual fund advisers have a responsibility to act in the best interests of their funds and shareholders. This means that they have a duty to obtain and evaluate all information material to their investment decisions. Independent directors are responsible for supervising the services advisers provide the funds.

SASB standards identify the types of sustainability- and ESG-risk information that should be viewed as material to investing in issuers engaged in specific industries. To fulfill their responsibilities, independent directors need to evaluate whether the advisers of their funds are obtaining all material sustainability and ESG risk information and should assess whether the manager is giving appropriate consideration to this information in the investment decision-making process.