ESG

Schulte Roth & Zabel

29TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 21, 2020

Partner
New York Office
+1 212.756.2009
jennifer.dunn@srz.com

Practices

Investment Management

Hedge Funds

Private Equity

Blockchain Technology & Digital Assets

Jennifer M. Dunn

Jennifer M. Dunn focuses her practice on advising hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities laws matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single investor funds.

Jennifer was named among the world's "50 Leading Women in Hedge Funds" by *The Hedge Fund Journal*. A member of the board of directors of 100 Women in Finance, Jennifer is recognized by *The Legal 500 US, Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds), *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and has been named an *IFLR1000* "Rising Star" (Investment Funds). She co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and presented at conferences on topics including attracting and retaining capital, operational due diligence, compliance issues, hedge funds and management company structures and considerations for emerging hedge fund managers. Jennifer earned her J.D. from Columbia Law School and her B.A., *cum laude*, from the University of Pennsylvania.

Partner
New York Office
+1 212.756.2024
andrew.fadale@srz.com

Practices

Mergers & Acquisitions

Distressed Investing

Private Equity

Energy

Financial Institutions

Andrew J. Fadale

Andrew J. Fadale practices primarily in the areas of mergers and acquisitions, leveraged buyouts, restructuring transactions and control and non-control investments. He also counsels clients in general corporate law matters. Andrew's experience includes transactions across multiple industries and structures, including representing private equity buyers and sellers in connection with investments in the automotive, energy, financial services, manufacturing and consumer retail sectors. Andrew received his J.D. from Washington and Lee University School of Law and his B.S. from the University of Florida.

Partner
London Office
+44 (0) 20 7081 8002
christopher.hilditch@srz.com

Practices

Investment Management

Regulatory & Compliance

Financial Institutions

Hedge Funds

Blockchain Technology & Digital Assets

Christopher Hilditch

Christopher Hilditch is co-head and co-founding partner of the firm's London office. With 25 years of experience advising many of the highest profile hedge funds, Chris focuses his practice on entrepreneurial and institutional investment managers, other financial services firms and investment funds, especially hedge funds, hybrid funds, co-investment funds and distressed funds. He provides practical and strategic advice on the structuring and operation of funds and investment managers, including fundraising, investor issues, investment transactions and financing as well as regulatory and compliance matters.

Chris has been described by interviewees in *Chambers UK* as "fantastic — practical, commercial and knows his stuff" and as a "go to lawyer for dealing with a complicated hedge fund" and in *The Legal 500 UK* as "excellent" and "knows the industry inside out." He received an "Outstanding Contribution" award for his services to the hedge fund industry (*The Hedge Fund Journal* Awards) and was one of only two hedge fund lawyers listed as a leading individual by *The Legal 500 UK* in 2015, which also included him as an elite leading lawyer in investment funds in 2014. Clients praise his "very strong technical knowledge and commercial awareness" as well as his "deep knowledge and experience in the fund industry." Chris has also been named as a leading funds lawyer in *Chambers UK, Chambers Europe*, *Expert Guide to the Best of the Best* (which named him as one of the top 25 funds lawyers worldwide), *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *IFLR1000*, *PLC Cross-Border Investment Funds Handbook*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *Who's Who of Professionals*. Chris has participated in the UK Financial Services Authority's Legal Experts Group in respect of AIFMD and has been an active participant on various AIMA and other industry committees on matters relating to the hedge fund industry. Chris is a frequent speaker at industry conferences and seminars, including invitation-only conferences for clients of prime brokers and other industry participants. He has also written on a wide range of hedge fund and regulatory topics. Recently, Chris was invited to be the general editor of the *Chambers Alternative Funds Guide 2019* — a guide examining key industry trends and regulatory and tax matters impacting funds, managers and investors. He has also authored a chapter on "Conflicts of Interest" in *Investment Management, Law and Practice* (Oxford University Press) and co-authored a chapter on "United Kingdom Considerations" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Chris attended law school at the College of Law, Guildford and holds an M.A., with honors, from Pembroke College, University of Oxford.

Environmental, Social and Governance (ESG)

I. Alternative Funds and the Responsible Investing Trend

A. *Background*. In recent years, the alternative funds market has seen a surge in responsible investing.

B. What Is Responsible Investing?

1. There is no single definition. However, the United Nations-supported Principles for Responsible Investment ("UN PRI") define responsible investing as "an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate long-term returns."[1]

2. Responsible investing may encompass one or more of the following specific types of investing.

(a) *ESG Investing/Sustainable Investing.* Investors consider ESG factors during the investment process and direct capital toward companies that have strong business practices as they relate to ESG.

(b) *Socially Responsible Investing.* Values-oriented approach where investors do not invest in companies that participate in businesses that misalign with their values.

(c) *Impact Investing*. Allocation of capital with the express purpose of generating a positive social impact alongside a financial return.

(d) *Ethical Investing*. Using investor's own ethical principles as the main filter for securities selection. This method is highly dependent on the investor's views.

(e) *Green Investing*. Activities that focus on companies or projects that are committed to the conservation of natural resources, alternate energy sources, implementation of clean air/water and other environmentally-conscious business practices.

(f) *Shared-Value Investing.* Profit-driven, social impact investing that creates value for both society and shareholders.[2]

(i) In 2019, the Business Roundtable, a group of nearly 200 CEOs of major U.S. corporations, issued a statement redefining the "purpose of a corporation." Instead of serving shareholders and maximizing profits, they reimagined it to serve all stakeholders of the company by investing in employees, delivering value to customers, dealing ethically with suppliers and supporting the broader community.[3]

(1) Among the 200 signatories were Jeff Bezos of Amazon, Tim Cook of Apple and Dennis Muilenburg of Boeing.[4]

(g) Some consider "Responsible Investing" to be a spectrum on which all the above types of investing, including ESG investing, lie — but no defined vernacular has been established as of yet.[5]

(h) While each of the above labels assumes that ESG factors are being considered at some point during the investment process, they each have their own nuances.

C. Environmental, Social, and Governance (ESG) Factors

---

[1] UN PRI, https://www.unpri.org/about/what-is-responsible-investment.

[2] Where ESG Fails, https://www.institutionalinvestor.com/article/b1hm5ghqtxj9s7/Where-ESG-Fails.

[3] The CEOs of Nearly 200 Companies Just Said Shareholder Value is No Longer Their Main Objective, https://www.cnbc.com/2019/08/19/the-ceos-of-nearly-two-hundred-companies-say-shareholder-value-is-no-longer-their-main-objective.html.

[4] *Id.*

[5] Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of "Doing Well by Doing Good," https://www.hflawreport.com/2686956/preparing-for-the-impact-revolution-how-fund-managers-can-implement-the-philosophy-of-doing-well-by-doing-good-.thtml.

1. Background

   (a) What exactly are ESG Factors?

      (i) There is no universal answer — the answer is usually in the eye of the beholder. Broadly, however, ESGs are various environmental, social and governance factors that are taken into account when making investment decisions.

   (b) Examples of ESG Factors

      (i) *Environmental*. Green energy, renewable energy, pollution, climate change, carbon emissions and resource depletion.

      (ii) *Social*. Working conditions (including child labor), health and safety, impact on indigenous peoples, diversity in the workplace, anti-gun and anti-abortion.

      (iii) *Governance*. Executive pay, board composition, corporate tax strategy, bribery/corruption and political influence.

   (c) Further complicating the above classification system is the fact that ESG factors are often interlinked and it can be challenging to classify particular issues as only environment, social or governance–related.

2. Types of ESG Strategies

   (a) *Affirmative Strategy*. Invest in companies that focus and/or prioritize specific ESG factors.

   (b) *Negative Strategy*. Avoid certain types of investments and/or companies that operate in unwanted ways.

      (i) Leading negative/exclusionary criteria for institutional investors include: companies doing business in Sudan, tobacco-related businesses and companies that lack equal employment opportunities (e.g., in emerging market jurisdictions).

   (c) *Takeaway*. There are many different considerations within ESG investing and not all are relevant to all investments. For example, a real estate fund manager might want to ensure that buildings are energy efficient and constructed from sustainable materials. In contrast, an equity manager may be more interested in the governance of an investee company.[6]

II. Importance: Why Should We Care?

A. Responsible investing is one of the biggest trends reshaping the global asset management industry.

1. Historically, such investing was much less prominent in the United States than in the EU.

   (a) The EU has even issued legislation on sustainable finance with regards to ESG disclosures and the new version of the U.K. Financial Reporting Council's Stewardship Code[7] (first published in 2010) sets out detailed expectations on how ESG issues should be integrated into the investment process. U.K. FCA authorized private fund managers are required to disclose on their website the nature of their commitment to the Stewardship Code or their alternative investment strategy.[8]

   (b) In the past, advisers would report that they had not been asked about ESG considerations by investors and would therefore assume that investors do not care. Rather, that their sole focus was on returns.

[6] *See* Alternative Funds, p. 4.

[7] *See* https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final.pdf.

[8] *See* https://www.handbook.fca.org.uk/handbook/COBS/2/2.html#D153.

(c) This has shifted in the past decade. In 2016, there were $22.89 trillion in global assets being professionally managed via responsible investment strategies.[9] This represented approximately 25% of total assets being managed by the global asset management industry.[10]

(d) From 2016-2017, 71.4% of hedge fund firms reported increased investor interest in responsible investment.[11]

(i) A separate study in 2019 found that an overwhelming majority of investors said that an ESG policy was either critically important (63%), or somewhat important (26%), when deciding whether to invest with a given manager.[12]

(ii) These numbers suggest that impact investing or responsible management of funds is by no means a short-term trend. Rather, it is likely to continue to shape the asset management industry — likely with permanent consequences.

B. Reasons Behind the Trend

1. The focus on responsible investing is linked with a generational change in attitude. Millennials are actively thinking about responsible investing as a guiding principle for their investment decisions. In fact, they are twice as likely to make ESG investments as the overall investor population.[13]

(a) Furthermore, Baby Boomers are expected to pass down their money to future generations with an unprecedented $30 trillion to change hands over the course of the next several decades.[14]

2. It is also driven by socially conscious investors seeking to achieve high returns while making a positive social impact.[15]

(a) With the downfall of large companies, such as PG&E, environmental considerations have moved to the forefront.

(b) Nike has vowed to source 100% renewable energy across all of its operations by 2025.[16]

3. Variations Across the Trend

(a) Interestingly, to date, private equity managers have embraced responsible investing at a much higher rate than hedge funds, as evidenced by the number of signatories to the UN PRI.

(i) Of the UN PRI signatories in 2016, approximately 5% (53) identify themselves as hedge funds, while 23% (253) identify themselves as private equity firms.[17]

(b) One explanation may be that private equity, which requires longer time horizon to gauge efficacy, lends itself better to this type of investing than hedge funds, which hedge shorter-duration risks.

---

[9] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 7.

[10] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 7.

[11] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 14.

[12] EY 2019 Survey Finds Hedge Funds losing Ground to PE; Need for Cost Controls; and Growth of Non-Traditional Investment Products, ESG and Separate Accounts (Part One of Two), https://www.hflawreport.com/4194722/ey-2019-survey-finds-hedge-funds-losing-ground-to-pe-need-for-cost-controls-and-growth-of-non-traditional-investment-products-esg-and-separate-accounts-part-one-of-two.thtml.

[13] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[14] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[15] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

[16] What is ESG Investing, https://www.fool.com/investing/what-is-esg-investing.aspx.

[17] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

(c) Other explanations include risk exposure and investor pressure. The private equity community arguably takes a more active role in managing companies and is warier of ESG-related risks. As for investor pressure, private equity funds face pressure from responsible investors (such as pension funds), which heavily consider ESG-related factors when investing.

III. United Nations Principles for Responsible Investment

A. In 2005, the United Nations invited the world's largest institutional investors to join a process to draft principles for responsible investment. By 2006, a group of six principles had been released.[18]

B. What are they?

1. The UN PRI are a set of six principles that offer signatories actions for integrating responsible investment into their investment decisions.[19]

2. Specifically, the principles include:

(a) Incorporation of ESG issues into investment analysis and decision-making processes;

(b) Active ownership and incorporation of ESG issues into fund ownership policies and practices;

(c) Seeking appropriate disclosure on ESG issues by the entities in which the fund invests;

(d) Promoting acceptance and implementation of the Principles within the investment industry;

(e) Working together to enhance the fund's effectiveness in implementing the Principles; and

(f) Reporting on activities and progress.

C. Unlike the other types of responsible investing (sustainable, impact, green, etc.), which have a moral or ethical component, the UN argues that responsible investing can and should be pursued by investors whose sole purpose is financial return.

1. To ignore ESG factors is to ignore risks and opportunities that have a material effect on an investment's return.

D. Who has joined UN PRI and what does joining mean?

1. By 2016, approximately 1,054 managers had become signatories to the principles. As previously mentioned, 5% of these identified themselves as hedge funds. 23% identified themselves as private equity advisers.

2. By 2018, the percentage of signatories that identified as private equity firms jumped to 29% (a total of 431, compared to the previous 253 firms).[20]

3. Today, the UN PRI boasts over 1,600 signatories representing over $70 trillion assets under management.[21]

4. One explanation for the lower number of hedge fund signatories is that many early adopters of PRI have large institutional investors, such as European pension plans, driving this issue (whereas small to medium-sized managers have not been confronted with this by their investors).[22]

5. In addition to committing to the principles, signatories must pay an annual fee to PRI and publicly report on their responsible investing activity.

---

[18] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

[19] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 6.

[20] 2018 Private Equity Snapshot: Summary, https://www.unpri.org/private-equity/2018-private-equity-snapshot-summary/3999.

[21] The Remarkable Rise of ESG, https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#2c3e4c181695.

[22] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

(a) This requires a company's service providers to adapt and adhere to the PRI as well.

(b) The UN has identified a number of firms that used the PRI label but were not compliant.

IV. Implementation of ESG Strategies

A. General Recommendations

1. Adopt an ESG policy, which itself should be a general statement of principle rather than a discrete list of procedures.

2. The policy should commit to process only, not to any results or specific outcomes (i.e., a good faith effort to identify/manage ESG risks.)

   (a) Be mindful that failing to adhere to an advertised policy may violate agreements with investors and general securities laws.

B. Structuring Options

1. *SMAs*. Some large institutions seek to bypass commingled funds by allocating to separately managed accounts (SMAs). This tactic allows them to dictate the specific ESG parameter they wish to have applied to the account or be excluded from the account.

2. "Opt out" right*s* excuse specific investors, as opposed to the entire fund, from participating in investments that would violate the investors' ESG investing factors.

   (a) This can be negotiated in a side letter agreement with the investment manager.

   (b) It is critical that the fund's governing documents permit the investment manager/general partner to:

      (i) Excuse certain investors from participating in a capital call (in the private equity context); or

      (ii) Permit an investor to opt out of certain investments (in the hedge fund context).[23]

3. An alternative to the "opt-out" right is to allow the investor to invest in a fund that runs in parallel to the main fund.

   (a) This parallel fund would follow the same investment strategies as the main fund, except with respect to investments in companies/securities that would violate the investor's ESG policy.[24]

4. Investors may also employ affirmative integration of ESG factors by a manager.

   (a) These are typically drafted as non-binding, flexible guidelines that permit investment professionals to take ESG factors into account when implementing the investment strategy.

   (b) Typically, no single factor is dispositive.

5. *Springing ESG Provisions*. Provisions in the main fund agreements whereby the manager incorporates a springing procedure into its policy.

   (a) Such a policy may include an introduction describing the manager's general commitment to ESG investing. However, the procedural aspects are only structured to "spring" upon:

      (i) Request by an investor and subject to the discretion of the investment manager; or

---

[23] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

[24] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

(ii) Alignment of ESG-specific procedures with the fund's investment strategy.[25]

V. Challenges to Implementation

A. Two Commonly Cited Challenges

1. *Inadequate Methodologies for the Calculation of Sustainability Risks*. There is no agreed-upon universal methodology. Rather, there are enormous disparities in the methods being used by investment management firms with regards to ESG calculation and analysis in the context of investment decisions.

2. *Lack of Relevant Disclosures From Companies*. Without companies publicly disclosing data that shows their ESG-related performance, firms find it difficult to evaluate the ESG impact of a potential investment.

3. There are now several initiatives to encourage more companies to report and disclose ESG factors.

(a) Examples include the Sustainability Accounting Standards Board ("SASB") and the Carbon Disclosure Project ("CDP"), which encourage companies to disclose data such as employee compensation and carbon emissions data, respectively.

(b) Some large companies, such as ExxonMobil, are embracing these disclosures due to continued pressure from their investors.[26]

4. In 2016, the SEC issued a concept release seeking public comment on amending regulation S-K, which governs the reporting of non-financial statements for public companies. Specifically, the SEC sought guidance as to which sustainability issues are relevant to investors when making informed voting/investment decisions.

B. Additional Concerns

1. *A Lack of Practical Understanding*. Unclear what exactly an ESG commitment entails, because it seems broad and impractical.

2. *Skepticism With Regards To Returns*. Many managers are skeptical about the viability of their investments being able to generate double-digit returns while implementing ESG strategies.

3. *Lack of Attractive Opportunities*. Some managers cite a lack of attractive investment opportunities when considering a responsible investment approach.

4. *Fund Manager's Fiduciary Duty*. Fear that ESG commitments are at the expense of shareholder value and that this violates a manager's duty.[27]

C. However, remember that these concerns may fade as responsible investment and implementation of ESG strategies become more mainstream.

VI. How Is ESG Investing Shaping the Alternative Funds Industry and What Is Its Future?

A. As mentioned earlier, there is no one-size-fits-all approach to ESG investing.

1. This is partly due to the fact that private fund advisers have had to incorporate ESG factors at the request of investors and have done so through a variety of approaches to meet the diverse needs of such investors.

B. As we go forward, we will likely see small adjustments in the investment management framework. For example, 30 years ago intangible assets represented only a third of the market, whereas today they account for roughly 90%.

---

[25] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part Two), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-two-of-two.thtml.

[26] From Niche to Mainstream: Responsible Investment and Hedge Funds, p. 29.

[27] The Past, Present and Future of ESG Investing in the Hedge Fund Industry (Part One), https://www.hflawreport.com/2551991/the-past-present-and-future-of-esg-investing-in-the-hedge-fund-industry-part-one-of-two.thtml.

C. There is a potential for accounting standards to change in order to better capture the importance of these intangibles, including ESG factors.

D. *Data Providers*. This interest and increase in ESG investing has led to the creation of several data providers, such as MSCI and Sustainalytics, which generate ESG ratings for companies. This may be a useful approach for fund managers moving forward with this trend.[28]

E. There is a potential that 401(k) options will change, as many millennials have expressed a desire for ESG investing as an option within their 401(k) plans.[29]

---

[28] Preparing for the Impact Revolution: How Fund Managers Can Implement the Philosophy of "Doing Well by Doing Good," https://www.hflawreport.com/2686956/preparing-for-the-impact-revolution-how-fund-managers-can-implement-the-philosophy-of-doing-well-by-doing-good-.thtml.

[29] What Is ESG Investing?, https://www.fool.com/investing/what-is-esg-investing.aspx.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com