DECHERT ON ESG

A Practical Guide for Asset Managers:Utilizing Principles and Frameworks for ESG Reporting and Disclosure

DECEMBER 2020

Dechert
LLP

DECHERT ON ESG: A Practical Guide for Asset Managers: Utilizing Principles and Frameworks for ESG Reporting and Disclosure

December 2020 / Authored by Brenden Carroll, Mikhaelle Schiappacasse, Tyler Payne, Claire Bentley, Nicholas DiLorenzo, Philippa List, Stanley Tiu, Julien Bourgeois and Mark Perlow

Asset managers across geographies and asset classes are increasingly incorporating environmental, social and governance ("**ESG**") considerations at all levels of the investment management business. Increased focus on ESG has been driven by investor demand and the introduction of new regulatory requirements in certain key jurisdictions.[1] ESG considerations now have a more important role to play in the development and implementation of investment strategies, analysis of investment opportunities, ongoing management of investments and interaction with investors, both at the point of investment and as part of ongoing reporting. In this article, which forms part of our 'Dechert on ESG' series,[2] we examine how asset managers can respond to evolving best practices by using principles-based standards and ESG reporting and disclosure frameworks established by global non-governmental organizations ("**NGOs**") and industry associations.

In the absence of uniform local rules and regulations, NGOs and industry associations have established ESG-related standards, some of which are more widely followed than others. Certain institutional investors in private funds (particularly European investors) have long been signatories to such standards, but have not typically expected asset managers to adhere to the same standards or provide detailed, if any, reporting on ESG issues. Rather, these investors have historically relied on side letters where an asset manager merely acknowledged the investor's status as a signatory and, in some cases, agreed to bear certain ESG principles in mind when making investments. When present, investor requirements for an asset manager to report on ESG issues were fairly limited. Generally, if these investors wanted ESG considerations to be taken into account, they specifically requested asset managers to provide updates on ESG matters or disclose significant ESG incidents capable of causing reputational risk to the fund. The situation is, however, rapidly changing; asset managers across geographies are facing increasing investor pressure to incorporate ESG considerations into their businesses as a matter of course, with investors expecting substantive action that goes beyond "greenwashing."[3] At the same time, more asset managers are starting to appreciate the positive impact that ESG considerations can have, not only on a strategy's attractiveness to clients and investors, but also on financial performance and risk management.

In response, asset managers are choosing to join or adhere to one or more global standards or frameworks and are actively engaging in ongoing research, standard setting and dialogue with regulatory authorities, portfolio companies and investors. These global standards and frameworks can assist asset managers in (I) understanding and addressing investors' expectations regarding ESG mandates, (II) collecting ESG data from

---

1 In the European Union ("**EU**") regulators are seeking to prescribe standardized ESG disclosure and investment practices. However, as of the date of this article, no similar single law or regulation codifies ESG requirements for asset management firms in Asia or the United States. For a general overview of ESG investing, the existing regimes and legal frameworks, and key regulatory developments, view *Dechert on ESG – An Overview for Asset Managers*. For more on the regulatory and compliance matters US registered investment advisers should consider in connection with ESG investing, see *The Investment Lawyer* article *ESG Investing – Considerations for US Registered Investment Advisers*, (VOL. 26, NO. 12) December 2019, written by Dechert Financial Services lawyers.

2 Click here to visit our ESG page, which contains other articles in this series and ESG related materials.

3 "Greenwashing" is described in the recitals to the Taxonomy Regulation (defined below) as the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards.

investee companies, (III) integrating ESG considerations into the investment process, and (IV) providing ESG-related pre-contractual disclosure and ongoing periodic reporting to clients and investors. We will consider each of these four points in turn.

I. Understanding and Addressing Investors' Expectations Regarding ESG Mandates

One of the primary ways in which asset managers can demonstrate their commitment to ESG matters to prospective investors is through adherence to one or more sets of industry standards. In any event, asset managers who choose not to adhere may nonetheless find themselves indirectly subject to such standards when their investors insist that they take one or more of these standards into account in the investment and reporting process. Familiarity with existing standards and frameworks can, therefore, help asset managers to shape their operations in a manner that is aligned with investor expectations with respect to ESG.

Principles for Responsible Investment (the "PRI")[4]

One of the primary ESG-related industry standards for asset managers is the PRI. The PRI are a set of voluntary principles developed by the PRI Association, in partnership with the United Nations Environment Program Finance Initiative and the United Nations Global Compact.[5] The PRI recognize that responsible investing can and should be pursued by investors whose sole purpose is to achieve financial return. The PRI set out six principles that call for signatories to integrate responsible investment into their investment decisions and active ownership. The six principles are to:

- *Principle 1*: Incorporate ESG issues into investment analysis and decision-making processes.
- *Principle 2*: Be active owners and incorporate ESG issues into ownership policies and practices.
- *Principle 3*: Seek appropriate disclosure on ESG issues by investee entities.
- *Principle 4*: Promote acceptance and implementation of the Principles within the investment industry.
- *Principle 5*: Collaborate to enhance signatories' effectiveness in implementing the Principles.
- *Principle 6*: Report on activities and progress towards implementing the Principles.[6]

From its establishment in 2006, the signatory list has grown to include over 3,000 institutional investors and asset managers. In order to assist its members in implementing the principles, the PRI Association has published a variety of tools, resources and guidance that seeks to enable asset managers to engage with investee companies and investors to engage with asset managers, on ESG matters, including guides for managing ESG issues in listed equity, fixed income, and private equity.[7] One such example is the PRI Association's guidance on incorporating responsible investment requirements into private equity fund terms. This guidance examines the role of ESG provisions in due diligence exercises and market practices, inclusion of ESG provisions in private placement memoranda and other fund documentation, and various options for ESG-related provisions in fund

[4] For an overview of the membership requirements of the PRI, view Dechert's *OnPoint*, *Overview of the Principles for Responsible Investment*.

[5] See here: https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.

[6] For additional information on the PRI, see here: https://www.unpri.org/.

[7] For further information, see here: https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-is-responsible-investment.

terms.[8] Additionally, the PRI Association has partnered with ERM, a group focused on environmental, health, safety, risk, and social consulting services, to produce a guide titled "*ESG monitoring, reporting and dialogue in private equity,"* which aims to help both investors and asset managers incorporate responsible investment considerations into fund due diligence, commitment and monitoring processes.[9]

The PRI Association has also developed a number of due diligence questionnaires ("**PRI DDQs**") intended to assist investors in eliciting relevant ESG information from asset managers. The PRI DDQs include questions around:

- The ESG policies an asset manager has in place and the types of ESG issues that an asset manager takes into account in making investments;
- How ESG-related risks are identified and managed;
- How an asset manager assists its portfolio companies in managing ESG-related risks and opportunities; and
- The manner in which an asset manager reports on ESG-related matters to its investors.

The guidance that accompanies the PRI DDQs provides suggested "developed questioning" that investors may also wish to consider, which may provide asset managers with some insight on the level of detail that an investor might expect to receive in response to the PRI DDQs.[10] The guidance also identifies certain other publicly available frameworks and guidelines that may help managers to better understand and apply the responsible investment practices referred to in the PRI DDQs. The initial PRI DDQ had a particular focus on private equity, but subsequent PRI DDQs have been developed to assist investors in hedge funds, infrastructure, private debt, real estate, farmland and forestry.[11]

Sustainable Development Goals and the United Nations Global Compact

Investors, asset managers and portfolio companies can also signal a commitment to a shared set of ESG goals by reference to the 17 sustainable development goals (the "**SDGs**"), which were adopted in 2015 as part of the United Nation's 2030 Sustainable Development Agenda.[12] These SDGs build on the Ten Principles of the United Nations Global Compact related to human rights, labor, environment and anti-corruption (the "**Ten Principles**"),[13] as well as the United Nations Guiding Principles on Business and Human Rights,[14] both of which are focused on providing a fundamental set of principles for conducting business responsibly, by providing an aspirational set of goals for the future. As an alternative, or in addition to a requirement to take into account the PRI, some investors might seek to require an asset manager to invest in companies that in some way further the SDGs and/or limit exposure to companies that hinder the achievement of the SDGs. Some asset managers also voluntarily disclose in the fund's investment strategy that the fund seeks to align its investments with some or all of the SDGs or the Ten Principles.

---

[8] To access the guidance, see here: https://www.unpri.org/download?ac=271.

[9] To access the guide, see here: https://www.unpri.org/esg-monitoring-reporting-and-dialogue-in-private-equity/3295.article.

[10] Available here: https://www.unpri.org/download?ac=262.

[11] For further information on the PRI DDQs, view *Dechert on ESG – An Overview for Asset Managers*.

[12] Available here: https://sustainabledevelopment.un.org/.

[13] Available here: https://www.unglobalcompact.org/what-is-gc/mission/principles.

[14] See here: https://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf.

The United Nations Global Compact has launched two platforms that asset managers can use to advance the SDGs: the Business for Reporting on the SDGs Action Platform, which leverages existing ESG disclosure frameworks to help portfolio companies report their progress on the SDGs to shareholders,[15] and the Financial Innovation for the SDGs Action Platform, which is a working group seeking to develop and promote investment strategies that support the SDGs.[16] Members of these platforms are eligible to attend various discussion forums or "labs" and meetings, which provide an opportunity for peer-to-peer learning on SDG reporting. The SDGs Action Platforms may assist asset managers to extract ESG data from portfolio companies and can also be leveraged to identify new investment opportunities that are intended to advance the SDGs or benchmark against other funds that seek to advance the SDGs.

Other Industry Standards

The PRI and the SDGs are only two of many industry standards that asset managers can utilize to demonstrate their commitment to ESG matters. Other standards include the American Investment Council's Guidelines for Responsible Investing,[17] the International Finance Corporation's Operating Principles for Impact Management,[18] and the Institutional Limited Partners Association's ("**ILPA**") portfolio company metrics template[19] (discussed below).

II. Collecting ESG Data from Investee Companies

Investors are increasingly interested in not just "whether," but "how," asset managers evaluate the ESG performance of the companies in which they invest. In the United States, the SEC disclosure review staff has encouraged registered fund managers to identify the type of ESG data or ratings used to assess companies' ESG performance. In the EU, asset managers who take account of ESG risks or pursue ESG strategies in their investment activity will shortly be required under new legislation to disclose the source of their ESG data and the methodology underlying any index or benchmark used. Regardless of the jurisdiction, asset managers have a choice as to what ESG criteria to consider. Recognized principles and frameworks can help asset managers determine what ESG criteria fit best with their investment strategy. Asset managers investing in large listed companies have access to a fairly robust set of ESG data produced by companies, many of which use the Global Reporting Initiative ("**GRI**") or the Sustainability Accounting Standards Board ("**SASB**") standards to produce annual sustainability reports. Asset managers pursuing a private equity or direct lending strategy or a strategy involving a more limited portfolio of companies may have the necessary business relationships to elicit the ESG data that the asset manager or its investors deem material. However, funds investing more widely in private markets, pursuing a global macro strategy with significant investments in developing countries, or running a quantitative strategy may find it difficult to obtain sufficient data.

Global Reporting Initiative

The PRI Association advocates that asset managers encourage investee companies to provide standardized reporting on ESG issues and integrate ESG data in annual financial reports. In particular, the PRI Association endorses the use of the GRI standards as a means for portfolio companies to standardize their ESG reporting.[20]

---

[15] See here: https://www.unglobalcompact.org/take-action/action-platforms/sdg-reporting.

[16] See here: https://www.unglobalcompact.org/take-action/action-platforms/financial-innovation.

[17] See here: https://www.investmentcouncil.org/guidelines-for-responsible-investing/.

[18] See here: https://www.impactprinciples.org/.

[19] See here: https://ilpa.org/portco-metrics-template/.

[20] See here: https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.

The GRI framework is the most widely adopted global standard for sustainability reporting;[21] approximately 40 countries refer to the GRI framework in listing requirements or ESG disclosure guidance.[22] GRI reports can take the form of stand-alone sustainability reports, or can be integrated into financial reporting. The benefit of adhering to GRI standards is that the reports use common disclosure numbers to tag information. Asset managers investing in companies with GRI reports benefit from fairly standardized ESG performance disclosure and reports that are consistent over time and can be benchmarked against other reports. Unfortunately, GRI reports are primarily produced by large public companies and are therefore of limited use in certain segments of the asset management industry.

Sustainability Accounting Standards Board

Asset managers are likely to find the standards produced by the SASB more relevant than the GRI as the SASB standards have broader application. SASB develops standards for portfolio companies to use to communicate ESG information that SASB has identified as most likely to materially impact the financial condition or operating performance of companies in an industry.[23] SASB's Materiality Map identifies issues for disclosure and their materiality to various sectors, ranging from environmental factors such as greenhouse gas and air quality to business model and innovation considerations such as supply chain management and materials sourcing and efficiency.[24] This tool enables asset managers on a sector or specific industry basis to assess those sustainability risks on an ESG factor by ESG factor basis, which may affect the financial condition or operating performance of their portfolio companies. For example, the SASB Materiality Map highlights that product quality and safety, supply chain management, and materials sourcing and efficiency are likely to be material factors in the apparel, accessories and footwear industry, while energy management, data security, product quality and safety and customer welfare are likely to be material factors for drug retailers. These factors help to frame the type of ESG criteria on which a company in that industry should be reporting. The SASB standards then provide industry standards for such disclosure. Asset managers can learn more about SASB's approach in the "*Engagement Guide for Asset Owners and Asset Managers*," which provides industry specific guidance as to how asset owners and asset managers can enhance ESG engagement with companies in 77 different industries.[25]

On December 1, 2020, the ESG Subcommittee of the SEC's Asset Management Advisory Committee (the "**ESG Subcommittee**")[26] put forth a preliminary recommendation that the SEC require the adoption of material ESG risk disclosure standards for corporate issuers in a manner consistent with the presentation of other financial disclosures by utilizing standard setters' frameworks, such as the one developed by SASB.[27] Whether or not SASB becomes the standard, the ESG Subcommittee's preliminary recommendation provides a clear indication

---

21 See here: https://www.globalreporting.org/Information/about-gri/Pages/default.aspx.

22 GRI reports, which can be sorted by size, sector, country, and region are available here: https://database.globalreporting.org/search/.

23 See here: https://www.sasb.org/standards-overview/.

24 See here: https://materiality.sasb.org/.

25 See here: https://www.sasb.org/knowledge-hub/engagement-guide/.

26 The Asset Management Advisory Committee is comprised of a group of outside experts, including individuals representing the views of retail and institutional investors, small and large funds, intermediaries, and other market participants.

27 See here: https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf; https://www.sec.gov/files/10152020-sasb-sec-amac-esg-subcommittee.pdf.

that investee companies in the US may one day be required to provide uniform, consistent, and reliable reports on ESG risks.[28] This outcome is more likely under an SEC chair appointed by President-elect Joe Biden.

The EU Non-Financial Reporting Directive (2014/95/EU) ("NFRD")

The NFRD requires public-interest entities (as such term is defined in the NFRD) in the EU with more than 500 employees (and that have either a balance sheet total of more than EUR 20 million or a net turnover of more than EUR 40 million) to include a non-financial statement disclosing certain non-financial data relating to the company (including in relation to ESG matters) in their annual report.[29] The EU recognizes the weaknesses with existing non-financial information disclosure obligations and is working to improve the NFRD's ability to provide investors with access to non-financial information, including ESG data, about companies. The Taxonomy Regulation[30] will require companies in the scope of the NFRD to disclose the proportion of their activities that are classified as "environmentally sustainable" and, in turn, the degree to which investments therein can be considered "environmentally sustainable" according to the standards set out in the Taxonomy Regulation.[31]

Third-Party Data Providers

There are a number of third-party ESG rating providers, including certain credit rating agencies that have expanded their offerings to cover ESG. However, asset managers may find that third-party ESG rating providers will rate the same company differently, and that there are differences in transparency regarding the methodology and data sources that have been used to determine such ratings. On at least two occasions SEC Chairman Jay Clayton has expressed concern about the use of a single ESG score to determine a company's performance across "E," "S," and/or "G" issues in respect of a broad range of companies.[32] When asset managers are evaluating ESG data providers, they should use the same types of due diligence and ongoing monitoring procedures that they would for other service providers. Public and private reporting related to the collection and use of ESG criteria and third-party ESG rating providers should be clearly articulated and should accurately reflect current practices and any limitations thereof.

Other Industry Standards

While the GRI and SASB frameworks are the most commonly used, there are other frameworks for ESG disclosure such as the Taskforce on Climate-related Disclosures and the Climate Disclosure Standards Board. Some of these organizations have even pledged to work together to harmonize disclosure frameworks. The "Big Four" accounting firms have also recently launched their own ESG reporting framework in an initiative lead by the

---

[28] Similarly, the Board of Governors of the Investment Company Institute, the leading trade association for U.S. registered investment companies, "is urging companies to provide disclosure consistent with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and the standards of the [SASB]." See here: https://www.ici.org/pressroom/news/20_news_esg.

[29] See here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095; For further information on the NFRD, view Dechert's ESG Snapshot, *Overview of the EU Non-Financial Reporting Directive.* While the SEC does not explicitly require issuers to produce ESG disclosure, in May 2020 the SEC Investor Advisory Committee "encourage[d] the Commission's timely action to address investor need for relevant, material, decision-useful ESG disclosure." See here: https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf.

[30] Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

[31] For more information on the NFRD click here to access "Disclosure Regulation – What Is It and Who Is Impacted?"; For more information on the Taxonomy, view Dechert's *OnPoint*, *Overview of the EU Taxonomy Regulation*.

[32] Remarks at Meeting of the Asset Management Advisory Committee, Chairman Clayton (May 2020); Long-Term Investing, Sustainability, and the Role of Disclosures, Chairman Clayton (June 2020).

International Business Council. The initiative intends to build on the work done by existing disclosure frameworks and the SDGs to promote consistent and comparable ESG reports.

III. Integrating ESG Considerations into the Investment Process

Asset managers can determine the best way to incorporate ESG data into their strategies by considering their funds' investment objectives, philosophy, and process and, in the case of separately managed accounts, their clients' objectives.

Many asset managers may, at a basic level, integrate ESG investment criteria with financial information as part of the overall fundamental investment process. Other asset managers will screen companies based on industry or exposure to a particular activity (*e.g.* gambling, tobacco or firearms), often referred to as "negative screening" as companies that touch on the relevant industry or activity are then excluded from the investment portfolio.

Asset managers seeking to engage with ESG investing more actively may require each investment to satisfy a minimum ESG rating threshold or seek to maintain an average ESG rating across the portfolio, often referred to as "positive screening." ESG ratings can be developed internally or by using one or more outside data providers (see above), or a combination of the two.

Asset managers may also seek to pursue an ESG objective in their investment activity by, for example investing in companies that assist in the development of alternative energy sources or the eradication of certain social ills or diseases. This is often called impact investing. As a strategy becomes increasingly ESG focused, so too does the asset manager's need for accurate and useful ESG-related data and process, including information on risk management policies, comparative metrics and analytics and portfolio engagement processes.

Fiduciary Duty

US registered investment advisers have a fiduciary duty under the US Investment Advisers Act of 1940, which includes a duty of care, a duty of loyalty, and a duty to act in the best interest of the client. The duty of loyalty includes the duty to make full and fair disclosure of all material factors. While the concept of fiduciary duty is commonly associated with a client's pecuniary interest, the fiduciary relationship can be defined to include any interest or objectives of the client, including ESG objectives. The SEC acknowledged 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."[33] As such, an adviser, consistent with its fiduciary duty, could consider ESG criteria, or even the furtherance of ESG goals (like impact investing), provided that there is full and fair disclosure and the client has given informed consent to such a strategy. We note that this may not be possible in the case of management of plan assets subject to the US Employee Retirement Income Security Act of 1974 ("**ERISA**").[34]

Portfolio Company ESG Engagement

A key aspect of integrating ESG into an investment strategy is how the asset manager engages with its portfolio companies. One of the premises of the PRI is that asset managers will develop clear ownership and voting policies that are consistent with the Principles. In the EU, the Shareholders Rights Directive (EU) 2017/828 requires institutional investors and asset managers to develop and disclose engagement policies, including how

[33] SEC Release No. IA-5248 (June 5, 2019), 84 FR 33669, http://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[34] For a discussion of ESG considerations under ERISA, view Dechert's *OnPoint, An ESGplanation of ERISA's New Regulation on Social Investing*.

they monitor ESG factors.[35] One of the primary ways for asset managers investing in public companies to engage with those companies' management is through proxy voting. There are a number of ways to promote sustainability principles through proxy voting. For example, the Institutional Shareholder Services group of companies ("**ISS**") has launched ISS ESG to assist investors with developing ESG investment policies and engaging with portfolio companies on ESG issues.[36] ISS offers Socially Responsible Investment, Sustainability, and Faith-Based proxy voting guidelines and policy updates, which are intended to help US and international investors navigate the numerous ESG issues that come to a vote.

IV. Disclosure and Reporting to Clients and Investors

Regulators in various jurisdictions are focusing their attention on ESG disclosure to clients and investors, both at the pre-investment (*e.g.* pre-contractual) or marketing stage, as well as in the form of periodic post-investment reporting and some examples are discussed below.

In the EU, asset managers will soon be obligated to disclose the manner in which they incorporate ESG (or sustainability) risks into their investment process – both at a firm and a product level – pursuant to Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "**Disclosure Regulation**"). The Disclosure Regulation establishes harmonized rules on transparency for financial market participants ("**FMPs**") and financial advisers with regard to the integration of sustainability risks, the consideration of adverse impacts on sustainability factors and the provision of sustainability related information in respect of certain "green" financial products. FMPs that are in scope of the Disclosure Regulation include alternative investment fund managers (including both EU AIFMs as well as non-EU AIFMs seeking to market their funds in the EU), UCITS management companies and investment firms authorized under Directive (2014/65/EU) ("**MiFID**") that provide portfolio management or investment advice, as well as certain other specified entities. As a result of the Disclosure Regulation, FMPs will need to provide certain ESG-related disclosure on their websites, in the offering documents or managed account agreements governing the products they manage and in certain circumstances in the products' annual report. To the extent that the disclosure and reporting relate to environmentally sustainable criteria, in scope FMPs may need to draw on the vocabulary and methodology provided in the Taxonomy Regulation. The majority of the obligations set out in the Disclosure Regulation will apply starting on March 10, 2021.

In Hong Kong, the Securities and Futures Commission of Hong Kong ("**SFC**") developed a green finance action agenda (the "**Agenda**"). The key focus of the Agenda is on (i) listed company disclosure of environmental and climate-related information, and (ii) asset manager disclosure on ESG labelled products. The Agenda highlights the need for investment managers with ESG-focused funds to articulate to the SFC how the funds consider and incorporate investors' ESG preferences when conducting suitability assessments, and clearly articulate to investors how the fund integrates ESG factors in its investment processes.

In the United States, asset managers are currently under no general duty to consider ESG criteria. Certain SEC Commissioners have, however, indicated interest in ensuring that voluntary ESG data disclosure is not misleading and that those asset managers who choose to consider ESG data are accurately disclosing the type of ESG criteria they consider, how that information is incorporated into the investment process, and the risks associated with the strategy so that investors can make informed decisions. The SEC's Office of Compliance Inspections and Examinations ("**OCIE**") listed ESG as an area of interest for the first time in its 2020 Examination Priorities, stating that "*OCIE has a particular interest in the accuracy and adequacy of disclosures provided by registered investment advisers offering clients new types or emerging investment strategies, such as strategies*

[35] See Dechert's *OnPoint*, *Overview of the EU Shareholder Rights Directive II*.

[36] See here: https://www.issgovernance.com/esg/.

focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria."[37] Moreover, the ESG Subcommittee recommended that the "*SEC should suggest best practices to enhance ESG investment product disclosure, including alignment with the taxonomy developed by the ICI ESG Working Group,[38] and clear description of each product's strategy and investment priorities, including description of non-financial objectives such as environmental impact or adherence to religious requirements*"[39]

In order to better understand the SEC Staff's position on ESG disclosure, Dechert surveyed approximately 369 Staff disclosure review process comments on registered fund registration statements regarding ESG between January 1, 2017 and September 25, 2020. Based on information gleaned from the survey, asset managers that incorporate ESG considerations into their investment process should be able to clearly and accurately articulate their:

ESG Criteria – what ESG data the asset manager considers and whether the asset manager utilizes outside data providers and/or their own research to collect and analyze this data, as discussed in Part II;

ESG Investment Process – how ESG criteria are incorporated in the investment process, as discussed in Part III;

ESG Risks – the risks posed by the use of ESG criteria in the investment process; and

Proxy Voting Policies – whether the asset manager uses proxy voting to advance ESG goals.

There are a number of frameworks that can help asset managers ensure that the information related to their ESG practices is sufficiently transparent and consistent with industry standards, both in terms of pre-investment disclosures to investors and periodic post-investment reporting.

Pre-Investment Disclosures

At the pre-investment stage, the level of detail required in terms of ESG disclosures largely depends on the particular investment strategy of the fund or separate mandate and applicable regulatory requirements. For instance, under the EU's Disclosure Regulation, certain pre-contractual disclosures must be made in the documentation relating to the relevant investment product; for AIFMs this will mean where disclosures are made pursuant to Article 23 of AIFMD, for UCITS management companies the disclosures must be made in the prospectus disclosures, and for MiFID firms in the MiFID-required regulatory disclosures. The required pre-contractual disclosures include (i) the manner in which sustainability risks are integrated into investment decisions, (ii) the likely impacts of sustainability risks on returns, or an explanation of why these are not considered (items (i) and (ii) are required regardless of whether the product has an ESG strategy) and (iii) where it is an ESG product, information on how the promoted environmental or social characteristics are met, or sustainable investment objective is to be attained.

Asset managers may also find that investors require specific ESG disclosures in their due diligence questionnaires ("**DDQs**"). A familiarity with the types of information required by such DDQs, as well as other

[37] OCIE, *2020 Examination Priorities*, (Jan. 7, 2020), available here: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[38] "Funds' Use of ESG Integration and Sustainable Investing Strategies: An Introduction," Investment Company Institute, July, 2020, https://www.ici.org/pdf/20_ppr_esg_integration.pdf

[39] Available here: https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf.

disclosure frameworks, is likely to be helpful in addressing ESG-related questions from investors during the due diligence stage.

Template DDQs

In addition to the PRI DDQs described above, asset managers that utilize, or are required by investors to complete, the *Institutional Limited Partners Association ("**ILPA**") DDQ*[40] will also be required to answer certain basic ESG-related questions, including whether the asset manager is a signatory to the PRI and whether it has in place certain ESG-related policies. Additionally, while primarily utilized as a tool for conducting ESG-related due diligence on potential portfolio companies, managers may also find it helpful to consider the questions set forth in the *Invest Europe ESG Due Diligence Questionnaire for Private Equity Investors and their Portfolio Companies*[41] for a more detailed set of ESG questions to take into consideration.

OECD Due Diligence Guidance for Responsible Business Conduct

The Organization for Economic Co-operation and Development ("**OECD**") has produced *Due Diligence Guidance for Responsible Business Conduct* (the "**Guidance**").[42] The Guidance offers a framework for individuals within multinational businesses to conduct risk-based due diligence of their organization's operations, supply chains, and business relationships. The Guidance provides organizations with detailed recommendations as to how to identify and address issues related to employees, human rights, the environment, bribery, consumers and corporate governance. The approach taken is intend to be preventative and pragmatic, in that it can help organizations prioritize their risks and resolutions. The OECD intends the Guidance to be customized to the unique characteristics of specific organizations and supplemented with more technical analysis in areas where risks are most pronounced. FMPs are encouraged to consider the Guidance when integrating ESG risk considerations into their due diligence policies under the Disclosure Regulations.

The European Sustainable and Responsible Investment Transparency Code (the "Transparency Code")

Any asset manager considering incorporating ESG criteria into the investment process may find it helpful to be a signatory to, or at least consider the types of questions posed by, the Transparency Code, which was developed by Eurosif43 as a common framework that sustainable and responsible investment funds distributed in Europe can use to articulate their ESG policies and practices, particularly to retail investors.44 Signatories to the Transparency Code submit publicly available responses to a survey that asks the asset manager to classify the fund's ESG investment strategies into one or more of seven categories and disclose, among other things, details about the investment process, the ESG criteria taken into account by the fund, the ESG risks and opportunities considered, and any ESG standards or frameworks in which the asset manager is involved or makes use of in respect of the fund.45 It remains to be seen how the Transparency Code will interact with the new EU sustainable finance legislation, but Eurosif has launched a strategic review to consider its future mandate, including ways in which it can support implementation of the EU's sustainable finance measures.[46]

---

[40] Available here: https://ilpa.org/wp-content/uploads/2018/09/ILPA_Due_Diligence_Questionnaire_v1.2.pdf.

[41] Available here: https://www.investeurope.eu/media/1777/invest-europe_esg_dd_questionnaire.pdf.

[42] Available here: http://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf.

[43] Eurosif is a European association that aims to promote and advance sustainable and responsible investment across Europe.

[44] See here: http://www.eurosif.org/.

[45] See here: http://www.eurosif.org/wp-content/uploads/2018/04/Transparency-Code-4.0.pdf.

[46] See here: https://www.ipe.com/eurosif-launches-strategy-review-in-light-of-esg-regulatory-changes/10029052.article.

Periodic Reporting

Investors increasingly expect disclosure of ESG-related matters on an ongoing basis. Asset managers can look to various templates to present such information. Periodic ESG reporting is not required as a regulatory matter in the US, but in the EU, FMPs that offer financial products that promote environmental or social characteristics or that have an ESG-related investment objective will need to provide periodic reports covering the extent to which such environmental and social characteristics are met, or the overall sustainability related impact of the financial product, as applicable. For AIFMs and UCITS management companies, this information should be included in the annual reports of the fund, while for MiFID firms, it should be included in the periodic reports prepared under MiFID.

The PRI

Asset managers may be able to fulfill investor expectations, at least in part, in terms of reporting on ESG by becoming signatories to the PRI. PRI signatories are required to submit an annual transparency report that consists of modules on the organization, strategy and governance, climate change, and the signatory's business area.[47] The annual transparency reports consist of certain mandatory sections for all signatories[48] as well as asset class-specific modules required to be completed, if applicable.[49] Each question is intended to identify relevant indicators, establish a peer group, and highlight the signatory's ESG policies and procedures. The PRI Association then conducts an assessment of each signatory's performance (both on an individual and a peer-relative basis) before awarding such signatory an official PRI rating for the year. While the annual reports are publicly available, the PRI's assessment and rating are provided only to the filing signatory, although signatories may voluntarily share their assessments. Becoming a signatory and obtaining a PRI rating may assist asset managers in demonstrating their ongoing commitment to ESG-related matters to their investors.

Separately, the PRI Association's guide to ESG monitoring, reporting and dialogue in private equity, mentioned above, provides an overview of how investors may monitor asset managers with regards to ESG integration, including how ESG disclosure is used by investors. The PRI Association also produces an ESG monitoring and reporting framework, which provides a practical structure for limited partners to submit requests for disclosure and for asset managers to report information in the categories of (i) policy, people and process, (ii) portfolio, and (iii) material ESG incidents.[50] The framework also includes useful examples of how asset managers may respond to investor requests for ESG disclosure. Completing a report requires asset managers to answer questions such as how their responsible investment policy is implemented, how they consider ESG criteria, and whether there have been any recent ESG issues with their portfolio companies.

ILPA Portfolio Metrics Template

For a framework that focuses specifically on communicating ESG data about portfolio companies to investors, ESG managers can report on the basis of the ILPA portfolio metrics template. The template has recently been updated to include a section on ESG reporting, and requires asset managers to confirm whether investee

---

47 PRI, *Investor Reporting Guidance*, available here: https://www.unpri.org/reporting-and-assessment/investor-reporting-guidance/5373.article.

48 These include discussions of (i) organizational overview, (ii) strategy and governance and (iii) climate change reporting.

49 For example, there are separate modules for hedge funds, private equity funds, fixed-income, and listed equity, among other categories.

50 See here: https://www.unpri.org/private-equity/esg-monitoring-reporting-and-dialogue-in-private-equity/3295.article.

companies have ESG policies in place and the level of oversight the asset manager has, as well as any material ESG issues that have arisen.[51]

SASB's Standards for Asset Management

In addition to providing standards for portfolio companies to communicate ESG information, SASB has also produced a sustainability accounting standard for the asset management and custody activities industry (the "SASB Standard").[52] The SASB Standard provides a guide for asset managers to identify and disclose material sustainability issues in a manner consistent with Rule 12b-20 in SEC filings.53 A number of leading asset managers produce SASB disclosure reports on an annual basis. These reports are useful to investors concerned with the ESG performance of their manager. The SASB Standard includes the following industry-level material sustainability topics: employee incentives and risk taking, employee inclusion, transparent information and fair advice for customers, management of the legal and regulatory environment, systemic risk management, and integration of ESG risk factors in investment management. The 'integration of ESG risk factors in investment management' topic includes narrative response questions on how ESG criteria are integrated into investment analysis and decisions and on how ESG integration intersects with fiduciary duties. There are also quantitative questions on the percentage of assets in strategies that employ ESG analysis, proxy voting history and carbon emissions.

The frameworks discussed in this section are just a few examples of many frameworks available to assist asset managers in communicating their ESG practices to investors.

Conclusion

In the absence of robust regulations with global scope regarding ESG, and in the face of new regulations with limited regulatory guidance and political uncertainty in key jurisdictions, the principles and frameworks developed by NGOs and industry associations can assist asset managers as they attempt to incorporate ESG analysis into their investment processes and as they communicate their approach to ESG investing to prospective and existing clients and investors. The decision as to which standards and frameworks to follow ultimately depends on the investment strategy of the relevant mandate or fund and the requirements of clients and investors. While expectations may vary, the use of commonly accepted standards and principles can help to promote uniformity that allows for self-assessment over time and peer-to-peer comparisons, and can aid communication with clients and investors if they are already familiar with such standards.

***

The role of ESG criteria in the asset management industry is still relatively new; with increased client and investor advocacy and growing regulatory focus, further industry guidance and regulatory requirements are to be expected. ESG criteria are already impacting, and will continue to impact, the way in which asset managers operate their organizations, interact with clients and investors and make investment decisions. We are monitoring political and regulatory developments in the United States, where the incoming Biden administration is expected to make social and environmental issues a priority, and on a global basis, and we can assist clients in navigating and evaluating the implications of ESG matters for their business.

---

51 See here: https://ilpa.org/portco-metrics-template/.

52 See here: https://www.sasb.org/wp-content/uploads/2014/02/SASB_PrvStandard_Asset-Management.pdf.

53 Rule 12b-20 of the Securities Exchange Act of 1934 requires that in addition to providing the information expressly required in a report or other statement to the SEC, companies must include any additional material information that may be necessary to make the required statements not misleading in light of the circumstances.

This update was authored by:

Brenden Carroll
Partner
Washington, D.C.
+1 202 261 3458
brenden.carroll@dechert.com

Mikhaelle Schiappacasse
Partner
London
+44 20 7184 7845
mikhaelle.schiappacasse@
dechert.com

Tyler Payne
Associate
Boston
+1 617 728 7197
tyler.payne@dechert.com

Claire Bentley
Associate
London
+44 20 7184 7411
claire.bentley@
dechert.com

Nicholas DiLorenzo
Associate
Boston
+1 617 728 7171
nicholas.dilorenzo@
dechert.com

Philippa List
Professional Support Lawyer
London
+44 20 7184 7872
philippa.list@dechert.com

Stanley Tiu
Associate, Registered
Foreign Lawyer in Hong Kong
Hong Kong
+852 3518 4755
stanley.tiu@dechert.com

Julien Bourgeois
Partner
Washington, D.C.
+1 202 261 3451
julien.bourgeois@
dechert.com

Mark Perlow
Partner
San Francisco
+1 415 262 4530
mark.perlow@dechert.com