



DECHERT ON ESG
AN OVERVIEW FOR ASSET MANAGERS

DECEMBER 2019

Dechert
LLP

Dechert on ESG: An Overview for Asset Managers

December 2019 / Authored by Matthew Duxbury, Nathalie Sadler, Mikhaelle Schiappacasse, Michael Sherman, Paul Stevens and Stanley Tiu

ESG is not a new phenomenon, but its significance for asset managers is growing. With continued media scrutiny of sustainability and environmental pressures, “millennials” forming a greater proportion of the investing population and more vocal demands for a fairer society, it has become an increasing priority for investors and, particularly in Europe, a key consideration in asset allocation.

Asset managers are responding to this shift in investment practice and regulators are focusing on ESG matters. In the first of our Dechert on ESG series, we examine what is meant by ESG, review the existing regimes and legal frameworks and outline some of the key regulatory developments across Asia, the European Union, the United Kingdom and the United States that are impacting the industry.

What is ESG?

There is not a uniform definition of ESG. However, it can broadly be described as a set of criteria which are used to evaluate a company or business (including an investment or an asset manager) or governmental issuance or issuer by assessing their performance in the following three categories:



Environmental – Factors relating to environmental impact, which can include effects on climate change, greenhouse gas emissions, use of renewable and non-renewable resources, waste generation, approach to recycling, pollution, deforestation, and treatment of animals.



Social – Factors relating to societal impact, which can include working conditions, effect on local communities, approach to health and safety, human rights, and child labor.



Governance – Factors relating to operations and accountability, which can include executive pay, bribery and corruption, diversity and equal opportunities, tax strategy and transparency, board-level oversight and independence, and shareholder rights.

This list of ESG factors is by no means exhaustive. Investors and managers will consider and weigh factors differently based on individual priorities and values.

ESG’s impact on asset managers can be felt at all levels, from the manner in which an asset manager interacts with its investors, to the evaluation and ongoing management of investments, as well as the operation of the business itself.

Managers who take ESG into account integrate ESG factors into their investment decision making and monitoring process in a variety of ways. The level of importance attached to ESG, and the theory as to whether and how ESG drives or accompanies investment performance, differs from manager to manager and investor to investor. Consistent with each party’s views, a variety of approaches to incorporating ESG into investment decision making have arisen, including:

- i. negative screening by refraining from investing in assets which fail certain ESG criteria; and
- ii. positive screening by investing only in assets which satisfy certain ESG principles.

ESG standards used by investors and managers are currently influenced by a variety of public and private organizations and initiatives. There is little guidance from governments or regulators on the best approach to implementing ESG standards, although ESG is now attracting greater focus from legislators and regulators as we discuss below.

Instead, non-governmental organizations (“**NGOs**”) and bodies have become key standard-setters driving how asset managers, investors, issuers and the markets think about ESG, as each NGO or body has developed its own framework and principles. Certain institutional investors, such as sovereign wealth funds and state public pension funds, have also developed their own ESG investment principles and methodologies, in many cases building on existing frameworks established by non-governmental organizations and bodies. In addition, a number of private for-profit and non-profit organizations have developed ESG investment ratings and indices, to which investors and managers are increasingly turning.

This article focuses on ESG matters, which are distinct from (but of course related to) impact investment. The former is ultimately a risk framework used as a tool in the investment and monitoring process, whereas the latter goes a step further and requires social and/or environmental matters to form part of the investment strategy, with the positive intention of making a measureable impact.

Existing Standards and Frameworks

As the principal source of existing standards, discussion properly begins with an overview of some of the different frameworks developed by non-governmental organizations and bodies that are of particular relevance to the asset management industry and which often form the basis for investment restrictions, investor reporting, and evidence of ESG integration, as each is commonly requested by investors concerned with ESG. An asset manager’s agreement to conform to these standards is often critical for securing an investment mandate from such investors. The standards have become a common starting point for managers as they consider how to incorporate ESG considerations into their investment processes and structure ESG-focused products.

As a general matter, the existing standards and frameworks, which are discussed in more detail below, can be categorized as either:

- i. **principles based standards**, which a financial institution may follow in integrating ESG into its investment process, demonstrating its ESG commitment; and
- ii. **reporting and disclosure frameworks**, which allow investors to measure and compare ESG performance.

The 17 sustainable development goals (“**SDGs**”),¹ adopted in 2013 by the United Nations as part of the 2030 Sustainable Development Agenda, are an overarching global inter-governmental set of targets which have influenced or are the basis for a large number of the existing frameworks and standards.

¹ The 17 SDGs are available [here](#).

Principles Based Standards

UN Principles of Responsible Investment (“PRI”)

The PRI is a set of voluntary principles for investors seeking to integrate ESG considerations into investment practice,² which was established by the PRI Association in April 2006. The PRI Association is an independent non-profit organization funded by signatories to the PRI.

The PRI is the most widely used responsible investment standard. It currently has more than 2,300 signatories³ globally, representing over US\$80 trillion of assets⁴ and it has grown consistently since it was launched. It has the support of the United Nations and is partnered with the UN Environment Programme Finance Initiative and the UN Global Compact, each of which hold a seat on the PRI Association board. Many asset managers and investors are signatories to the PRI and the principles often form the basis of ESG sections of investor questionnaires and side letter requests.

As the PRI is principles based, it does not prescribe specific criteria that should be part of an ESG strategy or identify types of investments which should be excluded. However, the PRI Association does describe some means by which an investor or asset manager may incorporate the principles reflected in the PRI into practice, including: (i) providing ESG training for investment professionals; (ii) developing ownership and voting policies that are consistent with the principles; (iii) asking for standard reporting on ESG issues and integration within annual financial reports; (iv) communicating ESG expectations to service providers; and (v) disclosing how ESG issues are integrated within investment practices.

The PRI Association has also developed a wide range of tools, resources and guidance to assist signatories and requires its signatories to report annually to evaluate their performance. It has promoted a number of initiatives and regularly engages with market participants, including pioneering research which supports a view that incorporating ESG factors into investment decision making should be a fiduciary duty.⁵ The PRI Association has also focused on the integration of ESG and responsible investing in specific asset classes, most recently reporting on private debt and hedge funds, which historically have had less coverage from an ESG perspective.⁶

UN Global Compact⁷

The UN Global Compact is a UN-led sustainability initiative which has adopted ten principles on human rights, labor, the environment and anti-corruption. The principles are intended to assist businesses in advancing the SDGs established by the 2030 Sustainable Development Agenda.

American Investment Council’s Guidelines for Responsible Investing⁸

In 2009, the members of the American Investment Council adopted a set of responsible investment

² The PRI is available [here](#).

³ See [here](#).

⁴ As of 2018. See [here](#).

⁵ See the UN PRI’s report: “Fiduciary Duty in the 21st Century”.

⁶ The main reporting and disclosure frameworks developed by the PRI Association are described in more detail below under “Reporting and Disclosure Frameworks”.

⁷ See [here](#).

⁸ See [here](#).

guidelines that cover environmental, health, safety, labor, governance and social issues.

Eurosif – European SRI Transparency Code⁹

Eurosif is one of Europe’s leading proponents of sustainable and responsible investment, with over 400 Europe-based members totaling over €8 trillion in assets under management.¹⁰ In 2008, Eurosif launched the European Socially Responsible Investing Transparency Code which is intended to be used by sustainable and responsible investment funds and to ensure that managers disclose the relevant and correct information that will assist investors in understanding the policies and practices of a given “SRI” fund. The present version of the European Socially Responsible Investing Transparency Code was approved in February 2018.

International Finance Corporation (“IFC”) – Operating Principles for Impact Management (the “OPIM”)¹¹

Whilst this article focuses on ESG matters, it is also worth noting the OPIM, which are a set of standards intended to accelerate the growth of “impact investing”. The OPIM was released by the IFC, an arm of the World Bank. The OPIM identifies impact investments as those targeting measurable positive social, economic or environmental impact, alongside financial returns. Launched in April 2019, the OPIM already has over 60 signatories representing more than US\$350 billion of assets.¹²

Reporting and Disclosure Frameworks¹³

Global Reporting Initiative (“GRI”)¹⁴

The GRI standards are the first and most widely adopted global standards for sustainability reporting, being used by 61 percent of European sustainability reporters as of January 2018.¹⁵ Endorsed by the PRI Association, the GRI standards are divided into economic, environmental and social categories and are to be used by reporters as the basis for preparing a publicly-available sustainability report. While the GRI standards were designed to be useful for various types of business, they have primarily been adopted by larger businesses (particularly those which are publically listed). As a result, its use in the asset management industry has mainly been restricted to some of the largest institutional managers.

ESG Disclosure Framework for Private Equity¹⁶

The Disclosure Framework for Private Equity was the first attempt to provide a harmonized ESG reporting standard in the asset management industry. With a focus on private equity, this framework poses a series of due diligence style questions which are separated into eight objectives designed

⁹ See [here](#).

¹⁰ See [here](#).

¹¹ See [here](#).

¹² See [here](#).

¹³ The reporting standards included in this section cover both pre-investment questionnaires from investors and ongoing reporting by asset managers.

¹⁴ See [here](#).

¹⁵ See London Stock Exchange Group, *Your guide to ESG reporting*, January 2018.

¹⁶ See [here](#).

to be asked by investors and answered by fund managers at different stages during the fund's life cycle. It was developed with the support of more than 40 investors, more than 20 private equity associations and a number of asset managers from all over the world.

PRI ESG Reporting Framework¹⁷

The PRI Association partnered with consultancy firm ERM to produce guidance on ESG monitoring, reporting and dialogue in private equity. The guidance aims to create a business case for ESG monitoring, provide guidance on existing practices, create a monitoring and reporting framework that can be adopted by managers and investors, streamline ESG information exchange by encouraging a more consistent approach and assist managers by demonstrating how they can respond to ESG monitoring requests from investors.

PRI Due Diligence Questionnaires

The PRI Association has developed a number of Due Diligence Questionnaires (the “**PRI DDQs**”) intended to aid discussion about ESG issues with investors across a range of asset classes. The initial PRI DDQ, the “PRI Limited Partners’ Responsible Investment Due Diligence Questionnaire”, was released in November 2015 and is described by the PRI Association as building on the high-level guidance provided by the ESG Disclosure Framework for Private Equity. It includes specific questions which managers are encouraged to answer with respect to their application of ESG, with a particular focus on private equity.¹⁸

The initial PRI DDQ was followed by a number of PRI DDQs, which were each tailored for a specific asset class:

- **Hedge Funds.**¹⁹ Published in May 2017, this PRI DDQ includes ESG-related questions specific to hedge funds. The PRI Association notes that this questionnaire is the first industry-standard tool for investors to assess external hedge fund managers on their responsible investment policies and practices.²⁰
- **Infrastructure.**²¹ Published in September 2018, this PRI DDQ is intended to help investors understand and evaluate infrastructure investment managers’ approaches to integrating material ESG factors into their investment practices. The PRI Association hopes that uptake of this DDQ will help to streamline industry practices and curb the proliferation of different approaches which it believes could ultimately become counterproductive for both investors and their infrastructure managers.
- **Private Debt.**²² Published in February 2019, this PRI DDQ is tailored to apply specifically to private debt investments. The creation of a specific, standalone questionnaire for private debt reflects the growth of the private debt market and recognition of private debt as an asset class in its own right, as well as ESG practices which have already developed in the private debt

¹⁷ See [here](#).

¹⁸ See [here](#).

¹⁹ See [here](#).

²⁰ The Alternative Investment Management Association (AIMA) has replicated the questions from this DDQ into its usual questionnaire format.

²¹ See [here](#).

²² See [here](#).

space, some of which differ from those in private equity or other asset classes.

- **Real Estate.**²³ Published in June 2019, this PRI DDQ is intended to be used by an investor when selecting an investment manager for a real estate mandate, with the questions aimed at managers that make direct real estate investments. This DDQ also flags where questions align with sections of the European Association for Investors in Non-Listed Real Estate Vehicles (INREV) DDQ.

The PRI Association has also developed DDQs for farmland and forestry investors.

Sustainable Accounting Standards Board (the “SASB”)²⁴

The SASB is an independent standard setting organization that develops reporting standards to enable businesses to communicate financially-material sustainability information to their investors. The SASB standards identify the ESG factors which they believe are most likely to materially impact the financial condition or operating performance of companies in an industry. The SASB Engagement Guide for Asset Owners and Asset Managers also provides industry specific guidance for how asset owners and asset managers can use the SASB standards to inform and enhance their engagement with companies.²⁵

ILPA Portfolio Metrics Template voluntary ESG reporting section²⁶

The Institutional Limited Partners Association’s portfolio companies metrics template includes a voluntary ESG template that managers may choose to use to disclose information about the ESG metrics of their portfolio companies.

IFC Toolkit for disclosure and transparency²⁷

The IFC Toolkit provides practical tools and advisory services for companies, stock exchanges and regulators in emerging markets with the aim of achieving integrated corporate reporting that includes ESG matters.

Ratings and Indices

A number of organizations provide ESG research, including ESG ratings and indices. ESG ratings operate in a similar manner to credit ratings and can be used to assess a company’s ESG credentials, typically by reference to their exposure to ESG risks and their ability to manage such risks, whilst ESG indices are designed to help investors benchmark ESG investment performance. Like all matters ESG, this is an evolving area and there are questions as to how these ratings and indices are designed and then applied at the level of the underlying investments.

Asset managers and investors can consult a variety of providers for ESG ratings and indices. For example, the MSCI ESG Ratings provide a seven point scale rating from “AAA” to “CCC” which is used to provide an overall ESG rating for individual companies by reference to their exposure to industry-specific ESG risks and their ability

²³ See [here](#).

²⁴ See [here](#).

²⁵ See [here](#).

²⁶ See [here](#).

²⁷ See [here](#).

to manage those risks relative to their peers. MSCI also maintains over 1,000 equity and fixed income ESG indices. Other ESG indices include the Dow Jones Sustainability Indices (DJSI), which offer global and regional indices highlighting the most sustainable companies from across 61 industries, as well as indices intended to assist investors in limiting their exposure to certain “controversial” activities. Other ESG rating providers include Sustainalytics and RepRisk.

Rules and Legislation

To date, rules and legislation regulating ESG as a single concept have been limited. However, as ESG investing takes greater prominence, regulators around the world are responding. An overview of some of the proposals being considered in Asia, the European Union, the United Kingdom and the United States which will have a direct impact on the asset management industry follows.

Asia



Existing Rules and Legislation

While there is a spectrum of awareness and commitment to ESG investment across the major financial centers in Asia (i.e., Hong Kong, Singapore, Mainland China, South Korea, Japan and Taiwan), there is no single ESG standard set by law or regulation in Asia. Rather, as of the date of this article, integration and the definition of ESG standards continues to be driven predominately by market forces, even as certain regulators in the region have begun to set out their expectations of best practice. For example, the Hong Kong Stock Exchange has published its expectations for corporate governance in the Principles of Good Governance, Code Provision and Recommended Best Practices; the Monetary Authority of Singapore (“MAS”) administers the Code of Corporate Governance which listed companies in Singapore are required to reference in their corporate governance practices and similarly, the Japan Exchange Group has produced the Corporate Governance Code setting out recommended corporate governance practices concerning leadership, accountability, remuneration and shareholder relations.

In a similar vein to the UK Stewardship Code (see below), Hong Kong investors are encouraged by the Securities and Futures Commission of Hong Kong (“SFC”) to adopt the Principles of Responsible Ownership, which provide guidance on how shareholders should engage with investee companies, including on issues relating to ESG (but stops short of providing a definition of these terms). Hong Kong investors, including investment funds, who do not adopt these principles are encouraged to disclose that this is the case to their stakeholders. For Singapore investors, the Singapore Stewardship Principles similarly set out non-binding guidance to investors for responsible investment.

Legal and Regulatory Developments

The response of financial regulators in Asia to the nascent investor interest in ESG integrated investment products and the increase in the availability of ESG labelled investment products has varied. While Mainland China, Hong Kong, Singapore and Taiwan have all indicated a commitment to promote and develop sustainable and green financing, and have in one form or another launched their own initiatives (particularly to develop a green bond market), only Hong Kong has thus far taken even a relatively small step in regulating ESG-focused funds.

Acknowledging mainland China’s green development ambitions and Hong Kong’s position as a facilitator of capital flows between mainland China and the rest of the world, the SFC has recognized the need to develop a green finance framework in Hong Kong. Published on 21 September 2018, the Strategic Framework for Green

Finance sets out the SFC's green finance action agenda, which includes as key areas of focus listed company reporting on environmental and climate related information and asset manager disclosure on ESG labelled products. The SFC notes that among the challenges facing investors in ESG-focused funds are the lack of transparency as to how particular investment managers integrate ESG factors into their investment processes and the absence of a process that takes into account investors' ESG preferences when conducting suitability assessments.

As one of the first steps of the initiative set out in the Strategic Framework for Green Finance, the SFC published the Circular to Management Companies of SFC-authorized Unit Trusts and Mutual Funds – Green or ESG funds (the “**Circular**”) earlier this year. The aim of the Circular is to improve disclosure in order to permit comparisons between similar types of SFC-authorized “green” or “ESG” funds. It applies to SFC-authorized funds which incorporate one or more of the globally recognized green or ESG criteria (e.g. UN Global Compact and the SDGs). The Circular requires the offering documents of ESG funds to include certain ESG-related disclosure, including the ESG criteria considered, the stock selection process, any exclusion criteria and the risks associated with the investment theme. The SFC will also launch a central database listing all ESG funds complying with the Circular.



European Union

Existing Rules and Legislation

At the European Union level, existing regulations have only focused on single aspects of ESG and in general the focus has been on the governance prong. The most recent example is the Shareholder Rights Directive II, which has now been implemented by EU member states and aims to encourage long-term shareholder engagement and transparency. The EU has also introduced European Social Entrepreneurship Funds, European Venture Capital Funds and European Long Term Investment Funds, which are required to have either a social, small business or long-term investment focus, respectively. Funds complying with the relevant requirements are entitled to use the appropriate “label” and enjoy certain exemptions from other regulations, although uptake has been mixed.

Legal and Regulatory Developments

ESG investment is now high on the regulatory agenda in the European Union. As part of its member states' commitments to implement the SDGs, the European Union is focused on developing the Capital Markets Union to advance “sustainable finance” (which it views as the provision of finance to investments taking into account environmental, social and governance considerations).

In 2018, the European Union released an action plan for financing sustainable growth, which underpins a number of the regulatory updates being implemented in Europe. At the heart of these measures are proposals for a unified EU classification system of sustainable economic activities (the “**Taxonomy Regulation**”, described below) and new disclosure requirements which are intended to provide improved information as to how managers integrate ESG factors in their investment processes (the “**Disclosure Regulation**”, described below).

*Taxonomy Regulation*²⁸

The proposed Taxonomy Regulation would establish a framework setting out uniform criteria for determining the environmental sustainability of an economic activity. Similar to existing principles based standards, its focus is on

²⁸ Regulation of the European Parliament and of the Council on the Establishment of a Framework to Facilitate Sustainable Investment COM/2018/353 (the “**Taxonomy Regulation**”).

identifying criteria rather than creating a label for sustainable financial products, the latter of which could run the risk of constraining the market and creating unintended consequences.

*Disclosure Regulation*²⁹

Signed by the European Parliament and the Council of the European Union on 27 November 2019 and published in the Official Journal of the European Union on 9 December 2019, the regulation on sustainability-related disclosures in the financial services sector (the “**Disclosure Regulation**”) will apply with effect from 10 March 2021. AIFMs, UCITS management companies, investment firms authorized under MiFID II providing portfolio management or investment advice and managers of qualifying venture capital funds and qualifying social entrepreneurship funds are all in scope of the Disclosure Regulation.

Regulating “greenwashing” has been high on the EU’s regulatory agenda and the disclosure regulation intends to provide harmonized disclosure requirements for investment products which (i) promote environmental and/or social objectives and (ii) have “sustainable investment” as its objective, which is defined as investing with an environmental objective. However, the regulations also bring firms within scope of certain requirements even when they are not managing or advising on such products. Whilst the Disclosure Regulation will not apply until 10 March 2021, firms in scope should start planning how they will implement the new disclosure requirements now, and should consider whether it is appropriate to address the pre-contractual disclosure requirements in offering documents for all new products going forward.

A summary of the application of the key requirements is set out below:

Requirement	All	Managing products which promote environmental and/or social characteristics	Managing products which have “sustainable investment” as its objective
Information on website regarding:			
<ul style="list-style-type: none"> ▪ policies on the integration of sustainability risks in investment decision-making 	●	●	●
<ul style="list-style-type: none"> ▪ how the adverse impacts of investment decisions on sustainability factors are considered, or clear reasons for not considering such impacts³⁰ 	●	●	●
<ul style="list-style-type: none"> ▪ how remuneration policies are consistent with the integration of sustainability risks 	●	●	●
<ul style="list-style-type: none"> ▪ the environmental or social characteristics or the sustainable investment objective of a product 	●	●	●

²⁹ Regulation of the European Parliament and of the Council on sustainability related disclosures in the financial services sector.

³⁰ Large financial market participants (defined as having on average 500 employees during a financial year and including group companies) cannot avail of this opt-out with effect from 30 June 2021.

Pre-contractual disclosure to cover: ³¹			
▪ the manner in which sustainability risks are integrated into investment decisions	●	●	●
▪ the likely impacts of sustainability risks on returns (or an explanation of why these are not considered relevant) ³²	●	●	●
▪ how the promoted environmental or social characteristics are met (including information on any benchmark index)	●	●	●
▪ information on how a sustainable investment objective is to be attained (including information on any benchmark index)	●	●	●
Periodic reports to include:			
▪ extent to which environmental or social characteristics are met	●	●	●
▪ the overall sustainability-related impact of the financial product (including, where relevant, a comparison of impact against the index)	●	●	●

- Applicable
- Not applicable

Amendments to MiFID II³³

The European Commission has published draft amendments to MiFID II in the form of a delegated regulation (the “**MiFID II Delegated Regulation**”), which would require investment firms to take into account any ESG considerations when providing investment advice and portfolio management to clients.³⁴ The proposed amendments include requirements to perform a mandatory assessment of a client’s ESG preferences, which should then be considered as part of any services subsequently provided, and, in respect of retail clients, reporting, which covers an explanation of how a product meets a client’s ESG preferences.

ESMA has also signaled its support for the integration of sustainability factors into the advice and portfolio management process, proposing amendments to the product governance rules, organizational requirements and suitability guidelines under MiFID II.

The MiFID II Delegated Regulation is at an earlier stage than the Disclosure Regulation, although they will likely now receive closer attention given the recent adoption of the Disclosure Regulation. Similar amendments to the Insurance Distribution Directive are also being proposed.

³¹ For AIFMs, this shall form part of the Article 23 disclosures. For UCITS management companies, this must be in the prospectus disclosures.

³² These disclosure requirements become more extensive with effect from 30 December 2022 for in-scope firms who have disclosed on their website that they do consider the adverse impacts of their investment decisions on sustainability factors.

³³ The current draft is available [here](#).

³⁴ A “client” in this context typically being a fund or a managed account.

*Amendments to AIFMD and the UCITS Directive*³⁵

Concurrent with the release of its advice on the proposed amendments to MiFID II, ESMA also published technical advice on integrating sustainability risks and factors into AIFMD and the UCITS Directive. Similar to its advice on MiFID II, ESMA has recommend that sustainability risks are taken into account in organizational procedures and managing conflicts of interest, in addition to proposing that AIFMs and management companies be required to consider resources and expertise for the integration of sustainability risks and consider sustainability risks when selecting and monitoring investments.



United Kingdom

Existing Rules and Legislation

Similar to European Union level regimes, existing legislation in the UK has not addressed ESG as a single concept, instead focusing on the wide-range of specific issues that would fall within the different factors. For example, legislators have sought to address social and governance concerns through legislation such as the Modern Slavery Act 2015, which contains provisions relating to slavery and forced or compulsory labor, and the Equality Act, which legislates for anti-discrimination and promotes equality in the workplace. There has also been an historic focus on promoting good corporate governance in the UK, with the UK Corporate Governance Code, which sets out good practices concerning board composition, risk management, remuneration and shareholder relations, and the UK Stewardship Code, which was developed to enhance the quality of engagement between investors and companies.³⁶

Legal and Regulatory Developments

As at European Union level, ESG issues have also been high on the United Kingdom Financial Conduct Authority's ("FCA") recent agenda.

Towards the end of 2018, the FCA released a discussion paper on climate change and green finance, which focuses on the risks climate change may have on the markets and institutions it regulates. The FCA highlighted additional disclosure and public reporting on how firms manage climate risk as areas requiring regulatory focus, with the regulation of pension investments given particular attention due to their long-term investment horizon.

The FCA's Asset Management Market Study this year also considered guidance regarding non-financial objectives (particularly ESG), reminding firms that the FCA's expectation remains that non-financial objectives must, like financial objectives, be explained in a way that is clear, fair and not misleading. The FCA has also advised firms that funds pursuing non-financial objectives must provide clear disclosure to investors on how the firm will measure whether those non-financial objectives are being met.

³⁵ ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD, published 3 May 2019 (ESMA34-45-688).

³⁶ The Financial Reporting Council published a revised version of the UK Stewardship Code on 24 October 2019. Further information can be found [here](#).



United States

Existing Rules and Legislation

In the United States, there is no ESG standard established as such by federal statute or regulation; however, like many other nations, the United States has an array of laws and regulations that impact or promote environmental, social and governance concerns. Asset managers, as a business, may be subject to regulations that concern these broad aims, however, regulations are generally more circumscribed in this area and typically do not directly impact investment decisions or require ESG considerations in making investments. Registered investment companies (e.g., mutual funds) are subject to a number of general requirements or requirements that must be met in order to avail of certain exemptive rules, related to governance principles and board composition, under the Investment Company Act of 1940 and, for funds that trade on exchanges, exchange rules and listing standards. Additionally, as fiduciaries, all asset managers must consider the risks of their investments and ensure that investments are in the best interests of their clients and consistent with disclosures to clients and investors. But these requirements leave considerable discretion to asset managers to develop investment services according to the demands and preferences of their clients.

For further information on some of the legal, regulatory and compliance considerations U.S. registered investment advisers may want to 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 (available [here](#)).

Legal and Regulatory Developments

There is currently no proposed rule or regulation pending before the United States Securities and Exchange Commission (the "**SEC**"), the Commodity Futures Trading Commission, the Department of Labor (the "**DOL**") or the Federal Reserve that would establish ESG requirements for asset management firms. In the past decade, Congress and the SEC have required public companies to provide additional disclosures regarding mine safety, conflict minerals and executive compensation, and provided shareholders with advisory votes on executive compensation, generally known as "say-on-pay" votes.

In recent years, certain groups have united to advocate the SEC to establish ESG disclosure requirements for publicly traded companies. For example, in October 2018, a group of institutional investors, asset managers, state treasurers and others petitioned the SEC to require disclosure of ESG information by publicly traded companies in a standardized form. The lack of useful disclosures and any standards for their presentation was a key complaint of the petitioners, who generally supported ESG investing. The SEC has so far declined to accept the petitioners' invitation to develop ESG disclosure standards.

While the DOL has recently issued guidance that ESG factors can be considered by plan fiduciaries, the DOL has also stated that plan fiduciaries cannot use ESG factors solely to promote social policy, or assume that ESG factors that correlate with positive market trends are inherently relevant economically. At the state level, various U.S. state governments have enacted legislation that imposes ESG restrictions on, or consideration of ESG factors in, the use of public funds. The state of Delaware, where many U.S. investment funds are organized, recently amended its trust and fiduciary law to permit fiduciaries to take into account "beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries."

The SEC's Office of Compliance Inspections and Examinations ("**OCIE**") reviews asset managers' disclosures, including claims related to management of client assets based on ESG principles and will expect managers'

practices to conform to those disclosures and that managers who claim to base investment decisions on ESG considerations will establish policies and procedures reasonably designed to assure that investment decisions are made consistently therewith. Recently, OCIE has conducted a series of “sweep” examinations to review ESG practices of asset managers.

The role of ESG in the asset management industry is still relatively new; with investor advocacy and growing regulatory focus, further industry guidance and regulatory requirements are to be expected. It is already, and will continue to, impact how asset managers operate their organizations, interact with investors and make investment decisions. We are monitoring developments on a global basis and can assist clients in navigating and evaluating the implications of ESG for their business.

This article is only intended to be a high level summary of certain existing regimes and legal frameworks and key regulatory developments, some of which will be explored in more detail in forthcoming articles as part of our Dechert on ESG series. In the next part of our Dechert on ESG series, we will explore how diversity and inclusion is a significant aspect of ESG, affecting managers, their funds and underlying investments alike.

Dechert's ESG Taskforce



Julien Bourgeois
Partner, Washington,
D.C.
+1 202 261 3451
[Send email](#)



Abbi Cohen
Partner, Philadelphia
+1 215 994 2352
[Send email](#)



Mark Perlow
Partner, San Francisco
+1 415 262 4530
[Send email](#)



**Mikhaelle
Schiappacasse**
Partner, London
+44 20 7184 7845
[Send email](#)



Michael Sherman
Partner, Washington, D.C.
+1 202 261 3449
[Send email](#)



Thiha Tun
Partner, London
+44 20 7184 7440
[Send email](#)



Carol Widger
Partner, Dublin
+353 1 436 8522
[Send email](#)



Anthony Zacharski
Partner, Hartford
+1 860 524 3937
[Send email](#)



John Ix
Special Counsel, Philadelphia
+1 215 994 2995
[Send email](#)



Claire Bentley
Associate, London
+44 20 7184 7411
[Send email](#)



Matthew Duxbury
Associate, London
+44 20 7184 7301
[Send email](#)



Gemma Long
Associate, London
+44 20 7184 7818
[Send email](#)



Jonathan Massey
Associate, San Francisco
+1 415 262 4539
[Send email](#)



Linda Muzere
Associate, New York
+1 212 698 3517
[Send email](#)



Tyler Payne
Associate, Boston
+1 617 728 7197
[Send email](#)



Nathalie Sadler
Associate, London
+44 20 7184 7468
[Send email](#)



Paul Stevens
Associate, Washington, D.C.
+1 202 261 3353
[Send email](#)



Stanley Tiu
Associate, Hong Kong
+852 3518 4755
[Send email](#)



Ysabelle Vuillard
Associate, Brussels
+32 2 535 5440
[Send email](#)

© 2019 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 31/F Jardine House, One Connaught Place, Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000).

Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at [dechert.com](https://www.dechert.com) on our [Legal Notices](#) page.