NSCP*Fundamentals*

ESG – What it is and How CCOs Can Get Ahead of the Issues at Their Firms

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As with any new function or process, only after understanding the underlying issues will you be able to create appropriate policies and procedures to protect the firm and its clients. A base knowledge of ESG: Environmental, Social and Governance, is a starting point. This article cannot possibly cover all of the sources out there to provide the base knowledge needed, however, hopefully, it provides some guidance on at least where to begin.

In the July issue of NSCP *Currents*, Beth Haddock provided an excellent overview of considerations that Compliance should keep in mind vis-à-vis the creation and maintenance of a program to oversee ESG procedures at firms. This article will cover items for compliance officers to keep in mind while creating an ESG compliance process. It is critical that all departments of a firm are involved in this process because each will have a different perspective on the "what, when, how, who, and why" needed for a workable program.

First: Define ESG

It is critical for a firm to first determine and document its definition of ESG. The SEC's ESG Risk Alert[1] simply states:

> This Risk Alert uses the term "ESG" in the broadest sense to encompass terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact," or "good governance" to the extent they describe environmental, social, and/or governance factors that may be considered when making an investment decision. These terms, however, are not defined in the Investment Advisers Act of 1940 ("Advisers Act"), the Investment Company Act of 1940 ("Investment Company Act"), or the rules adopted thereunder.

According to that great source of knowledge *Investopedia*, ESG is defined as:

> Environmental, social, and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights[2].

On the other hand, FINRA describes ESG as:

> ESG investing strategies use a variety of environmental, social and governance criteria to make investment selections that aim to create both competitive financial return and a positive impact on society[3].
>
> Various names are often used interchangeably to describe it, such as 'sustainable investing," "socially responsible investing" and "impact investing."

If you have read these descriptions repeatedly and still do not completely understand, it is time to create your own definition for your firm. This is because, as of the date of this publication, *there is not one formal, standardized definition of ESG investing*.. If you Google "Definition of ESG", you get, of course, the *Investopedia* definition, and you also will see what various firms call ESG.

First, use the "KISS" Method: "**K**eep **I**t **S**imple **S**marty-pants." The following is a perspective on the definition of ESG, not taken from any one source. Firms should create their own definition, but

1. https://www.sec.gov/files/esg-risk-alert.pdf.
2. https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.
3. https://www.finra.org/investors/insights/esg-investing-clearing-air-social-impact-financial-products.

the rationale behind the definition and how it is to be implemented MUST both be documented. Do not confuse the "S" in ESG with the "S" in sustainability. "Sustainability" is a broader term that is used for these types of investments, particularly the environmental piece.

Environmental – Think of the Navy SEALS—their name stands for **SE**a, **A**ir, and **L**and. Start with those three items when defining what the "E" means to your firm. What are entities doing to preserve and positively enhance the world's environment? Climate change concerns are usually thought of here. FINRA adds to this clean energy technology, water conservation, or other environmental issues.

Social – This piece considers a company's workplace environment (e.g., safety, work/life balance, gender equality, firm culture, product quality and safety, the company's relationship with its customers, and the company's relationship with the surrounding community, workplace diversity, and human rights)—is it a good corporate citizen?

Governance – This refers to how a company is governed; it's about the management of the company, its decision-making process (strong ethics), its relationship with shareholders, executive compensation, board diversity, anti-bribery and corruption policies might weigh into investment decision making, and whether its policies are transparent and fair to all who are affected by the policies.

As a compliance professional you must think about how the definition relates to your firm and to the products the firm recommends to clients. So, there are two perspectives: looking inside the firm itself and then looking inside the companies that the firm recommends to clients.

This article covers the outward-looking piece: what firms need to do to be able to say to clients that they are "ESG conscious," or that they can recommend securities that have high ESG/ sustainability ratings, and that they take into consideration the ESG ratings of the securities they recommend.

Second: Have an ESG Disclosure Process in Place

The SEC's Risk Alert does not provide any specific language regarding what it feels are appropriate disclosures about ESG investments. In commenting on what firms are doing, the Alert states:

> "…some investment advisers and funds had in place disclosures that accurately conveyed material aspects of the firms' approaches to ESG investing. Also, some firms maintained policies, procedures, and practices that appeared to be reasonably designed in view of their particular approaches to ESG investing. Advisers and funds may find these practices helpful in addressing the compliance issues identified above."

The Alert cites three examples of practices it observed that were "helpful in addressing the compliance issues":

1. Disclosures that are clear, precise, and tailored to firms' specific approaches to ESG investing, and which align with the firms' actual practices.

    a. Publish simple and clear disclosures regarding the firms' approaches to ESG investing.
    b. Use ESG factors that can be considered alongside many other factors.
    c. Explain how investments were evaluated using goals established under global ESG frameworks. (See, discussion below).

2. Policies and procedures that address ESG investing and cover key aspects of firms' relevant practices.

3. Compliance personnel that are knowledgeable about firms' specific ESG-related practices.

In December 2020, Rep. Andy Levin (D-MI) introduced House Bill 8960[4] (the "Sustainable Investment Policies Act of 2020") to "amend the Investment Advisers Act of 1940 to require large asset managers to establish Sustainable Investment Policies."

Importantly, the Bill would amend the registration requirements of an investment adviser by adding a requirement that a person or firm must file its sustainable investment policy with the SEC. The Bill lays out criteria for what should be included in the policy statement and requires the firm to engage an outside auditor to conduct annual testing of the policy. The policy statement should include the investment adviser's considerations of issuers':

- Corporate political spending and decision making;
- Worker and collective bargaining rights;
- Climate and other environmental risks;
- Global human rights and diversity and inclusion practices; and
- The plan's engagement with entities into which it invests, including proxy voting practices.

Levin also introduced H.R. 8969[5] (the "Retirees Sustainable Investment Policies Act of 2020") to amend the Employee Retirement Income Security Act of 1974 (ERISA) to require retirement plans to establish Sustainable Investment Policies. This would require fiduciaries of retirement plans to, among other things:

> "…incorporate all relevant factors, including environmental, social, and governance (hereinafter in this Act referred to as "ESG") factors, into investment analysis and decision-making processes, consistent with the investment time horizons of plan participants and beneficiaries."

This guidance for disclosures is somewhat open-ended. You might start with understanding the various global or international standards, some of which are touched on below. Once your firm has decided upon the appropriate disclosures that will be applicable to your firm, you can create compliance policies and procedures.

ESG investing will come up in at least two ways when working with clients. One is when the client comes to the firm looking for sustainable or socially conscious investments. The other is when the firm markets itself as providing such investments. In either case, as part of the disclosures, you will need to disclose how the firm determined that an investment meets the ESG goals of the client.

One of the ways to discuss the firm's rationale with clients is to explain how the firm ranks particular investments. Just as there is no one definition of ESG, there is no defined ranking system. The Sustainable Accounting Standards Board is attempting to become the source of a standardized system, however, with limited success so far[6].

While sustainability ratings are useful for assessing the ESG scores of securities, the various rating providers use different scoring criteria. For example, Morningstar published its

4. https://www.congress.gov/bill/116th-congress/house-bill/8960/text?r=1&s=1.
5. https://www.congress.gov/bill/116th-congress/house-bill/8959/text?r=2&s=1 .
6. https://www.sasb.org/ .

Sustainability Ratings Criteria[7]. Firms should review the criteria of the providers to determine which best fits their definition of ESG, their business model and investment strategies. Getting a head start on ESG issuers' ranking is easy—the firm can use the services of a ranking entity. Since there is not yet any SEC guidance on how to rank a company's ESG level, there are a number of ranking entities out there utilizing different factors, and the list is growing. Here are a few:

- Bloomberg[8]
- MSCI[9]
- Sustainalytics[10]
- FTSE Russell[11]
- ISS Governance[12]
- Morningstar[13]
- Investyourvalues.org[14]

The firm can choose one of these vendors, or one of the others available. Ensure that there are disclosures drafted regarding the features and rationale of the rankings. That being said, your firm can always create its own ranking system, but would you want to do that? That could be the topic of an entire other article.

There is one important caveat here: an issuer, ETF, or fund could have a sustainable rating that appears to meet the goals of the investor, but it may have business lines or own companies that, for example, "sustainably" grow tobacco, or produce harmful chemicals. So, you should look beyond the rankings at the underlying companies themselves.

Whatever course the firm decides to take, the process must be documented and followed.

Third: Create Compliance Policies and Procedures

As a compliance professional, the Risk Alert and the proposed legislation may have you wondering where to start.

Beyond the sources of ranking, big-picture principles of sustainable investing do exist. For example, the International Finance Corporation ("IFC") has put forth their *Guide to Investing for Impact: Operating Principles for Impact Management*[15]. In the guide, the IFC has published nine principals for impact investing that investment managers can adopt and follow[16]:

1. Define strategic impact objective(s), consistent with the investment strategy.
2. Manage strategic impact on a portfolio basis.
3. Establish the Manager's contribution to the achievement of impact.
4. Assess the expected impact of each investment, based on a systematic approach.
5. Assess, address, monitor, and manage potential negative impacts of each investment.
6. Monitor the progress of each investment in achieving impact against expectations and respond appropriately.
7. Conduct exits considering the effect on sustained impact.

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7. https://www.morningstar.com/content/dam/marketing/shared/research/methodology/744156_Morningstar_Sustainability_Rating_for_Funds_Methodology.pdf.
8. https://www.bloomberg.com/professional/solution/sustainable-finance/?gclid=CjwKCAjwxo6IBhBKEiwAXSYBs8shgO1ZZJbzQIiDuac8H8v12fCm1PRgotF6D82q5mAqSB1dPxQT3xoCEtgQAvD_BwE#scores/?utm_medium=Adwords&utm_campaign=ESG&utm_source=pdsrch&utm_content=esgscores&tactic=342352.
9. https://www.msci.com/our-solutions/esg-investing/esg-ratings.
10. https://www.sustainalytics.com/esg-ratings/.
11. https://www.ftserussell.com/data/sustainability-and-esg-data/esg-ratings.
12. https://www.issgovernance.com/esg/ratings/.
13. https://www.morningstar.com/try/esg-data?utm_source=google&utm_medium=cpc&utm_campaign=MORND:G:S:NB:Direct:ESG:US+MORND:Root:Phrase&utm_content=engine:google|campaignid:12462101963|adid:502359237274&utm_term=esg&gclid=CjwKCAjwxo6IBhBKEiwAXSYBs7-diyAoxaTp_YFw7F6LGAWt29SEAuWUgyMYJlWyQt1H8-m5X1YwNBoCdhcQAvD_BwE.
14. https://investyourvalues.org/.
15. https://www.impactprinciples.org/sites/default/files/2019-08/Operating%20Principles%20for%20Impact%20Management%20Guide%20Aug%202019.pdf.
16. https://www.impactprinciples.org/9-principles.

8. Review, document, and improve decisions and processes based on the achievement of impact and lessons learned.
9. Publicly disclose alignment with the Principles and provide regular independent verification of the alignment.

The United Nations has published its six Principles for Responsible Investment[17]:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

Related to these Principles, the U.N. has published 17 sustainability development goals[18]:

1. No poverty
2. Zero hunger
3. Good health and well-being
4. Quality education
5. Gender equality
6. Clean water and sanitation
7. Affordable and clean energy
8. Decent work and economic growth
9. Industry, innovation, and infrastructure
10. Reduced inequalities
11. Sustainable cities and communities
12. Responsible consumption and production
13. Climate action
14. Life below water
15. Life on land
16. Peace, justice, and strong institutions
17. Partnerships for the goals

Another place to look for guidance is the European Union Commission, which has promulgated guidance for companies on how to report the impacts of their business on the climate and the impacts of climate change on their business[19]. The EU's Sustainable Finance Disclosure Regulation (SFDR)[20] came into effect on March 10, 2021, with a goal of investing capital into sustainably oriented investments. For U.S. firms, the SFDR could offer some clarity. It covers asset managers, investment product providers, and financial advisors that operate within the EU. BlackRock has made its SFDR statements public[21].

The above guidelines are fairly broad, obviously. For more granular guidelines, the CFA Institute has published *Environmental, Social and Governance Issues In Investing: A Guide For Investment Professionals*[22]. This provides an idea of specific items to consider, both from the perspective of building out a compliance process and from the perspective of identifying specific sub-categories under each of the E, S and G categories. The CFA created a chart of typical ESG considerations:

17. https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.
18. https://sdgs.un.org/goals.
19. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/corporate-disclosure-climate-related-information_en.
20. https://eur-lex.europa.eu/eli/reg/2019/2088/oj.
21. https://www.blackrock.com/corporate/literature/continuous-disclosure-and-important-information/sfdr-sustainability-risk-statement.pdf.
22. https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx.

EXAMPLES OF ESG ISSUES		
ENVIRONMENTAL ISSUES	**SOCIAL ISSUES**	**GOVERNANCE ISSUES**
Climate Change and Emissions	Customer Satisfaction	Board Composition
Air and Water Pollution	Data Protection and Privacy	Audit Committee Structure
Biodiversity	Gender and Diversity	Executive Compensation
Deforestation	Employee Engagement	Lobbying
Energy Efficiency	Community Relations	Political Contributions
Waste Management	Human Rights	Whistleblower Schemes
Water Scarcity	Labor Standards	

So, where to begin actually drafting policies and procedures? Start with the First and Second sections above and involve as many people as possible.

Note that the firm can focus separately on each individual part of ESG (i.e., environmentally conscious issuers) or all three at once. It is critical, however, to have in place marketing and disclosures addressing what the firm is focused on and why, and what it considers while reviewing and recommending products that are ESG-centric.

Always start with "who, what, when, and how." Who is responsible for What? When will it be performed? How will it be performed?

Of course, the "who" will vary from firm-to-firm. Here are typical areas of the firm that should be involved in the process for developing new procedures:

- Senior Management
- Compliance, Surveillance, Supervision
- Operations
- Business Development
- New Products Committee
- Investment Committee
- Marketing
- Legal
- Training/Education
- Portfolio Management
- Sales
- Technology

It would be ideal if the firm would put in place a permanent ESG committee. The committee could create a statement of ESG core principles or mission statement which then would be disseminated throughout the firm.

Sample Policy and Procedures

Cowen, Inc. has published its ESG Policies[23], so they may be instructive for your firm, even though they are quite complex. The below sample language, which I have drafted, is intended to be a high-level starting point.

23. https://www.cowen.com/about/esg-policies/.

Policy: For any products which the firm will market as focused on Environmental, Social and Corporate Governance ("ESG") investments, the firm has in place the following procedures. The firm's policy is to review the issuer's ESG ranking, as discussed below, and create suitability and marketing guidelines for any product touted as appropriate for clients that have expressed a desire to invest in products whose issuers are either (or all) environmentally friendly, socially conscious, and have in place a governance hierarchy that meets the criteria set out by the firm.

The firm has determined to assess ESG issues in any products promoted as ESG-friendly or socially conscious. The firm will have in place a decision-making process for any ESG product that ranks the issuer's environmental, social and governance strengths and weaknesses.

ESG Defined:

The firm defines ESG as:

Here you will need to create a definition that applies to the firm and can be disseminated throughout the firm, especially to the marketing and sales teams . As discussed above, there is no single definition. Whatever definition your firm uses, you must ensure that everyone understands what it means.

Disclosures/ Marketing: Firm-issued marketing pieces will clearly address the rationale for including the investment in its ESG ranking. The firm will incorporate into its disclosures and marketing to clients the rankings of the issuer and how that ranking was reached. No adviser or registered representative shall market a product as "socially conscious," having ethical governance, or environmentally friendly unless the product and its marketing materials have been reviewed and approved prior to making a recommendation to a client.

Product Review Committee: The product review committee will create a due diligence process for reviewing products that will be marketed as environmentally friendly, socially responsible, or have strong corporate governance. Material risks must be covered. A portion of each investment analysis for a new portfolio company acquisition should be dedicated to this ESG and impact assessment. At a minimum the committee will review:

- Environmental considerations such as the impact of the business on the environment and the professed goals to implement processes to limit negative environmental impact.
- Does the issuer engage in a business that may be offensive to certain investors, such as firearms, toxic waste, alcohol, marijuana, tobacco, etc.?
- What is the corporate environment vis-à-vis its employees, its investors, its community involvement, and compensation transparency?

Training/Education: The Training department will create a program for all employees that addresses these policies and procedures. The training will be specific to each department or function, so that each will understand its unique responsibilities. The training will be conducted upon hire and annually thereafter.

Proxy voting: Proxy voting policies will be transparent to clients (either in a separate disclosure document, or as published on the firm's website). Portfolio managers are responsible for creating proxy voting policies that are transparent, and they must vote proxies according to those policies. The managers' voting proxies shall keep an ongoing record of their votes along with verification that the vote was consistent with the proxy voting policy.

Compliance: The Compliance department will be responsible for overseeing those items noted above, and for maintaining, monitoring, and updating the firm's ESG-related investing guidelines, as well as implementing procedures for testing each of the above. Compliance will include a review of the above in its annual compliance testing. Compliance will also include these processes in the firm's annual risk assessment.

Books and Records: Each firm department must maintain documentation of the processes in place and retain same in accordance with the firm's document retention policies and procedures. Compliance will review this documentation during its annual review process.

Conclusion

Marketing the firm as being socially conscious, or, as offering products, or strategies, that fit within an investor's needs to make the world a better place will involve a lot of work. This is especially true since the US regulators have not yet acted by promulgating concrete rules. Firms that are currently in this space or that are planning to be in the space will need to devote considerable time and resources to develop its own definition of ESG, educating its personnel and creating policies and procedures and disclosures that will meet clients' needs and examiners' expectations. ■