

# Environmental, Sustainable and Governance (ESG) Investing

PRESENTED BY: IMDDA

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## Our Cause

The Investment Management Due Diligence Association is the voice of the individual professionals of the investment management industry. Our goal is to advance the knowledge and skills of the due diligence community through continuing education and world-class information resources and the establishment of industry standards for conducting due diligence on potential and ongoing investments.

## Our Promise

IMDDA provides exceptional experiences, a vibrant community, and essential tools that make you and your organization more successful.



# Meet the Presenters



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Richard (Rick) Morris

Partner  
Herrick, Feinstein LLP



Shervin Shameli

Partner  
MJ Hudson



Shailen Amin

Transaction Services  
Partner  
BDO

# Meet Richard (Rick) Morris

Herrick, Feinstein LLP

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Richard (Rick) Morris

Partner  
Herrick, Feinstein LLP


- 25+ Years of Transactional Experience
- Commercial and Regulatory Issues, Acquisitions, Financings and Exit Strategies, Public Company Offerings, Public and Private REITs

**Background:** Legal

**Expertise:** Corporate Finance, Corporate Real Estate, Institutional Investment, M&A, Funds, Corporate Governance, Executive Employment and Benefits

**Accreditations:** Earlier in his career, Richard was a CPA in the securities industry.

 [rmorris@herrick.com](mailto:rmorris@herrick.com)

 Tel 212-592-1432

 <http://www.herrick.com/>



# Meet Shervin Shameli

MJ Hudson

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Shervin Shameli

Partner  
MJ Hudson

- 11+ Years of Investment Funds Experience
- Advising fund managers on the establishment, structuring and operation of investment funds, and institutional investors making investments into and co-investments alongside private funds

**Background:** Legal

**Expertise:** Private Equity and Venture Capital Funds, Investment Managers, FoF, Pension Plans, Family Offices

**Accreditations:** Shervin has undertaken secondments with Universities Superannuation Scheme and the EIF.

 [shervin.shameli@mjhudson.com](mailto:shervin.shameli@mjhudson.com)

 Tel +44 20 3693 7009

 <http://www.mjhudson.com/>

# Meet Shailen Amin

BDO

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Shailen Amin  
Transaction Services  
Partner


- 25 Years of Due Diligence Experience

**Background:** Due Diligence, Consulting, Accounting

**Expertise:** Hedge Funds, Private Equity Funds, Venture Capital Funds, Corporate Investment Managers, FOF, Endowments, Not-for-Profit and Family Office Funds

**Accreditations:** CPA

 [samin@bdo.com](mailto:samin@bdo.com)

 Tel 212-885-8559

 <https://www.bdo.com/>

# Agenda

- Introduction to ESG
- Review of Certain Industry Trends – Evolution of ESG Investment
- Due Diligence of ESG Elements
- ESG Metrics and Risk Assessment
- Some Expectations and Predictions regarding the future of ESG and its impact to investors and investment managers





# Introduction

- Basic terms of ESG – Environmental, Social and Governance Investments
  - “Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.” (PRI)
  - Impact investing to amplify value set
- Degree of ESG objectives to be included as an ESG asset
- Due diligence issues mostly presented with Private Equity Funds
- Hedge or stock funds diligence or benchmark public companies with governance standards and reported information, including Board composition and other factors
- Class B corporations and ESG provisions in the charter documents
- Trends in ESG allocations or investment demands / requirements
  - UK / EU
  - US

# ESG Influencers

- Foundations
- Other Institutional Investors
- Constituents of the investors
- Government
  - Investment allocations
  - Department Of Labor (Oct 22, 2015 speech by Secretary Thomas Perez and Interpretative Bulletin 2015-1 on ESG and Economically Targeted Investing or ETI)
  - Public / Private Partnerships or 3P
- NGO or Non Government Organization that is a not for profit
- Press and public scrutiny
- Tax incentives (carrot)
- Governmental regulations and regulatory actions (stick)



# ESG Investment

- Economic Case for ESG
  - Not only “sunshine and hugs”
  - Some managers have reported similar profit and returns
  - ESG, especially in real estate, can lead to sustainable profit
  - Certain “niche” ESG have become mainstream – solar
  - ESG as the “new bottom line”
- Certain initial due diligence areas:
  - Similar to any fund investment, need to diligence the investment strategy, risks, investment manager, internal controls and reporting regime
  - Additional diligence for tax incentives or 3P or NGO alliances and relationships
  - Additional diligence of the managers to confirm that they are aligned with ESG principals and strategy
  - Ability of Fund to remove a principal that is not aligned with ESG principals

# Certain observations – ESG Environment

- Trends in ESG requests or demands
- Increasing development of ESG policies and programs by Investment Managers – address ESG risks and opportunities
- Extent of diligence by LPs of ESG Issues
  - Extent of formal investment DDQ or “add on” to existing procedures
- Alignment of procedures to the ESG objectives of the LP
- Multi-tier ESG influences (a domino effect) and related diligence issues related to mandates by companies that require ESG from key suppliers/for key suppliers to go beyond regulatory compliance in terms of social and labor issues etc.



# Certain Observations – ESG Environment

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continued

- Certain ESG objectives that can be measured
  - Sustainable investments in real estate
  - Housing
  - Jobs or training
- Increasing integration of ESG management by managers into investment process, including the diligence
- Focus and mix on environmental, social and governance issues

# Certain ESG Standards

- Principles for Responsible Investment (PRI) which is in partnership with UNEP Finance Initiative and UN Global Compact (protocols). There are 6 Principles:
  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.



# Possible Actions PRI Principle - 1

## Incorporation of ESG issues

- Address ESG issues in investment policy statements.
- Support development of ESG-related tools, metrics, and analyses.
- Assess the capabilities of internal investment managers to incorporate ESG issues.
- Assess the capabilities of external investment managers to incorporate ESG issues.
- Ask investment service providers (such as financial analysts, consultants, brokers, research firms, or rating companies) to integrate ESG factors into evolving research and analysis.
- Encourage academic and other research on this theme.
- Advocate ESG training for investment professionals.

# Possible Actions PRI Principle - 2

Active owners that and incorporate ESG

- Develop and disclose an active ownership policy consistent with the Principles.
- Exercise voting rights or monitor compliance with voting policy (if outsourced).
- Develop an engagement capability (either directly or through outsourcing).
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights).
- File shareholder resolutions consistent with long-term ESG considerations.
- Engage with companies on ESG issues.
- Participate in collaborative engagement initiatives.
- Ask investment managers to undertake and report on ESG-related engagement.



# Possible Actions PRI Principle - 3

## Appropriate Disclosures of ESG Issues

- Ask for standardized reporting on ESG issues (using tools such as the Global Reporting Initiative).
- Ask for ESG issues to be integrated within annual financial reports.
- Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact).
- Support shareholder initiatives and resolutions promoting ESG disclosure.

# Possible Actions PRI Principle - 4

Promote acceptance and implementation of ESG

- Include Principles-related requirements in requests for proposals (RFPs).
- Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate).
- Communicate ESG expectations to investment service providers.
- Revisit relationships with service providers that fail to meet ESG expectations.
- Support the development of tools for benchmarking ESG integration.
- Support regulatory or policy developments that enable implementation of the Principles.

# Possible Action PRI Principle - 5

## Implementing the Principles.

- Include Principles-related requirements in requests for proposals (RFPs).
- Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate).
- Communicate ESG expectations to investment service providers.
- Revisit relationships with service providers that fail to meet ESG expectations.
- Support the development of tools for benchmarking ESG integration.
- Support regulatory or policy developments that enable implementation of the Principles.



# Possible Actions PRI Principle - 6

Report on activities and progress.

- Disclose how ESG issues are integrated within investment practices.
- Disclose active ownership activities (voting, engagement, and/or policy dialogue).
- Disclose what is required from service providers in relation to the Principles.
- Communicate with beneficiaries about ESG issues and the Principles.
- Report on progress and/or achievements relating to the Principles using a comply-or-explain approach.
- Seek to determine the impact of the Principles.
- Make use of reporting to raise awareness among a broader group of stakeholders.

# LP Investor Standards

- Measurement – the fundamental starting point for Due Diligence
  - Investors need to determine how to measure the relevant value of a given ESG metric from an operational perspective
  - Certain approaches exist, with LPs able to compare their ESG score by reference to:
    - Peers managing comparable portfolios
    - Certain common benchmark indexes
    - The LP's own historical record
    - Government metrics such as employment, parallel to EB-5 Visa program where investment is tracked to jobs created and number of jobs can be evidenced by an economist's analysis or report
- *Take away* is that LPs have to have this in hand when considering a manager and managers have to understand the mechanics to measure and report to LP standards

# Diligence Processes of LPs

- Options or Alternative Processes of LPs
  - Specific teams/personnel to measure ESG data from funds
  - Use of external providers/indices to assist i.e. MSCI ESG Ratings, PRI, SASB etc.
  - Outsourced or independent providers
- What are GPs doing/being required to do to measure and/or report on ESG data i.e. adding filters to company selection process etc.?
- Examples or ways that the Investment Manager has helped portfolio companies navigate and improve ESG
- Data “transparency” from portfolio companies



# Certain Due Diligence Procedures - DDQ

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- Due Diligence Questionnaires
  - Several examples or models are available
  - Certain Areas of Inquiry
    - ESG Policies including any specific language v. aspirational guideline
    - Individuals that oversee ESG issues (seniority in the Investment Manager and contribution to ESG events or publications)
    - Adoption of the UN protocols
    - Degree of commitment in “spend” in research and reporting
    - Management oversight and reporting by portfolio companies or other investments and service providers
    - Extent of review of ESG (annual or more frequent)
    - Manner that ESG risks are identified and managed
    - Reporting on ESG metrics
      - Discussion and consideration at investment committee or board
      - Reports to investors

# Certain Additional Factors to Consider in Due Diligence Process

- Staff training on ESG matters
- Reports to Investment Manager by suppliers and service providers
- Investment Manager's Monitoring systems with respect to portfolio companies
- Degree of board / investment committee / senior executive personal commitment to ESG

# Reporting ESG Status to the LPs

- Certain reporting standards
  - Sustainable Stock Exchanges Initiatives – Model Guidance on Reporting ESG Information to Investors
- Methods to establish reporting standards
  - Side letter
  - LP Agreement
- Verification of ESG Reporting



# Disclosures by Investment Manager of ESG Issues

- Offering documentation, including PPM and website
- Investment meetings and other communications during the solicitation process
- Disclosures during the investment term
- Certification or verification of ESG reporting
  - Attestation or similar action by the auditor
  - Outside consultant or other service provider reports
  - News reports

# Communication

- How the LP can raise ESG related issues and how they would be resolved
  - Arbitration or mediation
  - ESG incidents that require disclosure
  - Issues under the control of the GP
  - Issues not under the control of the GP

- British Private Equity & Venture Capital Association ESG Disclosure Framework for PE released on 25 March 2013. The framework aims to:
  - Provide guidance on rationale behind LPs' ESG-related questions
  - Facilitate an informed discussion between GPs and their LPs
  - Be used as a practical tool and not as a prescriptive rule
- Two parts to the Framework, covering:
  - Disclosure during fundraising – GP should disclose information sufficient to enable an LP that has expressed an interest in ESG management to meet five objectives
  - Disclosure during life of the fund – GP should disclose information to meet three objectives, including whether the GP is acting in a manner consistent with its investment policies re ESG management



# ESG Reporting

- Current US reporting standards
- SEC Concept Release on Changes to Regulation SK
- Sustainability Accounting Standard Board
- Will PE and VC usher in improved reporting?

# Expectations or Predictions For the Future of ESG

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- What may LPs expect or require
- What may Investment Managers expect or require
- Contract provisions (development and standardization)
- Changing landscape from “aspirations” to committed obligations
- Change in effecting remedies for ESG failures or breaches
  - Limited prima facie contractual remedies – damages not suitable remedy as there is not an effective way to measure the “loss”
  - Include as a standalone fault/cause removal event or constitute material breach of LPA?
  - Oblige GP to divest relevant asset in question, with LP/LPAC vote – beware issues with ‘management’ though, especially in UK funds
  - Public scrutiny/damage to reputation
  - Others specified or liquidated remedies
  - Impact to the solicitation process

# ? Q & A

# Presenter Contact Information

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Richard M. Morris  
Partner  
Herrick, Feinstein LLP  
[rmorris@herrick.com](mailto:rmorris@herrick.com)  
+1 212-592-1432



Shervin Shameli  
Partner  
MJ Hudson  
[shervin.shameli@mjhudson.com](mailto:shervin.shameli@mjhudson.com)  
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