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Professional Perspective

ESG and Private Funds

Stefanie Perrella, Julianne Recine and John Ward, Duff & Phelps

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Contributed by Stefanie Perrella, Julianne Recine and John Ward, Duff & Phelps

The investment management industry, particularly with respect to private funds, is broadly dispersed across the environmental, social, and governance (ESG) continuum. While many private fund managers and investors may be quite advanced in their approach to ESG investing, just as many are still trying to understand the concept. Based on communications with more than 1,400 private fund managers and hundreds of fund investors, this article addresses where many stand with respect to the ESG investment process and reflects on some hurdles they may experience as they further develop their ESG programs.

Evolution

ESG investing continues to gain momentum, having transitioned from a niche investment practice almost two decades ago to a major global initiative among both investors and managers. Indeed, ESG investment criteria is fast becoming a mandatory part of investment decisions. In the private fund space, today's proponents of ESG investing generally trend toward millennial analysts, female investors, pension trustees, family offices, and sovereign funds.

ESG investing traces its roots back to the socially responsible investing (SRI) movement, which evolved in the 1980s and 1990s with a focus on avoidance screens of what were considered "sin stocks." At the turn of this century, select managers began to offer investment products aimed at sustainable and ethical investing to meet the needs of a niche of concerned investors. In 2004, U.N. Secretary-General Kofi Annan's global initiative further encouraged the development of responsible investing, bringing ESG to the forefront and urging asset owners to integrate it into their decision-making. Europe overall was generally quicker to respond, whereas the U.S. is generally playing catch up after an initial lag.

Criteria and Regulatory Landscape

Today, the continued development of ESG investing criteria is widely seen as a response to a variety of investor pressures. While the criteria often still has elements of avoidance screens, a larger, renewed focus is on impact and proactive change. Investors now demand that managers consider goals regarding diversity, ethics, renewables, environmental damage, global warming, social equality, and other considerations. Managers are responding by developing and implementing policies that align with these goals, creating a wide range of investment products focused on these principles while attempting to label their firms as ESG-friendly.

Public corporations often maintain sustainability groups or assign a sustainability officer who is responsible for reporting on the corporation's sustainability via an annual report. These corporations also typically work with groups such as the Sustainability Accounting Standards Board (SASB), which developed sustainability accounting and materiality standards across industries. But in the private fund arena, no single set of formal guidelines or definition of ESG investing criteria exists. There is no commonly agreed-upon measurement process to validate a manager's ESG bona fides, or to rate the quality of any one fund's conformity with their ESG investing criteria. The gap is exacerbated among private funds, where transparency is generally more limited, and data is not standardized or made publicly available.

Various global organizations have promulgated lists of metrics or indicators to be considered and used as guidance for ESG investing. The U.N. Sustainable Development Goals framework was recently updated to include 232 different indicators. Large organizations like MSCI, FTSE, GIIN, and the PRI all advocate various measurement tools, frameworks, guidelines, and practice guides that have similarities and important differences. To date we have yet to see a convergence or standardization of criteria.

In this context, managers are understandably concerned about which ESG principles will become accepted as industry standards and which methods of measuring ESG impact will be viewed positively by investors. Simultaneously, while critics of ESG investing have long been concerned about how this type of investing aligns with a manager's fiduciary responsibilities, the Securities and Exchange Commission appears focused not so much on the standardization of criteria, but on how managers developed their individualized investment criteria and how they are following their own guidelines in their investment process. This mindset is embodied in the recent ESG-focused examination letters the SEC sent to managers that advertise as ESG funds.

The EU seems to be taking a similar approach–it has recently adopted Regulation EU 2019/2088 on sustainability-related disclosures, which requires all financial market participants and financial advisors to disclose their approaches to the integration of a “sustainability risk” into their investment decisions. Beginning March 10, 2021, financial services firms will need to provide certain disclosures and other forms of reporting will be required starting in early 2022.

Although we are beginning to see regulatory bodies monitoring ESG criteria, especially as it relates to disclosure, approach, and measurement, there are no universal requirements. In many ways this evolution is analogous to how valuation approaches for private funds have evolved over time. Not long ago, private fund managers had latitude on how they valued the investments within their portfolios. Occasional valuation frauds and investor lawsuits highlighted conflicts of interest among fund managers and fund investors around how the valuation process was being conducted. Investors pushed back, and fund managers responded to calls to become more transparent on how the portfolio's assets were being valued.

Third-party valuation firms and operational due diligence providers, in support of asset allocators, encouraged fund managers to fully document the valuation processes they employed, and to implement more rigorous, transparent valuation controls. It is interesting to note that investors did not demand that the industry adopt a single, unified valuation policy. Importantly, investors understood that the valuation processes implemented by a private equity manager that invests in solar and renewables will be materially different than those implemented by an emerging markets credit hedge fund.

We expect ESG investment frameworks to follow a similar path as fund managers develop customized processes and controls. Fund managers should define and incorporate an ESG framework that makes sense for their business and investment strategy, develop best practices, and continue to evolve with progressing ESG considerations.

Manager Approaches

Approaches by private fund managers vary with some in more advanced stages of adopting comprehensive ESG frameworks and measurement processes. Others seem to take a more measured response by adopting limited, objective ESG policies around select metrics they believe they can readily track and measure. Other fund managers are waiting for the fractured frameworks to converge or for definitive regulatory guidance before they begin implementing or formalizing their ESG policies.

Early Adopters

Private fund managers whose existing investment practices aligned with early ESG standards have been able to nimbly adopt available ESG principles and market their funds to investors who sought products that supported their sustainability objectives. Early adoption of ESG protocols has also allowed some managers to attract significant amounts of investor capital from ESG-focused investors. These managers have developed ESG policies with limited industry guidance and are helping shape the industry by regularly speaking at conferences and events.

The challenge for these managers is keeping abreast of developing ESG considerations. ESG policies that they may have initially adopted need to be regularly updated and expanded as the ESG landscape evolves. Emerging thought leadership on how to best measure ESG criteria including environmental effects, carbon offsets, staff diversity and opportunity, effective leadership, and oversight all need to be considered when policies are reviewed. These managers should avoid espousing ESG-friendly behavior without having a policy in place and the ability to quantify and objectively measure its impact.

Measured Adopters

Managers that have more recently integrated ESG investment criteria seem to take a more measured and/or “wait and see” approach. Many industry consultants have been advocating for a more gradual transition to an ESG framework rather than instituting an overly comprehensive framework that might be difficult to achieve. Consultants appear to concur that incremental growth and successes in ESG impact investing will, over time, lead to material benefits. In response, this subset of managers is implementing limited metrics that they can realistically and effectively measure and report on.

As with any new adopters, there has been a lack of clarity when identifying KPIs for measurement, collecting the data for analysis, developing management processes to implement change, and feedback loops for ongoing evaluation. Additionally, staff who oversee framework implementation at many of these more recent adoptees may not be knowledgeable in ESG principles. As such, a "one metric at a time" approach is taken.

Sideliners

As with any new technology or process, some groups will always wait until they are well-versed in a subject and have exhaustively analyzed every outcome before taking first steps. Some managers appear to be waiting until some still-evolving issues become more settled. Further, private fund managers that have not struggled to raise assets without an ESG framework may be reluctant to implement one, suggesting that such a framework may not significantly impact their business.

Regardless of rationale, slow adopters risk being precluded from certain investment mandates. They may also experience redemptions from investors who want private fund managers that meet both their financial and social impact return objectives. This risk increases with the growing number of investors that are mandating incorporation of ESG criteria in private fund managers' decision-making.

Conclusion

It is our view that ESG frameworks will become a standard, core part of every private fund manager's offering documentation and corporate policy. We believe that private fund managers will come to see this similarly to how the industry views other core financial valuation requirements and policies. As this landscape evolves, we recommend that private fund managers keep the following in mind:

- While certain non-U.S. jurisdictions may have initially led with respect to ESG, ESG is now being embraced globally.
- Investors will continue to send strong messages that they are focused on ESG. The investor base sending these messages will likely broaden.
- Private fund managers should develop an ESG strategy that can evolve and grow with investor demands and the regulatory landscape.
- It is unclear of there will ever be standardized ESG criteria; however, that does not mean that regulators will not be closely monitoring the approach funds take towards ESG.
- An effective ESG strategy will be focused on both criteria relevant to a specific fund and the implementation of those criteria by the fund.