BRIEFINGNOTE

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ESG as a component of investment DNA

Polarising debate

The question of whether ESG should be made a part of fiduciary duty in investments has supporters at both ends.

Take a look at the global political arena, where certain lawmakers and companies have banded to try to preclude the use of ESG factors when state fund managers make investment decisions. And then there's the other side, with notable global organisations setting out in the 2019 final report Fiduciary Duty in the 21st Century[1] that ESG issues are increasingly a standard part of regulatory and legal requirements for institutional investors, along with the need to integrate sustainability-related preferences of clients and beneficiaries.

Make no mistake, a client's best interests, traditionally speaking, is defined by financial return. In investments, this ideal is supported and protected by fiduciary duty – an established concept of corporate responsibility under both common and civil law – where investment managers need to act in good faith,

[1] The report was initially launched by the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation in 2015 to clarify investors' obligations and duties in relation to the incorporation of ESG issues in investment practice and decision-making. [Fiduciary Duty in the 21st Century – United Nations Environment – Finance Initiative (unepfi.org)]

impartially balance conflicting interests of different beneficiaries and avoid conflicts of interest, among other things.

However, if law purports to reflect, support and protect a people's perspectives - what they stand for as a general whole - it is understandable why many are calling for more ESG attributes to be included as part of the investment decision. In any case, does the inclusion of ESG priorities really redefine a client's best interests?

Significant investor support

According to the Principles for Responsible Investment (PRI)'s Annual Report 2021-2022[2], the growth in signatory numbers has continued to accelerate, increasing 28% year-on-year to 4,902 (4,395 investors and 507 service providers) as of 31 March 2022.

These signatories account for roughly US$121.3 trillion of assets under investment (AUM). What this means is that a very significant amount of assets is being committed to responsible investments by institutional investors – pension funds, endowments, foundations, insurance providers, development finance institutions, sovereign wealth funds, family offices, wealth managers and asset managers (multi asset or single asset), as well as businesses that provide services to investors.

PwC's 2021 global investor survey[3] reinforced this by pointing out that investors are poised to pay more attention to ESG risks and opportunities facing the companies they invest in: Nearly 80% in the survey said ESG was an important factor in their investment decision-making; almost 70% thought ESG factors should figure into executive compensation targets; and about 50% expressed willingness to divest from companies that didn't take sufficient action on ESG issues.

One investment firm's ESG head was quoted in the survey saying that "ESG has gone mainstream." The executive went on to add that "you can't walk into a financial institution now to talk about long-term themes without mentioning ESG." For now, such an approach seems right on the money: Since its establishment in 2019, the S&P Global 500 ESG Index has roughly tracked the standard S&P 500 index, and even outperforming it slightly since 2020 as of January 26, 2023.[4]

Regulation

Governments in many developed jurisdictions have also introduced or changed policy in favour of ESG priorities. For instance, on 26 November 2021, Hong Kong's Mandatory Provident Fund Schemes Authority introduced the Principles for Adopting Sustainable Investing in the Investment and Risk Management Processes of MPF Funds. These set out a high-level ESG integration framework for trustees of MPFs – investment entities for the city's mandatory retirement protection scheme – across four key elements consistent with widely followed recommendations by the Task Force on Climate-Related Financial Disclosures (TCFD): governance, strategy, risk management and disclosure.

This followed, on 20 August 2021, the Hong Kong Securities and Futures Commission's issuance of a circular to licensed corporations – Management and Disclosure of Climate-related Risks by Fund Managers, which set out standards for complying with its amended Fund Manager Code of Conduct that largely adopted the same elements.[5]

Further, in the UK, the Occupational Pension Scheme (Investment) Regulations 2005 (OPS Regulations) was amended in 2019 to define 'financially material considerations' as including ESG factors, which placed a legal

[2] New and former signatories | PRI Web Page | PRI (unpri.org)
[3] PwC's 2021 Global investor survey : PwC
[4] A 'fiduciary question' looms large over the ESG debate in 2023 | S&P Global Market Intelligence (spglobal.com)
[5] Circular to licensed corporations Management and disclosure of climate-related risks by fund managers | Securities & Futures Commission of Hong Kong (sfc.hk)

obligation on the concept that ESG factors contribute to financial performance. This means that integrating ESG factors into fiduciary duty is not inconsistent toward the beneficiary's best financial interests.

While the OPS Regulations apply to pension fund trustees, given that investment management is consistently outsourced, the amendment will inevitably influence how fiduciary duties of investment managers are generally interpreted. In addition, the Financial Conduct Authority published a policy statement in December 2021 that outlined rules and guidelines tied to requirements under a new climate-related disclosure regime for asset managers in alignment with TCFD recommendations.

Then there is the EU, where its Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation establish specific environmental criteria related to economic activities for investment purposes, and which forms part of enhanced disclosure obligations required by the SFDR.

Under such guidance, SFDR aims to reorient capital towards sustainable growth and help investors make better sustainable investing choices. A sustainability risk is defined as an environmental, social or governance event, or condition that, if it occurs, could have a negative material impact on the value of an investment. The SFDR applies to all EU-based financial market participants and financial advisers, as well as those who market products to investors in the EU.

In the US, the Department of Labor released a final rule (Final Rule) that addressed investment selection and ESG considerations for retirement plans tied to its Employee Retirement Investment Security Act (ERISA). It took effect the 30 January this year.

The Final Rule clarified that fiduciary duty should be based on factors that are reasonably relevant as reflected in a risk and return analysis, using appropriate investment horizons consistent with investment objectives and funding policy. Such factors may include the economic effects of climate change and other ESG factors on a particular investment decision, though they are not required to be considered. On the other hand, compared to a previous rule introduced in 2020, the Final Rule is expected to make it easier for ERISA plans to pick investments that prioritise ESG attributes. Further, as has been seen in other jurisdictions, the Securities and Exchange Commission (SEC) proposed amendments to rules and reporting forms which would require SEC-registered advisers to include ESG factors and strategies for investors in fund prospectuses, annual summaries and brochures.

Conclusion

It is not inaccurate to conclude that there is gradual and increasing support globally for ESG factors to feature in the investment DNA. This has been reflected in more and more investor and government impetus as both sets of parties converge in a way that arguably shows the market operating as we know it does: assigning limited investment resources to the most efficient use based on what it believes is most important.

And crucially it has been shown that ESG considerations do not necessarily impede the fiduciary's best interests-objective of financial profit. For better or worse, depending on one's beliefs, it is irreversible that ESG considerations are now an integral part of the fiduciary duty debate, if not already codified as a concept in markets like Hong Kong, the UK and the EU. It is also hence important that investment managers understand their obligations under these relatively new laws as they carry increased regulatory and legal risks. It will be imperative that they consider their clients' sustainability-linked preferences in order to avoid being taken to task for losses due to a lack of consideration for ESG attributes.

As the world ramps up on action to tackle climate change, it is certain that regulators everywhere will take an equally proportionate approach to imbuing investment mandates with ESG considerations. If it hasn't already been the new normal, we expect it will be, sooner rather than later.[6]

[6]

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