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ESG Best Practices For Private Fund
Managers

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February 17, 2022



Speakers



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Agenda

- ESG Overview & Strategies
- US ESG Regulatory Landscape
- ESG Enforcement
- ESG Standards
- What do we do?

Overview

- Rapid growth in the ESG space
- Growth outpacing regulators...BUT
- Regulators are paying attention
- Ambiguity in terms; lack of common definitions
- Consistency is key: Do what you say, say what you do.

What Is ESG?

E is for "Environment"	S is for "Social"	G is for "Governance"
<ul style="list-style-type: none">• Climate change• Greenhouse gas emissions• Energy use• Water use• Pollution• Hazardous waste• Recycling• Sustainability	<ul style="list-style-type: none">• Diversity and inclusion• Corporate giving and philanthropy• Working conditions• Workplace health and safety• Compensation and benefits• Internal pay equity• Employee opportunity• Labor and human rights• Child and forced labor• Supplier practices	<ul style="list-style-type: none">• Board structure and composition (including tenure and diversity)• Executive compensation• Shareholder rights• Enterprise risk management• Audit oversight• Disclosure and reporting• Ethics and compliance• Privacy and cybersecurity

What is an ESG Strategy?

Different ways to implement ESG:

ESG Integration/ESG Aware	ESG Screening (inclusionary/exclusionary)	ESG Objective/Impact Investing
<ul style="list-style-type: none">• ESG information considered when making investment decisions• Portfolio managers “think” about ESG all the time	<ul style="list-style-type: none">• Strategy excludes certain industries, sectors or issuers (e.g., tobacco, firearms, fossil fuels)• Only certain securities are eligible for investment after “making the cut” based on predetermined criteria	<ul style="list-style-type: none">• Investment mandate is ESG-focused• Product is intended to effectuate an ESG impact or result as part of its objective
Example Strategies:		
<ul style="list-style-type: none">• Emerging Market Small Cap• ESG High Yield	<ul style="list-style-type: none">• ESG International Stock	<ul style="list-style-type: none">• US Large Cap Low Carbon• Global Impact

US ESG Regulatory Landscape

SEC – Issuers

- What is “material” and does it even have to be?
- What is available and possible? Scope 1? Scope 2? Scope 3?
- Immediate focus on climate risk and carbon sensitivities
- **Prediction: Enhanced narrative climate-risk disclosure for all issuers; Scope 1/2 emissions where “material”**

SEC – Funds/Advisers

- Regulation to ensure “truth in advertising”
- Disclosures regarding investments and investment strategy
- What is available and possible? Data limitations.
- **Prediction: Enhanced “names rule” for US mutual funds; more granular disclosure of ESG processes; investment adviser disclosures**

DOL

- ERISA creates challenges for ESG investing – “solely in the interests of the [plan] ... and for the exclusive purpose of ... providing benefits ... and defraying reasonable expenses”
- New proposed rule intended to smooth these challenges
- New Request for Information re: Climate-Related Financial Risk
- **Prediction: Proposed rule risks another reversal; practical impact TBD**

US ESG Enforcement: Focus Areas

Disclosures

- Clear and prominent ESG disclosures
- Marketing materials and regulatory filings are current, updated and accurate
- Tailored to and consistent with the actual approaches to ESG investing

Policies and Controls

- Written procedures and policies regarding due diligence or selecting, then subsequently monitoring ESG-related investments
- Consistency between written policies and actual practices

Compliance

- Appropriate oversight and review of ESG-related practices
- Written policies to assess ESG investing analysis
- Involvement of compliance personnel in oversight of ESG-related marketing materials and public documents

US ESG Enforcement Trends

- Issuers and managers asked to “show their work”
- Scrutiny of ESG-branded funds/strategies/managers
- Even generic statements can be triggers for inquiries – many access points to start an examination or investigation that can become an enforcement
- **Prediction: More examinations; more enforcement**

ESG Standards

HOW STANDARDS PROLIFERATE:
(SEE: A/C CHARGERS, CHARACTER ENCODINGS, INSTANT MESSAGING, ETC.)



ESG Standards

- Growth of nonregulatory ESG standard-setters:
 - UNPRI (Principles for Responsible Investment)
 - US SIF (Forum for Sustainable and Responsible Investment)
 - CFA Institute proposed ESG standards
 - GRI (Global Reporting Initiative) Standards
 - SASB (Sustainability Accounting Standards Board)
 - TCFD (Task Force on Climate-Related Financial Disclosures)
 - Net Zero Initiative (Asset Managers, Asset Owners, Foundations, etc.)
- Individual client commitments
 - Reduced carbon footprint (as a company or in investment portfolios)
 - Service provider diversity

ESG Trends for Different Client Types

US Mutual Funds and ETFs

- Generally disclosure-oriented, but no fundamental barriers
- Explosive growth in ESG funds

ERISA/Bank Maintained Pools

- Regulatory ping-pong created uncertainty, even with new rule proposal
- Plan fiduciaries will likely continue a cautious approach, at least through 2024
- DC plans may consider ESG factors as investment enhancers/risk reducers; but no ESG objectives
- Bank maintained pools face similar issues, but common trust funds with no plan assets are not subject to these concerns

Public Pensions

- State by state – and often contradictory
- Illinois, Oregon require ESG considerations; Maine, New Jersey promote fossil fuel divestment; Texas prohibits investment in companies that “boycott” energy companies; similar bills in Oklahoma and North Dakota

Other Institutional Clients

- **Endowments:** Significant pressure on university endowments, but still digesting 403(b) litigation on excessive fees and investment options
- **Foundations:** ESG investing consistent with their missions
- **Corporate:** Investing consistent with corporate disclosure and business needs
- **Insurance:** Governed by state insurance regulations; interested in ESG as better investing, especially climate

ESG Risk Areas

- ESG risk is increasingly important to consider when making investment decisions
 - Data integrity, operational risk, transition risk, litigation risk, opportunity cost
- ESG demand may differ among client types and jurisdictions
- Increased demand and regulatory scrutiny require heightened care
 - Even benign ESG representations could be “material,” so they must be accurate and unexaggerated
- Consistency in messaging across all documentation (including website disclosures, public statements, and client communications)
- Avoid overstating ESG characteristics, even accidentally!

Practice Points – Strategy Discussion

- Clear communication is critical – ESG claims may be “material”
- ESG and related terms do not have standardized definitions
- Landscape ripe for miscommunications (both internal and external)

Example Strategies

ESG Integration/ESG Aware	ESG Screening (inclusionary/exclusionary)	ESG Objective/Impact Investing
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Practice Points – Greenwashing Risks

- The portfolio manager “considers” ESG factors when making investments
- Semiconductors or money markets as “low carbon” strategies
- Screening cluster munitions from biotech strategy
- Fannie Mae and Freddie Mac as “S” investments
- ESG is at the heart of everything we do

Practical Tips for Client Conversations

Vocabulary

- Be clear in word choice; precisely define words like “sustainable.”
- Ask clients/prospects what they mean when they talk about ESG.
- Avoid generic representations such as “ESG has always been core to our business.”

Discuss Client Goals

- Are they looking for ESG objective funds, or just to mitigate ESG risk through passive screens?
- Where does ESG fit in their broader portfolio?

Understand Strategies

- Understand how strategies incorporate ESG factors and considerations.
- Are there binding requirements or merely advisory guidelines?
- Will the strategy hold any investments that do not fit the ESG criteria?

Communicate

- Offer clear descriptions of what the strategy’s ESG approach is, and, equally important, what it is not.

Themes/Questions

- Precision in definitions is paramount (do not make assumptions; generalizations and ambiguity can cause miscommunication)
- Consider ESG information material
- Do what you say, say what you do – be capable of backing up any statements regarding ESG

Lawyer Biographies

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Miranda Lindl O'Connell is a private investment fund partner, co-leader of the ESG & Sustainability working group and office managing partner of the firm's San Francisco office. Her practice focuses on fund formation and investor side representation for clients such as fund of funds, private foundations, public charities, family offices, social impact entrepreneurs, pension plans and other institutional investors in a variety of structures including private equity funds, co-investment funds, venture funds, captive funds, separate accounts and other customized private finance options. She advises social impact entrepreneurs, private foundations, and public charities on a range of social impact investments including program-related investments, mission-related investments, and innovative investment vehicles and structures including social impact funds and debt and equity investments.

The American Bar Association presented Miranda with its Outstanding Volunteer in Public Service Award for her work at the Homeless Advocacy Project.

While in law school, Miranda served as an extern for Judge John T. Noonan of the US Court of Appeals for the Ninth Circuit. Prior to law school, she worked as the race director for the San Francisco Marathon.

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With more than a decade of experience as senior in-house counsel with global investment managers, Lance Dial has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury.

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John J. "Jack" O'Brien counsels registered and private funds and fund managers in connection with organizational, offering, transactional, and compliance matters. He regularly works with a variety of different fund structures, including open-end and closed-end funds, exchange-traded funds, and hedge funds. He also counsels investment adviser and broker-dealer clients on various matters, particularly with respect to registration and disclosure, marketing regulations, pay-to-play issues, and transactions in exchange-traded funds.

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Clients rely on Susan Resley's guidance to counsel and defend them in regulatory matters concerning accounting and disclosure issues, insider trading, Foreign Corrupt Practices Act (FCPA) (including due diligence and compliance), internal controls, cybersecurity concerns, whistleblower-related issues, and Securities and Exchange Commission (SEC) or Financial Industry Regulatory Authority (FINRA) rules related to broker-dealers and investment advisors. She has represented clients in international regulatory and internal investigations, including in the United Kingdom, France, China, Japan, Korea, and India. Susan has been recognized as one of the Top Women Lawyers in California in 2019 by the *Daily Journal* and recommended by *Chambers* for Securities Litigation and by *The Legal 500 US* in White Collar Criminal Defense, Corporate Investigations, and Securities Litigation.

Susan has obtained favorable results for her clients, including dismissals in litigation involving regulators and private plaintiffs. On numerous occasions, the SEC, US Department of Justice (DOJ), and Public Company Accounting Oversight Board (PCAOB) have declined to pursue actions against her clients, including after informing Susan of their intent to do so. Her clients include private and public companies, boards and their committees, accounting firms, brokerage and investment advisory firms, and other financial institutions. Individual directors, senior company officers, and employees also look to Susan to represent them in regulatory and private litigation where their reputations are at stake.

Before joining Morgan Lewis, Susan was a securities litigation partner with an international law firm. Prior to that, she held a partnership role at the global firm. She brings government experience to her clients, as she worked for the SEC before starting in private practice. At that agency's Division of Enforcement in its Los Angeles Regional office, Susan oversaw and took part in investigations into insider trading, broker-dealer practices, municipal bond offerings, accounting practices, and market manipulation. She lectures frequently on such legal topics as conducting internal investigations, SEC enforcement trends, accounting and controls matters, and the FCPA. She also comments on media outlets including National Public Radio (NPR) and Fox News, and several news and legal publications often quote her. Susan holds multiple leadership positions at Morgan Lewis. She is the leader of Morgan Lewis's San Francisco litigation practice and is the firm's securities trade clearance partner. She also serves on the firm's Audit, Sarbanes-Oxley, and Investment Committees.

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