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Why Compliance Officers Should Consider ESG and Sustainability Principles

By Beth Haddock

Environmental, Social and Governance (ESG), impact investing, and sustainability are considerations you may believe are outside the scope of your compliance and ethics program, but evolving standards now place these issues well within the compliance mandate.

This article will illustrate the applicability of ESG and impact investing to general compliance programs. For example, understanding what is meant by ESG claims, or borrowing ESG principles to identify and manage risk, can help compliance officers not just protect their companies and end customers, but also add important commercial value by helping companies make prudent business decisions and reap the advantages a modern, proactive governance regime has relative to a check-the-box compliance program. Moreover, since the heart of a compliance officer's job is to help ensure claims to investors or consumers are accurate and absent of fraud, ESG principles can help a compliance officer more comprehensively meet that responsibility.

The three reasons this mega trend matters to Compliance

About $23 trillion in total global assets were professionally managed employing environmental, social, and governance (ESG) strategies in 2016, according to the [Global Sustainable Investment Alliance](). That figure represents a 25% increase over 2014, and this mega trend is projected to continue its rapid growth trajectory.[1]

ESG represents a conceptual paradigm that can be implemented across asset classes and investment strategies to improve risk-adjusted returns.[2] These ESG risk considerations are not just important to business leaders; they are also key for compliance officers within companies. For instance, understanding trends, practices and red flags are important to compliance officers in financial services companies monitoring the investment management process, particularly if they are one of the over 1000 Principles of Responsible Investing signatories, or compliance officers in companies that manufacture goods within a sustainable supply chain compliance program in adherence with the United Nations Sustainable Development Goals ("UN SDGs").[3]

For many, ESG (in other words, "responsible investing") means recognizing the influence that investment decisions can have on society at large, and the importance of good stewardship, while providing attractive risk-adjusted returns for investors.

Reason No. 1

Compliance Officers will be among the beneficiaries of this mega trend. These strategies will change the perception of compliance programs to incentivize sustainable governance programs that not only protect companies from risks but also add bottom-line value as an integral component of the business evaluation. Governance is part of UN SDG 12, 17, and arguably imbedded within many others. The UN SDGs are being adopted at every level within companies

Resource:

https://blogs.cfainstitute.org/investor/2018/06/15/effective-esg-investing-an-interview-with-andrew-parry

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1. Recent policy changes support the move to an ESG framework; in May, the European Commission released an ESG proposal advocating enhanced transparency and duties for institutions. http://europa.eu/rapid/press-release_IP-18-3729_en.htm
These principles are already incorporated in the investment mandates of US pensions such as CalSTRS and the New York Common Fund.
https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf
https://www.osc.state.ny.us/reports/esg-report-mar2017.pdf
2. There are many new private funds, ETFs and mutual funds using a socially responsible index as a performance benchmark. http://www.flatworld-partners.com/; https://www.calvert.com/Calvert-US-Large-Cap-Core-Responsible-Index-Fund-CISIX.php; https://www.msci.com/msci-kld-400-social-index,
3. The United Nations Principles of Responsible Investing (PRI) is a global investment standard that continues to gather signatories that commit to compliance with its principles. https://www.unpri.org/ Currently, there are over 2000 signatures. The United Nations Sustainable Development Goals likewise encourage a commitment to sustainability and compliance with 17 broad ethical and socially responsible goals. https://sustainabledevelopment.un.org/sdgs

– in their corporate responsibility programs, strategic plans and values, as well as products, services and investment strategies. Consumers, investors and others will more carefully judge business success by the measure of how well "they walk the walk," thrusting onto center stage the effectiveness of compliance and governance programs, and the compliance officers who lead and promote this opportunity to add business value.

Example: ESG Principles Applied to Compliance Officers' Performance

Let's look at ESG-related certification to illustrate some of the ESG compliance issues and the opportunity for a more holistic approach to compliance and ethics programs that incorporate sustainable governance principles.

> Imagine a compliance officer for a global investment firm who has finished the annual compliance review and is eagerly planning next year's training program when she receives a call from the head of the London office. The caller explains that a client at a large pension fund requires a complete report on the firm's promised ESG investment strategy in order to certify that its funds have been tracking ESG guidelines from the time of the initial investment.

Narrow Response

"Why are you calling Compliance? I don't make the investment decisions. Please talk to the investment team," the compliance officer says reflexively.

Sustainable Governance Response

A better response would have been to offer to be a liaison between the London and the investment team. The compliance officer could help prevent the investment team's submission of a certification that isn't accurate, comprehensive, and transparent. She could get details from the London office about when the client came on board and what promises were made. If there were any compliance deficiencies in reporting or adherence with investment guidelines, she can help the investment team respond and remedy any gaps.

Compliance officers can maintain independence and avoid involvement in ESG investment decisions while still helping uncover and address governance gaps and any related systemic risks and repeat deficiencies. For example, what if the investment team doesn't have written guidelines and hasn't been investing in the manner the pension fund expected? Compliance officers should not "own" compliance with ESG investment instructions, but they should help confirm investments are aligned with investment guidelines. Common compliance and governance gaps to look for include:

- **Requests for Proposals:** The investment team could over-sell the client about ESG capabilities. Compliance officers should review RFPs and sales materials to make sure representations are supported by process and documentation.

- **Documentation to Support Certifications:** There may be inconsistency between investment holdings and client instructions or investment guidelines because of a lack of written protocols. ESG investments entail specialized investment strategies and typically require additional investment instructions that may relate to higher standards for corporate accountability for investable assets; for example, with regard to use of resources, labor practices, supply chain management, conflicts of interest, internal controls, and board diversity. These instructions must be documented and followed as the client expects. Since clients may be required to adhere to standards, regulations or laws such as PRI and/or specific pension fund mandates, they will often ask for certifications to ensure they are followed. Compliance officers should help, or at least test, to make sure the certifications are handled appropriately.

- **Accountability and Collaboration:** ESG investments may be consistent with the client's expectations, but the documentation may be inadequate or simply not filed or vetted as needed because of a lack of coordination. Without engagement of all stakeholders, the business can make mistakes and compliance can be bureaucratic. Engagement is a key benefit of sustainable governance. Compliance officers help the business by using project management skills as much as their technical knowledge. Establishing a disclosure committee or process to ensure accountability for each part of the ESG certification process can bring meaningful value to an organization by increasing rapport among business units and engagement with the compliance program. The business will appreciate an engaged compliance officer who helps the business with its ESG obligations.

Reason No. 2

Compliance officers can help detect and prevent fraud, including misrepresentations or omissions of material facts about ESG and sustainability. Compliance officers are often involved in considering the adequacy of disclosures and disclaimers. They can play that same role for ESG encouraging the business to test key assumptions, the source of data, and the credibility of the scope of qualitative claims. Sustainability and ESG claims are often based on anecdotal data about performance and impact. Whether a company is producing sustainability or corporate social responsibility reports for public consumption or relying on such data to make an investment or other business decisions, compliance officers should help assess the validity of claims about data that is often unaudited and can be subject to manipulation. For example, former SEC Chair, Mary Schapiro, recently covered the importance of accurate ESG disclosures in Episode 2 of NASDAQ's Tomorrow's Capital podcast.

Example: Testing ESG Claims

ESG principles can surface when a compliance officer tests investment governance, supports development of new ESG products and services, conducts or responds to due diligence requests, or reviews sales and marketing campaigns. Compliance officers should keep the following in mind as they work:

- **Sales and Marketing:** Make sure promotional statements don't misrepresent products or services to customers, particularly retail customers. Regulators, such as the SEC, have recently focused on performance reporting and sales practices related to retirement investments. The same concepts apply in the ESG arena when it comes to impact reporting. If an investment purports to be in line with ESG or impact investing mandates, ask for the quantitative and qualitative evidence to support any statements. When reviewing ESG claims, compliance officers should understand the claims by asking how impact is measured.

- **Due Diligence:** Whether conducting due diligence on a service provider, providing certifications to clients or testing your firm's adherence with impact investing or sustainability claims, ask targeted due diligence questions. For instance, if a real estate development firm asserts it meets LEED or WELL Building Standards because it uses technology and research to build a sustainable, clean work environment, and a company relies on those claims to build its offices, without further due diligence, it takes on liability if the claims are exaggerated or inaccurate. In this scenario, if the research is faulty or the new sensors misses toxins in the building's air, the company is open to legal and compliance risks. In extreme cases, sick employees may file a class action lawsuit. On the other hand, if the company asked questions about the supporting science, operations and technology behind the sensors, the company may avoid such liability because it prudently assessed the validity of the claims and risks associated with the new technology. A few questions to consider as compliance officers test claims, review marketing materials or consider new investments:

    - Does any ESG claim include a guaranteed impact? If so, what is the basis and are there any exclusions? If not, why not?
    - Is there an extra layer of costs either through a fund-of-fund structure or sales intermediary? If so, consider the costs when analyzing returns.
    - Is the provider publicly committed to and aligned with any impact-related marketing statements? How does it run its own business; is it sustainable?
    - Has a trusted third-party affirmed its ESG or impact statement so you know it isn't limited to a branding exercise?
    - How can you test environmental claims? Can you see a demonstration rather than rely on market demand or excitement for a new offering?
    - What is the desired time horizon? Is the timing for positive impact and positive returns and any liquidity risks well documented?

Compliance officers can bring value-add by helping the business ask the tough questions.

Reason No. 3

Compliance officers can help manage enterprise risks and encourage good business decisions and sound operational processes that help prevent compliance breaches by understanding and encouraging the operational benefits of ESG principles. Most companies' internal controls, management and oversight, and culture can be analyzed in terms of ESG factors.

Resources:

https://www.nasdaq.com/podcasts/tomorrowscapital/

https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf; https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf