ESG INVESTMENT RISK MITIGATION: SUPPLY CHAIN REVIEW

Date: 26 August 2019

Investment Management Alert

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ESG (environmental, social, governance) investing has experienced relatively new status as a hot-button topic in the general investment community in recent months, and many private fund managers and their investors are beginning to review, and in many cases modify, their investment strategies to incorporate ESG investment principles. The lion's share of attention has in the past been focused on the potential for achieving economic upside associated with ESG investments; in light of recent developments, however, attention should perhaps also be paid to risk mitigation, particularly with respect to ESG strategies with social governance and implications.

This development is principally attributable to governments', nongovernmental organizations', consumers' and, ultimately, investors' increasingly vocal efforts to encourage companies to pro-actively manage their businesses in alignment with ESG principles, including by vetting their suppliers carefully and maintaining supply chains that are free of elements that cause harm to the human health, and social well-being, as well as the environment. Several countries have enacted laws directly intended to pressure companies to both monitor their supply chains and proactively police them, incentivizing companies to utilize suppliers that implement ethical practices in their workforce and operations management and reject suppliers that do not.

The effects of these developments are felt not only at level of the product development, manufacture, and distribution companies, but, increasingly, at the shareholder level as well. As shareholders, investment funds, as well as their managers, must be prepared for potential exposure to reputational fallout, and even civil and criminal liability, resulting from business practices and policies at the portfolio company level that may be considered untenable in the current social climate or may actually violate human rights, environmental labor, and corporate laws already in place.

To address this latent risk, many forward-thinking fund managers are looking at ways of mitigating their funds' potential exposure to such consequences by (i) implementing supply chain review policies incorporating ESG principles as an element of their acquisition due diligence criteria in order to identify ESG-related risk and assess its potential economic effect; (ii) developing internal ethical supply chain maintenance policies and monitoring portfolio companies' compliance efforts during the fund's tenure as a shareholder; and (iii) including robust supply chain ESG review disclosures detailing the results of the fund's ESG-related risk assessments in the risk factors sections of their fund marketing materials.

This Alert provides a brief overview both of the evolution of the ESG context in which ethical supply chain review is most often discussed within the investment industry and of the expanding legal framework underlying ethical supply chain enforcement efforts around the world, from the perspective of the mid-market investment fund managers who may not be fully aware of these issues and who may benefit from a brief look at the issues relevant to their industry.

HISTORICAL EVOLUTION OF ESG

The term "ESG" was first coined in 2004 in the United Nations' ("UN") landmark study titled "Who Cares Wins," issued as part of a joint initiative by the UN and major financial institutions. The initiative, and its report, was based on the assumption that ESG principles have economic significance and should be integrated into capital markets. This was in contrast to the existing conventional wisdom, embodied in the SRI ("socially responsible investment") movement, which focused on negative screens to evaluate investments ethically and morally, but without attempting to determine value based on economic impact. Since the advent of ESG, the terms "ESG" and "SRI" are often used interchangeably in the public discourse.[2]

ESG investment has grown exponentially in the years since the UN study was published: In its 2018 Report on US Sustainable, Responsible and Impact Investing Trends, the US SIF Foundation, a non-profit organization whose mission is to promote SRI investing, notes that, as of the date of publication, SRI assets were valued at over one-fourth of the total assets under management in the United States ($12 trillion of $46.6 trillion). This figure represents a 38 percent increase in the two years since US SIF's immediately prior report was published in 2016, and an 18-fold increase since US SIF released its very first report in 1995. According to a July 11, 2018 article published in Forbes, The Remarkable Rise of ESG, by Georg Kell, ESG assets under management as of the date of the article were estimated to account for over $20 trillion of professionally managed assets worldwide.

The idea that ESG principles are material to investment valuation has subsequently been fomented, with considerable effect, by an independent, non-profit organization supported by the UN called "The PRI," an acronym for The PRI's six founding "Principles for Responsible Investment"[3] developed "by investors, for investors." PRI launched in April 2006, and, according to its website, currently claims 1,600 members representing $70 trillion globally in assets under management.[4] PRI provides a platform for its members to publish data on their adherence to the six principles and related performance. Other organizations have since sprung up that provide alternative platforms focused on various aspects of ESG activity, including the Global Reporting Initiative, International Integrated Reporting Initiative, and Sustainability Accounting Standard Board, and provide complementary platforms for ESG disclosures. In addition, in the year following The PRI's establishment, the UN Conference on Trade and Development instituted the Sustainable Stock Exchange, which has influenced forty-six established stock exchanges around the world to promulgate particularized guidance, directed toward their listed companies, relating to ESG reporting. Such new forums for ESG reporting supplement the historical reliance on annual reports, company websites, stock exchange filings and other traditional reporting venues, and provide a platform for comparing ESG data in isolation.

As a consequence of these developments, mandatory and voluntary corporate disclosure has evolved as the principal enforcement tool for ensuring compliance with ethical investment principles, both via government, in the promulgation of laws and regulations requiring corporate disclosures in specified public forums, and via industry organizations, such as the PRI, that have developed to provide companies and investors with guidance in implementing ESG principles and complying with applicable regulations as well as a platform for ESG disclosures. Many companies and investors feel that such transparency, in addition to serving a compliance function, enhances the reputation of the company making the disclosures, and several industry organizations have developed analytical scoring systems that can be used to determine relative values for companies' ESG performance and risk exposure.[5]

ESG disclosures typically address, at a minimum, a company's impact on climate change (environmental factor), its diversity and/or human rights record (social factor), and its employee relations and management structure (governance factor), factors felt by many investors to be material to a corporation's sustainability and long-term economic success. Most disclosures to date have focused on the company's direct operations and have largely overlooked supply chains, which can be highly complex, often opaque, and difficult and expensive to review. However, with the recent occurrence of several highly publicized supply-chain-related events and resulting litigation naming manufacturers as defendants, and the subsequent passage of human rights and environmental legislation in several countries directly impacting supply chains, companies and their investors are becoming increasingly sensitized to the reputational and legal risks that such developments pose, and the potential resultant deleterious impact they would have on corporate value. A few recent examples of this are as follows:

- A top British supermarket pulled corned beef brands off its shelves after a newspaper found it might contain meat linked to slave labor.
- The U.S. Customs and Border Protection halted the entry of tuna by a Taiwanese vessel after obtaining information that the crew was using forced labor.
- The European Union warned Thailand that it would ban all Thai seafood imports if the government failed to eradicate the trafficking of migrant fishers. In 2015, a U.S. marine-services company filed for bankruptcy after a jury awarded $14 million to victims of forced labor, imperiling the $70 million investment of two major public pension funds. In an effort to salvage their investments, the pension funds offered to finance the bankruptcy sale and settlement effort with $20 million in loans.
- One of Europe's largest private equity firms faced questions from its institutional investors after a retail company it owns was found to have used a garment factory in Myanmar that employed underage workers. One public investor, a pension fund, reminded the private equity firm that it expected the firm to mitigate ESG risks as outlined in its investment standards.

Such events increase the cost of doing business due to fines, litigation, insurance premiums, and/or the replacement of suppliers. Disruptions also threaten business continuity through contract breaches, product boycotts, supplier loss, and capital flight, all of which may impact corporate value. Accordingly, many companies and their shareholders are adopting the view that early attention to mitigating potential supply chain risk, and implementing robust vetting and monitoring protocols, is one of the many ways that companies can protect themselves from value-eroding ESG-related events and enhance their, and their investors', long-term financial success.

SUPPLY CHAIN ESG RISK AS AN INVESTMENT FACTOR

A February 2017 survey[6] of senior investment professionals at asset-managing and asset-owning institutions suggested that 82 percent of the respondents “use ESG information because it is financially material to investment performance.” According to some studies, institutional investors are, with increasing frequency, insisting that the supply chain risks be not only assessed, but also, pro-actively addressed by the managers of funds in which they invest. For example, a 2015 Ernst & Young survey found that more than 88 percent of the institutional investors surveyed would either reconsider or rule out immediately an investment if an identified risk in the investee's supply chain is not satisfactorily addressed. (But cf. footnote 4.)

Accordingly, the incorporation of supply chain ESG data as an element of investment due diligence review may be an important factor in attracting the capital of a growing group of environmentally and socially conscious investors. In this regard, while many investors opt, for economic, fiduciary, and various other reasons, not to adopt ESG principles as an element of their investment program,[7] the market trend toward investment in ESG assets is nevertheless significant: Global ESG assets under management increased by 73 percent from $13.3 trillion in 2012 to $22.9 trillion in 2016.[8] According to McKinsey & Company,[9] as of 2017, more than one quarter of assets under management globally have been acquired utilizing acquisition criteria that prominently incorporate ESG data.

There are challenges to implementing successful ESG investment strategies, including supply chain review policies, that deter many investors and managers from considering ESG entirely, from both the investment strategy and risk mitigation perspectives. Many of the challenges that investors and fund managers face in implementing ESG principles are attributable to the fact that ESG principles are still actively evolving, and there currently exists no standard definition. This fluidity makes it difficult to value and compare the upside potential of competing ESG strategies and much more difficult to evaluate the downside risk.[10] In fact, a 2019 study by Natixis found that only 47 percent of the surveyed investors felt that they possessed enough information to make “socially responsible investment decisions.”[11]

There is currently no uniform industry or regulatory definition or standard for determining what activities are subsumed within the ESG umbrella. Lack of a universally recognized, standard definition of the scope of “ESG investment” renders it difficult for investors to accurately evaluate the returns of funds implementing ESG strategies. In this void, fund managers tend to adopt individual definitions incorporating a broad range of activities, especially within the “Social” category of ESG, that vary from manager to manager. ESG as it relates to supply chains, for example, may be an element of some fund managers' ESG policies, while omitted by others. Some managers who do adopt a supply chain ESG review policy may consider only the degree to which the company has developed sustainable sourcing for its products, whereas others review supply chains for both sustainability and modern slavery risks.

This lack of standardization is a double-edged sword. While it allows corporations, investors, and fund managers to develop proprietary ESG policies that conform to their underlying investment philosophies and objectives, it also makes it difficult for investors to value a given ESG investment strategy and the results it is likely to yield. The resulting ambiguity has given rise to skepticism among some investors regarding fund-produced ESG data due to the potential both for “greenwashing” — claiming to adhere to stated ESG principles without actually following through — and for over-inflation of the underlying data, potentially running afoul of the U.S. Securities and Exchange Commission's track-record regulations. Funds also receive such disparate ratings from organizations performing ESG investment evaluations that determining which funds are most capably performing ESG investing often depends on which survey an investor reads. For these reasons, fund managers must be diligent in implementing the principles they profess to utilize when adopting a supply chain ESG review policy and in analyzing the strategies adopted by competing funds.

LEGAL ENFORCEMENT FRAMEWORK

With increasing frequency, countries around the world are adopting new legislative regimes that aim to hold companies accountable for the acts of participants in their supply chains, particularly in the realm of modern workforce slavery. Existing modern slavery laws generally fall into one of the following two categories: “Disclosure-based” laws require a company only to prepare a modern slavery statement detailing what efforts, if any, the company is taking to detect and remove slavery from its supply chains. By contrast, “due diligence” systems require that a company that detects slavery or a risk of slavery in its supply chains actively take steps to eradicate its existence or else face serious consequences, including hefty fines and imprisonment for corporate directors.[12] Although many of the early supply chain transparency regimes were disclosure-based systems that did not include penalties (e.g., California and the United Kingdom), more jurisdictions are promulgating disclosure-based regimes that impose consequences on non-compliant companies (e.g., New South Wales) or, more frequently, due diligence regimes (e.g., France, The Netherlands, and proposed efforts in Germany and Finland).

Violations under either approach entail possible financial risk to fund investors in the form of significant fines imposed on, and eroding the value of, the violating portfolio company, and, perhaps more importantly, reputational risk, if the investor is publicly associated with the violating company. In some jurisdictions, the laws even provide for the incarceration of a company's directors. Needless to say, faced with the possibility of such risks, it would be worth considering implementing a supply chain review policy that incorporated, at a minimum, a modern slavery law compliance component.

CONCLUSION

ESG investing presents fund managers with a “damned if you do, damned if you don't” quandary. Given the difficulty of accurately valuing the potential economic upside and downside of implementing a proactive ESG-based investment strategy, many fund investors may opt to avoid the issue altogether and stick to a more conventional strategy based on less fluid, tried-and-true principles of economic analysis. However, if, at minimum, a supply chain ESG review policy is not implemented as a risk mitigation strategy, fund managers may be tossing the dice with respect to the potential downside risks of supply chain ESG-related events that could substantially damage a portfolio company's business, and by extension, a fund investor's portfolio returns and the reputation of the fund manager, not to mention the potential limitation of a manager's ability to raise capital among increasingly ESG-sensitized investors.

Accordingly, while ESG investing per se may not be appropriate for all fund investment strategies, nevertheless, the potential downside risks associated with supply chain ESG issues in vetting certain investments and monitoring portfolios would seem to warrant serious consideration by nearly all investment managers. It is increasingly important that fund managers be aware of the expanding body of law and policy globally that impacts supply chains and consider whether it would be advisable to adopt internal policies for reviewing and monitoring supply chains for latent environmental, social (human rights), and governance risks. The benefit of reducing exposure to potentially catastrophic supply-chain related liability in the future may well outweigh cost of implementing effective, prophylactic policies early on.

**Thank you to Jimmy L. Ma for being a contributing author to this alert.*

To read the Japanese translation of this alert, click here.

Notes:

[1] Sources and additional information for the data referenced in this Alert can be accessed by clicking on the embedded links in the text.

[2] The term "ESG" tends to have greater currency among asset managers than "SRI," particularly in the context of investment fund management, but certain organizations, such as the US SIF Foundation cited herein, tends to use the term "SRI" consistent with its founding charter.

[3] Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
Principle 6: We will each report on our activities and progress towards implementing the Principles.

[4] https://www.unpri.org/

[5] *See, e.g.*, Thomson Reuters EIKON, Thomson Reuters ESG Scores (May 2018) and Guido Giese and Zoltan Nagy, *How Markets Price* ESG, MSCI ESG Research LLC (Nov. 2018).

[6] Amir Amel-Zadeh and George Serafeim, *Why and How Invesetors Use ESG Information: Evidence from a Global Survey*, published as a draft working paper by the Harvard Business School (Feb. 2017).

[7] For example, the Managed Funds Association ("MFA"), an industry association representing the global alternative investment industry, states on its website that, "MFA cautions against overly prescriptive measures obligating asset managers to include ESG in investment if they do not reflect the preferences of underlying investors such as pensioners and life insurance companies." Similarly, Preqin Ltd. stated, in a brief comment entitled "Will Hedge Funds Ever Truly Embrace ESG Principles?" published on its website and based on 2018 data, "In the world of hedge funds . . . the topic is far from clear cut, and managers are divided on whether ESG has a place in a sector designed around unconstrained investments."

[8] Daniel B. Berkowitz et al, *ESG, SRI, and impact investing: A primer for decision-making*, VANGUARD RESEARCH (Aug. 2018), https://personal.vanguard.com/pdf/ISGESG.pdf.

[9] Sara Bernow et al, *From 'why' to 'why not': Sustainable investing as the new normal*, MCKINSEY INSIGHTS (Aug. 14, 2019, 4:31 PM), https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal.

[10] *See, e.g.*, Wayne Winegarden, *Environmental, Social, and Governance (ESG) Investing: An Evaluation of the Evidence*, PACIFIC RESEARCH INSTITUTE (2019), https://www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf; Eshe Nelson, *Sustainable Investing Risks Becoming a Victim of Its Own Success*, QUARTZ (Dec. 13, 2018), https://qz.com/1490365/esg-investing-risks-becoming-a-victim-of-its-own-success/.

[11] Rebecca Moore, *Lack of Track Records Hinder ESG Investing*, PLANSPONSOR (May 23, 2019), https://www.plansponsor.com/lack-track-records-hinder-esg-investing/.

[12] In The Netherlands, for example, a company that repeatedly fails to comply with the Child Labor Due Diligence Law could face criminal charges and substantial fines. This bill, as of the time of this writing, has passed both chambers of the Dutch parliament and is currently awaiting the king's signature to become law.

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