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SYMPOSIUM: CORPORATE SUSTAINABILITY IN THE ERA OF SHIFTING FEDERAL PRIORITIES

Why Corporate Attorneys and Other Gatekeepers Should Consider ESG and Sustainability Principles

Beth Haddock* Tucker Pribor† Kate Starr‡

*CEO and founder of Warburton Advisers
†Investment Associate at Flat World Partners
‡Chief Investment Officer of Flat World Partners

WHY CORPORATE ATTORNEYS AND OTHER GATEKEEPERS SHOULD CONSIDER ESG AND SUSTAINABILITY PRINCIPLES

Beth Haddock,[*] Tucker Pribor,[**] Kate Starr[***]

Environmental, Social, and Governance (ESG), impact investing, and sustainability are considerations corporate attorneys, compliance officers and other gatekeepers ("Gatekeepers") may believe are outside the scope of efforts to manage legal risks, but evolving standards place these issues well within that mandate.

This article will illustrate the applicability of ESG and impact investing to general legal and compliance programs. For example, understanding what is meant by ESG claims, or borrowing ESG principles to identify and manage risk, can help Gatekeepers 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 system as opposed to a narrow litigation prevention orientation.

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[*] Beth Haddock (www.warburtonadvisers.com), CEO and founder of Warburton Advisers, is the author of Triple Bottom-Line Compliance: How to Deliver Protection, Productivity and Impact. She has more than 20 years of experience as a compliance and business executive. Her consulting firm provides sustainable governance and compliance solutions to leading international corporations, technology companies, and non-profits.

[**] Tucker Pribor is an Investment Associate at Flat World Partners, an impact investing firm. He served as a Research Analyst at Ironwood Capital Management in San Francisco and UBS as an Analyst in the Private Funds Group. Tucker holds a B.A. in Economics and English from Washington and Lee University. Tucker is a 2015 CAIA Designee.

[***] Kate Starr is the Chief Investment Officer of Flat World Partners. Previously, she led the capital deployment team at the Heron Foundation that invests Heron's approximately $300 million portfolio for impact. She is a CFA and active member of NYSSA's Sustainability Committee and advisor to the Sustainability Accounting Standards Board. Kate graduated from Indiana University with an Honors degree in English and Italian, and earned a Master's degree in International Relations and Economics from Johns Hopkins School for Advanced International Studies.

Moreover, since the heart of a Gatekeeper's job is to help ensure claims to investors or consumers are accurate and absent of fraud, ESG principles can help a Gatekeeper more comprehensively meet that responsibility.

THE THREE REASONS THIS MEGA TREND MATTERS TO GATEKEEPERS

About $23 trillion in total global assets were professionally managed employing ESG strategies in 2016, according to the Global Sustainable Investment Alliance.[1] That figure represents a 25% increase over 2014, and this mega trend is projected to continue its rapid growth trajectory.[2] 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.[3]

ESG represents a conceptual paradigm that can be implemented across asset classes and investment strategies to improve risk-adjusted returns.[4] These ESG risk considerations are not just important to

1. *See* GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, GLOBAL SUSTAINABLE INVESTMENT REVIEW 3 (2016); *see also* Antonella Puca et al., *Effective ESG Investing: An Interview with Andrew Parry*, CFA INSTITUTE, https://blogs.cfainstitute.org/investor/2018/06/15/effective-esg-investing-an-interview-with-andrew-parry/ [https://perma.cc/N2HL-V5DN] (last visited Nov. 7, 2018).

2. *See* GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, *supra* note 1, at 3. Recent policy changes support the move to an ESG framework. In May 2018, the European Commission released an ESG proposal advocating enhanced transparency and duties for institutions. *See* Press Release, Eur. Comm'n, Sustainable finance: Making the financial sector a powerful actor in fighting climate change, (May 24, 2018) (IP/18/3729), http://europa.eu/rapid/press-release_IP-18-3729_en.htm [https://perma.cc/PW9C-N8CL]. These principles are already incorporated in the investment mandates of US pensions, such as CalSTRS and the New York Common Fund. *See generally* CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, GOVERNANCE & SUSTAINABILITY PRINCIPLES (2018), https://www.calpers.ca.gov/docs/forms-publications/governance-and-sustainability-principles.pdf; OFFICE OF THE NEW YORK STATE COMPTROLLER, ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT (2017), https://www.osc.state.ny.us/reports/esg-report-mar2017.pdf.

3. *See* Puca, *supra* note 1.

4. Many new private funds, ETFs, and mutual funds use a socially responsible index as a performance benchmark, including Flatworld Partners, Calvert, and MSCI. *See Forward Thinking Financial Advisory – Impact Investments that Meet*

business leaders; they are also key for Gatekeepers within companies. For instance, understanding trends, practices, and red flags are important to Gatekeepers in financial services companies monitoring the investment management process, particularly if they are one of the over one thousand signatories of the Principles of Responsible Investing, or Gatekeepers in companies that manufacture goods within a sustainable supply chain program in adherence with the United Nations Sustainable Development Goals ("UN SDGs").[5]

Gatekeepers will be among the beneficiaries of this mega trend. These strategies will change the perception of legal, risk and 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 SDGs twelve and seventeen, and arguably imbedded within many others.[6] The UN SDGs are being adopted at every level within companies – 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 legal and governance programs, as well as the Gatekeepers who lead and promote this opportunity to add business value.

Your Needs, FLATWORLD PARTNERS, http://www.flatworld-partners.com/ (last visited Nov. 7, 2018); *Calvert US Large-Cap Core Responsible Index Fund*, CALVERT, https://www.calvert.com/Calvert-US-Large-Cap-Core-Responsible-Index-Fund-CISIX.php [https://perma.cc/FQL8-V2MW] (last visited Nov. 7, 2018); MSCI KLD 400 Social Index, MSCI, https://www.msci.com/msci-kld-400-social-index [https://perma.cc/M4V6-K578] (last visited Nov. 7, 2018).

5. 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. S*ee About the PRI*, UNPRI, https://www.unpri.org/pri/about-the-pri [https://perma.cc/7V3L-6NSB] (last visited Nov. 7, 2018). Currently, there are over eighteen hundred signatures. *Id.* The United Nations Sustainable Development Goals likewise encourage a commitment to sustainability and compliance with 17 broad ethical and socially responsible goals. *See Sustainable Development Goals*, SUSTAINABLE DEVELOPMENT, https://sustainabledevelopment.un.org/sdgs [https://perma.cc/QW6P-5CGE] (last visited Nov. 7, 2018).

6. *See* SUSTAINABLE DEVELOPMENT, *supra* note 5.

Reason No. 1: Uncover and Address Governance Gaps

Gatekeepers 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 a pension fund client expected? Gatekeepers should not "own" compliance with ESG investment instructions, but they should help confirm investments are aligned with investment guidelines. Common legal and governance gaps to look for include:

- **Requests for Proposals**: The investment team could over-sell the client about ESG capabilities. Gatekeepers should review requests for proposals 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 with regard to, for example, 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. Gatekeepers 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 from all stakeholders, the business can make mistakes and compliance can be bureaucratic. Engagement is a key benefit of sustainable governance. Gatekeepers 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 legal and compliance program. The business will appreciate an engaged Gatekeeper who helps the business with its ESG obligations.

Reason No. 2: Fraud Prevention

Gatekeepers can help detect and prevent fraud, including misrepresentations or omissions of material facts about ESG and sustainability. Gatekeepers 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.[7] 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.

Example: Testing ESG Claims

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

o **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.[8] The same concepts apply in the ESG arena when it

7. The former SEC Chair, Mary Schapiro, recently covered the importance of accurate ESG disclosures in Episode two, season one, of NASDAQ's Tomorrow's Capital podcast. *See Are the Markets More Resilient Today Than in 2008? Former SEC Chairman Shares Her Thoughts*, NASDAQ (June 12, 2018), https://www.nasdaq.com/podcasts/tomorrowscapital/.

8. *See* OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS (OCIE), THE MOST FREQUENT ADVERTISING RULE COMPLIANCE ISSUES IDENTIFIED IN OCIE

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, Gatekeepers should understand the claims by asking how impact is measured.

o **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 Gatekeepers 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?

EXAMINATIONS OF INVESTMENT ADVISORS 2-4 (2017), https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf; OCIE, 2018 NATIONAL EXAM PROGRAM EXAMINATION PRIORITIES 4-7 (2018), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf.

- 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?

Gatekeepers can bring value-add by helping the business test ESG claims before they invest in a purported sustainable business or product. See Chart 1 for examples of how Gatekeepers can help officers and directors meet their duty of due inquiry and care.[9]

Chart 1: Example: Testing ESG Claims

Attribute	Due Diligence Inquiry	Result	Liability Mitigated
Basis for Impact Claims	Does any ESG claim include a guaranteed impact? If so, what is the basis and are there any exclusions? If not, why not?	No, the manager has estimates based on previous deals used to represent and illustrate potential environmental impact.	When one understands claims are projections not guarantees, one can ask about assumptions and inputs to understand the opportunities and assess risks mitigating claims of inadequate due diligence.
Transparency of Cost Structure	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.	No, this was a direct investment into the private equity fund.	When investments have lower costs and expenses particularly in funds, the investor may benefit as more of the investor's funds earn potential returns and risks of misunderstanding or hidden fees is mitigated.
Qualitative Test of Long-Term	Is the provider publicly committed and aligned with	The investment thesis of the fund	When an investor is informed about measurable

9. On October 1, 2018, Osler Chair in Business Law Cynthia A. Williams, Osgoode Hall Law School and Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch, University of Pennsylvania Law School, petitioned the SEC for expanded ESG disclosure that could, in part, address challenges related to making informed ESG investment decisions. Cynthia A. Williams & Jill E. Fisch, Request for rulemaking on environmental, social, and governance (ESG) disclosure, No. 4-730 (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf.

Commitment and Reasonable Reliance	any impact-related marketing statements? How does it run its own business; is it sustainable or is it a signatory to PRI?	is one in which the manager is investing in companies utilizing sustainable agriculture practices with the explicit aim of installing and implementing sustainable goals and key performance indicators (KPIs) at the underlying management levels.	benchmarks such as KPIs, good business judgment can be used to determine whether an initial investment is prudent and whether redemption is required to support duties of loyalty and best interests.
Authenticity and Credibility	Has a trusted third-party affirmed its ESG or impact statement so you know it isn't limited to a branding exercise?	The fund brings in third-party experts to help evaluate the impact of underlying investments while also relying on internal resources and guidelines. The investor or any adviser will also evaluate the statement and practices themselves.	Third-party independent review of claims can support the investors business decision and mitigate issues of potential conflicts of interest or bias.
Stress Test and Quantitative Review	How can you test environmental claims? Can you see a demonstration rather than rely on market	Fund actively tracks specific KPIs that are designated based on the underlying	Quantitative metrics help mitigate unknown risks and inform an investor about time horizon and redemption strategies as

	demand or excitement for a new offering?	investment / company including measurements of environmental factors such as water usage and Greenhouse Gas emissions.	well as inform an investor about performance claims to mitigate risk of using inflated projections.
Product Fit for Time Horizon and Liquidity	What is the desired time horizon? Is the timing for positive impact and positive returns and any liquidity risks well documented?	The fund has an eight-year term which aligns well with both the impact and financial outcome expectations of the fund.	Understanding the long-term horizon helps mitigate the risk that an investment does not meet risk tolerance or holding period requirements.

Reason No. 3: Improve Business Decision-Making and Risk Management

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

Example: Using ESG Principles to Support Business Judgment and Risk Management

Public companies have a duty to deliver a return on investment (ROI) to shareholders,[10] technology companies and those that manage

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10. Corporate officers and directors owe to the company and its shareholders a fiduciary duty of due care and loyalty. This entails using a rational and good faith process to understand potential liabilities before making decisions. Importantly, these leaders should receive timely and adequate information in order to consider and understand the implications of their decisions. Without this informed process, officers and directors cannot rely on business judgment rule as protection against

personal information have a duty to protect information,[11] and investment advisers and brokers have a range of duties.[12] Likewise, Gatekeepers and business leaders should consider ESG principles as meeting a necessary enterprise risk management (ERM) duty. ERM is the process of identifying and rating material risks to decrease the probability a company will be harmed by an unexpected risk. ERM helps avoid predictable and unpredictable risks and errors, such as reliance on inflated performance or underestimating the importance of controls to protect against a data breach or systems hack.

Leveraging ESG as an ERM duty teaches Gatekeepers to prioritize and strategically work on systemic risks. It teaches Gatekeepers to manage risks as projects, setting deadlines and requiring backup for process solutions to help avoid repeat deficiencies. It also teaches Gatekeepers to continuously broaden risk factors - staying on top of technology and global legal and regulatory developments. As the business world becomes more complex and global, so too should Gatekeepers' approach to managing risks. In *Turning Corporate Compliance into a Competitive Advantage*, Professors Bird and Park describe the benefits of using an efficient investment-risk (EIR) model to build and manage an effective governance and compliance program.[13] The model similarly focuses on the benefits of tailored and strategic planning to address the most impactful enterprise issues by finding the governance "sweet spot" on what amounts to a governance

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liability for their decisions. The Caremark decision involved fines and penalties under civil and criminal law and ultimately a settlement of claims against the members of a board for failing to meet their fiduciary duty of due care. *See In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996). The court reiterated liability for decisions that are "ill advised" or "negligent" or "unconsidered inaction" because of a lack of attention or due inquiry. *Id.* at 967. It's important for members of boards, of both private and public companies, to consider whether they have adequate information, including information about ESG claims, to satisfy the business judgment rule. An organization that leaves the ESG discussion in a silo with investment personnel or a corporate social responsibility team may unnecessarily leave itself open to potential liability.

11. *See generally* Jack M. Balkin, *Information Fiduciaries and the First Amendment*, 49 U.C. DAVIS L. REV.1183 (2016).

12. *See* General Rules and Regulations - Securities Exchange Act of 1934, 7 CFR pt. 240 (2012).

13. *See* Robert C. Bird & Stephen Kim Park, *Turning Corporate Compliance into Competitive Advantage*, 19 U. PA. J. BUS. L. 286 (2017).

efficient frontier.[14] It also acknowledges the mistakes legal and compliance professionals can make if they do not adopt an ERM approach, and instead choosing to focus on process over results and/or undue emphasis on fear of personal liability or sanctions.[15]

Gatekeepers' not considering ESG principles is like an online business not considering cybersecurity. Approaching these principles as an ERM duty helps a company and its Gatekeepers to strategically focus on identifying and mitigating material risks, which can mean knowingly accepting reasonable risks while eliminating blind spots that can cost a company money and reputational damage. When businesses consider a new investment, product or service provider, they often rely on others' claims to forecast their own returns or profits. What happens if those claims are inaccurate and forecasts are consequently inflated? Faulty due diligence can lead to unseen risks and liability. However, by leveraging ESG principles, companies can minimize these blind spots and avoid predictable surprises that come along with unsubstantiated claims.

Take, for example, a company like Wells Fargo, which has experienced numerous enforcement actions resulting in fines, lost share value, and a tarnished brand, with an arguably adverse impact on investors.[16] By leveraging ESG principles, an allocator considering a new investment in Wells Fargo can more accurately forecast returns after considering risks such as the sustainability of its historical sales success, the efficiencies and costs to fix recurring systemic operational processes, and the impact of a tainted brand on growth projections. If an allocator does not consider systemic "social" and "governance" attributes by studying the effectiveness of Wells Fargo's whistleblower program, its regulatory enforcement cases, and its incentive compensation programs, the allocator may not meet its legal duties such as best interests, suitability and even a fiduciary standard during the sales process.

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14. *Id.* at 289.

15. *Id.* at 309-11.

16. *See* Meredith Mazzilli, *Wells Fargo sees no end yet to sales scandal costs, gets tax boost*, REUTERS, https://www.reuters.com/article/us-wells-fargo-results/wells-fargo-sees-no-end-yet-to-sales-scandal-costs-gets-tax-boost-idUSKBN1F11LE [https://perma.cc/X5HY-YG6J] (last visited Nov. 7, 2018).

CONCLUSION

The pace of change in American businesses has never been faster. From programmers to line workers, continuous skill enhancement is essential to career growth. This is no less true for Gatekeepers who will need to respond to a changing legal landscape in order build an enduring career and remain a valuable contributor in helping companies manage their current and evolving risks.