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ESG in the Time of COVID: Key Considerations for Investment Fund Managers

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Since June 5, 2019, the date on which the Securities and Exchange Commission (the SEC) published its interpretation regarding the standard of conduct for investment advisers under the Advisers Act[1] the world has changed dramatically. On February 3, 2020, Larry Fink, the Founder, Chairman, and CEO of BlackRock Inc., published his open letter to CEOs asserting that climate change "has become a defining factor in companies' long-term prospects".[2] The World Health Organization declared COVID-19 as a pandemic on March 11, 2020. The Black Lives Matter movement has gained increased prominence following the death of George Floyd in Minneapolis on May 25, 2020.

The managers of many investment funds have made representations or covenants with respect to the incorporation of environmental, social and governance principles in their investment decisions. Prior to the COVID-19 pandemic, in the context of ESG, the investment community was focused on climate change, as evidenced in part by Larry Fink's letter.[3] However, since the start of the current pandemic, that focus has shifted, at least temporarily.[4] The "S" in "ESG" appears to have gained more prominence than the "E" or the "G".[5]

Registered advisers are fiduciaries under U.S. federal law and owe a duty of care and a duty of loyalty to their clients.[6] The SEC has stated that this fiduciary duty requires an adviser "to adopt the principal's goals, objectives, or ends"[7] and that an adviser's duty "follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[8]

Investment fund managers may wish to take the following actions to address ESG in the time of COVID-19:

- **Review Scope of Existing Commitments.** As investment fund managers monitor and evaluate their portfolios, they should review any side letters and the governing documents of the funds that they manage, including the limited partnership agreement and the private placement memorandum, to ensure that fund managers understand the scope and extent of their commitments and representations made to investors with respect to ESG.
- **Evaluate Effectiveness of Existing ESG Policies and Procedures.** Investment fund managers that have made commitments with respect to ESG should evaluate the manner in which ESG principles are incorporated into investment decisions, the ongoing management of portfolio companies, and the management of the fund manager's own business (such as the manner in which key employees are recruited and promoted, and the compensation of employees for sick days).
- **Adopt an ESG Policy.** Investment fund managers that have not yet adopted an ESG policy may wish to consider doing so as a way of identifying and managing risks not addressed through their existing processes, thereby improving the fund's ability to weather (and potentially thrive in) the COVID-19 storm. While conventional wisdom has pitted ESG considerations against healthy economic returns, the current pandemic has demonstrated that the two are not mutually exclusive. Funds that have already identified and addressed ESG risks, for example, may find that their portfolio companies are more resilient than those of their peers.[9]
- **Adjust the Investment Strategy.** Managers of funds without the benefit of an investment strategy broad enough to include new types of attractive investment opportunities should consider amending the fund's investment strategy (which would generally require

investor consent) or forming a sidecar fund (which may also require investor consent, depending on the terms of the existing fund) for the purpose of pursuing those types of opportunities.

- Fund managers that wish to pursue this approach should engage with investors early in the process to identify and address any concerns that investors may have with respect to style drift or potential conflicts of interest. Investors may want to know, for example, how conflicts will be managed if two different funds that are managed by the same manager could potentially invest in different parts of the capital stack of the same company.
- Any fund manager that wishes to form a sidecar fund should be prepared to answer fresh new questions from investors about how the manager will address ESG risks: the investment strategy of the sidecar fund could raise materially different ESG considerations — and result in a materially different risk profile — than that of the existing fund.

These actions will not necessarily ensure the success of an investment fund or result in top-quartile returns. There are sure to be investment funds that are unable to rebound from their losses or that are ultimately unable to produce the returns expected by their investors as a result of the current pandemic. However, at a time when health, safety, and stability are of paramount concern to many institutional investors, among others, an investment fund manager that chooses to disregard its own ESG commitments, or disregard ESG considerations more generally, does so at its own peril.

[1] U.S. Securities and Exchange Commission, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 17 CFR Part 276 (Release No. IA-5248; File No. S7-07-18) (June 5, 2019).

[2] Laurence Fink, "A Fundamental Reshaping of Finance" (2020).

[3] David Katz and Laura A. McIntosh, "Corporate Governance Update: EESG and the COVID-19 Crisis" (May 31, 2020).

[4] Olivia Raimonde and Hailey Waller, "CEOs Drop Climate Change Talk to Focus on Surviving Covid-19" (July 1, 2020).

[5] See, for example, "Investor Statement on Coronavirus Response", a statement released by over 300 institutional investors which urges the business community to consider providing paid leave, prioritizing health and safety and maintaining employment, among other things: "the prospect of widespread unemployment will exacerbate the crisis and grave risks to basic social stability and the financial markets".

[6] *Interpretation*, supra note 1 at 6-7, citing Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) and Proxy Voting By Investment Advisors, Investment Advisers Act Release No. 2106 (Jan. 31, 2003).

[7] *Ibid* at 7-8.

[8] *Ibid* at 9.

[9] Jon Hale, "Sustainable Funds Weather the First Quarter Better Than Conventional Funds" (April 3, 2020).

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