

EXHIBIT A

As You Sow Comment Letter

Financial Factors in Selecting Plan Investments

Proposed Regulation (RIN 1210-AB95)

BEST INTERESTS IN THE LONG TERM: FIDUCIARY DUTIES AND ESG INTEGRATION

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Two persistent misconceptions continue to affect the way fiduciaries think about sustainable investing: (1) fiduciary duties block a fiduciary investor from considering environmental and social factors; and (2) the portfolio will suffer financially if a fiduciary investor engages in sustainable or responsible investing. An examination of socially responsible investing; ESG integration (an investment process that considers material environmental, social, and governance (ESG) factors alongside traditional financial metrics); corporate social responsibility; and impact investing, shows that neither of these assumptions is correct. Analyses of different forms of sustainable investing have found no necessary cost to a portfolio when sustainable funds are compared with traditional funds. The SEC already requires companies to report material information, and reporting standards developed by the Sustainable Accounting Standards Board (SASB) and the Global Impact Investing Network (GIIN) are improving understanding of the financial materiality of ESG factors.

Given the development of new financial products and strategies, fiduciary duties require examination. The duty to act as a prudent investor is of central importance to anyone acting

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as a fiduciary, and the available data explain why a prudent investor should consider ESG information. Moreover, since the duty of impartiality protects future beneficiaries, that duty requires a long-term investment time horizon, increasing the need to take ESG information into consideration. It follows that a prudent fiduciary investor not only may, but should, use ESG information in developing financial policy and decisions.

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INTRODUCTION

When a fiduciary manages assets for a pension plan, university or charitable endowment, or private trust, the fiduciary acts for the benefit of the beneficiaries, both current and future. Legal duties called fiduciary duties constrain the fiduciary and protect the interests of the beneficiaries from fiduciaries who might otherwise be tempted to act for their own personal interests. The duties of obedience, loyalty, care or prudence, and impartiality all affect investment decision-making.

When fiduciaries invest assets held for others, they must act as prudent investors. Because what it means to be a prudent investor shifts with developments in financial theories and investment processes,¹ lawyers who advise fiduciaries find themselves in the uncomfortable situation of needing to understand these shifts.² The prudent investor standard depends on investing norms, and those norms change to incorporate new ideas and new information. Lawyers accustomed to the slow evolution of the law of trusts find themselves confronted with rapid changes in investment strategies. This Article explains changes embraced by investment advisors without delving too deeply into the specifics of investment practices. The goal is to

1. Changes in investment norms in the second half of the twentieth century led to a shift in the prudent investor standard and the creation of the Uniform Prudent Investor Act (UPIA). *See infra* Section V.C (describing the history of UPIA). In describing the development of UPIA, John Langbein wrote, “These adjustments to the legal regime were driven by profound changes that have occurred across the past generation in our understanding of the investment function.” John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 642 (1996).

2. Most lawyers are not financial analysts and do not keep up with the rapid changes in the finance industry, but in order to help clients understand the prudent investor standard, a lawyer must understand the basic shifts in financial theory and practice. These finance developments may be outside the lawyer’s comfort zone. A 2014 article provides a good example of the difficulty of keeping up. The author defines “socially responsible investing” using a definition that is over thirty-five years old and ignores developments in finance. *See* William Sanders, *Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing*, 35 PACE L. REV. 535, 537 (2014).

give lawyers an understanding of the prudence standard's shift toward the use of information that investors have traditionally ignored.

Financial analysts increasingly consider environmental, social, and governance (ESG) factors³ in rating companies⁴ because studies show that these factors provide useful information about the financial strengths and weaknesses of the companies.⁵ The complication for a fiduciary is that these factors may also reflect benefits or costs beyond a company's financial bottom line.⁶ In addition to making a profit, a company will exert positive or negative effects on the environment, the community in which the company is located, and the health and well-being of its workers. Environmental factors may indicate whether a company improves the environment or damages it. Social factors may reflect whether workers are paid a fair wage or are subject to sweatshop conditions. These extrafinancial impacts may be important to investors; they are certainly important to the health of workers and the environment. However, due to outdated understandings of "social investing," some deci-

3. Environmental factors include climate change, carbon emissions, pollution, energy efficiency, waste management, biodiversity, deforestation, and water use related to water scarcity. Social factors include labor conditions, employee engagement, human rights, gender and diversity policies, and community relations. Governance factors include diversity on the board, executive compensation, audits and transparency for shareholders and other stakeholders, corruption policies, lobbying activities, and political contributions. The types of ESG factors, and which factors should be considered material, vary from industry to industry. See GORDON L. CLARK ET AL., FROM THE STOCKHOLDER TO THE STAKEHOLDER: HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE 13 (2015), https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf [<https://perma.cc/VM24-A9JC>].

4. See Matt Turner, *Here Is the Letter the World's Largest Investor, BlackRock CEO Larry Fink, Just Sent to CEOs Everywhere*, BUS. INSIDER (Feb. 2, 2016, 8:03 AM), <http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2> [<https://perma.cc/3X9C-3LKT>]. A letter sent by the CEO of BlackRock to the CEOs of the S&P 500 companies stated, "At companies where ESG issues are handled well, they are often a signal of operational excellence. BlackRock has been undertaking a multi-year effort to integrate ESG considerations into our investment processes, and we expect companies to have strategies to manage these issues." *Id.*; see also Robert G. Eccles et al., *Market Interest in Nonfinancial Information*, 23 J. APPLIED CORP. FIN. 113, 113 (2011) (analyzing "hits" by accessing extrafinancial data in the Bloomberg database from 2010 and 2011).

5. See *infra* Part II.

6. That is, these factors may have both financial and nonfinancial consequences, a "double bottom line."

sion makers still worry that any strategy that considers environmental or social impacts will breach their fiduciary duties.

This Article examines the fiduciary duties of those who manage pension plans, charitable and university endowments, and private trusts, focusing on how those duties relate to investment decision-making. The Article considers strategies that evaluate material ESG factors, together with traditional financial metrics, and argues that fiduciaries can—and should—consider those factors in their investment policies and investment decision-making. Along the way, this Article addresses two persistent misunderstandings: that using ESG factors in investment decision-making will result in lower returns,⁷ and that fiduciary duties preclude a fiduciary from doing so.⁸

7. See, e.g., Jon Hale, *Does Sustainable Investing Help or Hurt Returns?*, MORNINGSTAR (Dec. 7, 2017), <http://news.morningstar.com/articlenet/article.aspx?id=839607> [<https://perma.cc/F5JL-RRMH>] (describing the continuing “misimpression” that sustainable investing will hurt returns). A 2015 study found that “misperceptions of negative impact of investment performance” was considered a major challenge by 60 percent of respondents and a moderate challenge by 28 percent. ROBERT G. ECCLES & MIRTHA D. KASTRAPELI, *THE INVESTING ENLIGHTENMENT: HOW PRINCIPLE AND PRAGMATISM CAN CREATE SUSTAINABLE VALUE THROUGH ESG* (2017) (quoting UNPRI & CERULLI ASSOCIATES, *Evolving Product Trends: Strategic Beta and ESG/SRI*, U.S. PROD. & STRATEGIES 2016, 80 (2016)), http://www.statestreet.com/content/dam/statestreet/documents/Articles/The_Investing_Enlightenment.pdf [<https://perma.cc/GB53-ZM8H>]; see also COMMONFUND INST., *THE NAT’L ASS’N OF COLL. AND UNIV. BUS. OFFICERS & THE ASS’N OF GOVERNING BODS. OF UNIVS. AND COLLS., COMMONFUND STUDY OF RESPONSIBLE INVESTING: A SURVEY OF ENDOWMENTS AND THEIR AFFILIATED FOUNDATIONS* (Apr. 2015) [hereinafter COMMONFUND STUDY]. Concern about investment performance was identified as a substantial impediment by 36 percent of the two hundred institutions surveyed and as a moderate impediment by 43 percent. *Id.* at 7, 15. This view persists, but may be shifting. In a survey of 582 institutional investors and 750 individual investors, published in 2017, only 35 percent of investors surveyed, both individual and institutional, agreed that “incorporating ESG factors necessarily means missing out on potential returns,” and one-half disagreed. ECCLES & KASTRAPELI, *supra* at 8.

8. See COMMONFUND STUDY, *supra* note 7, at 7, 15. When asked about impediments to adoption of ESG integration, 15 percent identified violation of fiduciary duty as a substantial impediment and 47 percent identified it as a moderate impediment. When asked whether responsible investing was consistent with fiduciary duties, 9 percent of the survey participants said yes, 3 percent said no, and most said they did not know. *Id.* at 16. For an example of the persistence of this misconception, see Sanders, *supra* note 2, at 579. After Sanders defines socially responsible investing (SRI) as screening for social reasons without regard to financial implications, he asserts that “fiduciary duties stand in the way of SRI by default” and suggests using authorization, ratification, and exculpatory clauses to protect the fiduciary from liability. *Id.*

Part I of this Article discusses the terminology and development of the different investment strategies that consider extrafinancial information. Then, Part II briefly explains modern portfolio theory and its influences on the prudent investor standard. This Part makes use of empirical studies, including metastudies, that have compared investment outcomes of funds that consider ESG factors with those that do not. These studies show that investment strategies that use ESG factors do not result in a necessary cost to an investment portfolio. The studies also demonstrate the potential benefits of considering ESG factors in investment decision-making. A challenge with understanding sustainable and responsible investing is the availability of useful data, so Part III looks at changes in reporting—new requirements and standards—that make more information available to investors and to the companies themselves. Finally, Part IV analyzes the fiduciary duties related to investment decision-making, focusing on the investment strategy referred to as ESG integration. The Article concludes that a prudent investor may—and should—consider material ESG factors as part of a robust financial analysis.

I. TERMINOLOGY AND TYPES OF SUSTAINABLE AND RESPONSIBLE STRATEGIES

A variety of investment strategies use nontraditional factors as part of the decision-making process.⁹ The terminology is not used consistently, which can make discussions of these strategies confusing. This Part briefly describes four terms or categories: socially responsible investing using negative screens and best-in-class selection, ESG integration, corporate social responsibility, and impact investing.¹⁰ For purposes of

9. A fiduciary may adopt an investment policy directing the investment committee or an external investment advisor to consider ESG factors in creating an investment portfolio that meets specified benchmarks. Alternatively, the policy might direct the use of impact investing for a portion of the funds under management. Ideally, the investment policy will clarify the intention and not rely on terminology that is inconsistently applied.

10. For more detailed explanations of the history of responsible or sustainable investing and impact investing, see ANTONY BUGG-LEVINE & JED EMERSON, *IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE* (2011); LAUREN CAPLAN ET AL., *COMMONFUND INST., FROM SRI TO ESG: THE CHANGING WORLD OF RESPONSIBLE INVESTING* (2013); Susan N. Gary, *Values and Value: University Endowments, Fiduciary Duties, and ESG Investing*,

this Article, these terms represent different strategies. Elsewhere, the terms may be used in ways that overlap. When discussing these strategies as a group, this Article uses the term socially responsible investing (SRI), because it was the first term in general use and remains widely used.¹¹ The recommendations in this Article focus on the strategy called ESG integration, but an understanding of the various strategies, both past and current, is important to an understanding of the fiduciary's duties.

A. *Socially Responsible Investing and the Use of Negative Screens*

Early SRI developed with the idea of using negative screens, also called exclusionary screens, to remove a category of companies from a portfolio. An investor could choose not to invest in companies that did something the investor found morally or ethically wrong, perhaps to make a political statement, or perhaps because the investor did not want to support a type of business. SRI gained attention during the anti-apartheid era, when some funds screened out companies that did business in South Africa.¹² The divestment movement had little

42 J.C. & U.L. 247, 261–73 (2016); Susanna Rust, *ESG: From Niche to Norm?*, INVS. & PENSIONS EUR. (Apr. 2017), <https://www.ipe.com/investment/esg/esg-from-niche-to-norm/www.ipe.com/investment/esg/esg-from-niche-to-norm/10018287.full> article [<https://perma.cc/5RTJ-BS4P>].

11. The letters are now used by some to represent sustainable, responsible and impact investing. Kevin Mahn, *The Changing Face of Socially Responsible Investing*, FORBES: ADVISOR INTELLIGENCE (Apr. 26, 2016, 11:09 AM), <https://www.forbes.com/sites/advisor/2016/04/26/the-changing-face-of-socially-responsible-investing> [<https://perma.cc/EKS2-BHEG>]. Sustainable investing may be more commonly used now as the generic term covering various strategies. Cary Krosinsky describes sustainable investing as encompassing seven strategies: values first, value first, community investing, thematic investing, ESG integration, engagement/advocacy, and norms-based screening. Cary Krosinsky, *The Seven Tribes of Sustainable Investing*, in SUSTAINABLE INVESTING: REVOLUTIONS IN THEORY AND PRACTICE 7, 7–9 (Cary Krosinsky & Sophie Purdom eds., 2017) (describing each of these strategies).

12. See Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986); Richard A. Posner & John H. Langbein, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 72–73 (1980). In the 1960s, protests in the United States began to raise public awareness of apartheid, a system of racial segregation in South Africa. Student organizations pushed universities to divest all or part of their endowments of any companies doing business in South Africa. See also Gregory Gethard, *Protest Divestment and the End of Apartheid*, INVESTOPEDIA (Oct. 7, 2018, 6:29 PM),

financial impact,¹³ but it brought attention to the plight of people living under apartheid and conveyed a sense of support to the people in South Africa who were fighting for the end of apartheid.¹⁴ Other common early screens focused on the so-called sin stocks: tobacco, alcohol, munitions, and gambling.¹⁵ These screens did not seek improved returns but rather reflected a decision by investors not to support industries they viewed as immoral.¹⁶

Negative screens base decision-making on something other than a financial metric.¹⁷ An investor may hope to use invest-

<http://www.investopedia.com/articles/economics/08/protest-divestment-south-africa.asp> [<https://perma.cc/5LJZ-72DT>].

13. A 1998 study demonstrated that South African divestment had little valuation effect on the financial sector, including targeted companies and the South Africa financial markets. Siew Hong Teoh et al., *The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott*, 72 J. BUS. 35 (1999).

14. See Gethard, *supra* note 12; Adele Simmons, *Outside Opinion: Skeptics Were Wrong; South Africa Divestment Worked*, CHI. TRIB.: BUS. (Dec. 15, 2013), <https://www.chicagotribune.com/business/ct-xpm-2013-12-15-ct-biz-1215-outside-opinion-20131215-story.html> [<https://perma.cc/39GY-5QCG>] (stating that both F.W. de Klerk, the last president of South Africa under apartheid, and Nelson Mandela, the South African leader of the movement against apartheid, said that the divestment movement was a factor in ending apartheid).

15. A study by Hong and Kacperczyk found that stocks associated with tobacco, alcohol, and gambling outperformed the broad equity market. Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets*, J. FIN. ECON. 15 (2009). They suggest that the outperformance may occur because analysts neglect these stocks. Kurtz and diBartolomeo attribute the outperformance of tobacco stocks to the stocks being “cheap” and suggest that the low valuations may be related to social investing or may be the response of investors who worry about product liability. See Lloyd Kurtz & Dan diBartolomeo, *The Long-Term Performance of a Social Investment Universe*, 20 J. INVESTING 95, 100 (2011). For investors who want to target sin stocks, a fund called the Vice Fund does just that. VICEX is the ticker code. See *The USA Mutuals Vice Fund Celebrates Its 15th Year with High Ranking in Morningstar Category*, CISION PR NEWSWIRE (Dec. 21, 2017), <https://www.prnewswire.com/news-releases/the-usa-mutuals-vice-fund-celebrates-its-15th-year-with-high-ranking-in-morningstar-category-300574253.html> [<https://perma.cc/T4SF-HWMB>].

16. Negative “sin stocks” screens are still common. See Kurtz & diBartolomeo, *supra* note 15, at 96 (describing the methodology of the KLD 400 and explaining that the KLD 400 excludes “[c]ompanies involved beyond specific thresholds in alcohol, tobacco, firearms, gambling, nuclear power and military weapons”).

17. Langbein and Posner defined SRI as a process of “excluding the securities of certain otherwise attractive companies from an investor’s portfolio because the companies are judged to be socially irresponsible, and including the securities of certain otherwise unattractive companies because they are judged to be behaving in a socially laudable way.” Posner & Langbein, *supra* note 12, at 73. They also assumed that in SRI funds, “stocks are added to and subtracted from the portfolio by the social investor without regard to the effect on diversification.” *Id.* at 85. In

ments to influence behavior or may simply not want the investor's money used to produce things that the investor considers harmful, like cigarettes or firearms. After screening out the designated sector, the financial manager may adjust the portfolio in other respects to account for the fact that a category or sector has been removed.¹⁸ However, observers critical of a fiduciary's use of negative screens focus on the screening decisions themselves and fail to consider the accompanying adjustments to the overall portfolio.¹⁹

Divestment movements continue to use negative screens to raise awareness about issues. One campaign, Fossil Free, urges divestment from oil, coal, and gas projects to increase attention on the need to combat climate change.²⁰ Other recent divestment movements have targeted private prisons,²¹ companies supporting "the occupation of Palestine,"²² and companies

a 2014 article, William Sanders relies on this definition and defines SRI to exclude any strategy that considers the financial implications of ESG factors. Sanders, *supra* note 2, at 537–38 ("Real SRI occurs when a fiduciary makes an investment decision based on criteria wholly separate from the investment's financial aspects.").

18. See *Our Investment Process*, DOMINI, <https://www.domini.com/about-domini/investment-process> (last visited Nov. 17, 2018) [<https://perma.cc/7FGA-GZKA>].

19. Mark Kritzman and Timothy Adler used a Monte Carlo simulation to show that if a manager randomly removed a percentage of stocks from a portfolio, the portfolio would suffer a financial cost. They then argued that an SRI fund using a screen related to fossil fuels would bear that cost. Timothy Adler & Mark Kritzman, *The Cost of Socially Responsible Investing*, 35 J. PORTFOLIO MGMT. 52 (2008); see also DANIEL R. FISCHER, FOSSIL FUEL DIVESTMENT: A COSTLY AND INEFFECTIVE INVESTMENT STRATEGY 6–11 (2017), http://divestmentfacts.com/pdf/Fischer_Report.pdf [<https://perma.cc/966W-ZZ3R>] (finding, after a study commissioned and financed by the Independent Petroleum Association of America, a potential diversification cost for fossil fuel divestment by focusing on divestment from the "energy sector" as a whole); Posner & Langbein, *supra* note 12, at 85 ("[S]tocks are added to and subtracted from the portfolio by the social investor without regard to the effect on diversification.").

20. *About*, FOSSIL FREE, <https://gofossilfree.org/about/> (last visited Nov. 17, 2018) [<https://perma.cc/TE5Z-LS2P>]. 350.org is also leading a divestment campaign. See Mark Hertsgaard, *How 350.org Is (Still) Changing the Climate Justice Movement*, NATION (Dec. 8, 2014), <https://www.thenation.com/article/how-350org-still-changing-climate-justice-movement/> [<https://perma.cc/KV7C-YM5S>].

21. Tara Subramaniam, *Campaign Demands Divestments, Endowment Transparency*, HOYA (Dec. 13, 2016), <http://www.thehoya.com/campaign-demands-divestments-endowment-transparency/> [<https://perma.cc/8ZLQ-FXWZ>] (describing a divestment campaign at Georgetown University).

22. *Id.*

doing business with the government of Sudan.²³ These divestment movements focus on removing investments from a portfolio. They may result in additional costs associated with selling existing investments and then in administrative costs associated with managing the portfolio to adjust for the removal of a sector of investments.²⁴ For these reasons, a decision to divest presents challenges for a fiduciary. The divestment movements are beyond the scope of this Article, which focuses on ESG integration as a type of investment strategy that complies with a fiduciary's duty to invest and manage assets prudently.²⁵

Socially responsible investing has developed in complexity from its early years, but the thinking of lawyers and fiduciaries continues to be influenced by the idea that SRI means negative screens—perhaps because negative screens came first, or perhaps because they are easy to understand. Some funds continue to use negative screens but do so as part of a more sophisticated strategy. Some funds use a best-in-class selection process,²⁶ focusing on including rather than excluding companies. A best-in-class process might consider ESG factors in identifying a sector for investment, creating what might be called a positive screen. For example, an investor might use “clean energy” as a positive screen and then look for best-in-class companies within the group of companies that meet the standards of the screen. For this reason, best-in-class strategies

23. Sam Graham-Felsen, *Divestment and Sudan*, NATION (May 8, 2006), <https://www.thenation.com/article/divestment-and-sudan> [<https://perma.cc/ML8E-36TJ>]. This divestment movement protests Sudanese actions in the Darfur conflict.

24. See FISCHER, *supra* note 19.

25. Laura Deeks has written about divestment and fiduciary duty, explaining that the activists seeking to affect climate change through divestment campaigns might be more successful if they worked within the framework of the fiduciary rules and sought the adoption of ESG investment policies rather than divestment. See Laura E. Deeks, *Discourse and Duty: University Endowments, Fiduciary Law, and the Cultural Politics of Fossil Fuel Divestment*, 47 ENVTL. L. 335 (2017).

26. A best-in-class process looks for the “best” companies in an industry or sector, from the standpoint of environmental or social factors. Rather than excluding a sector, a best-in-class selection process could include a sector that did not have the highest sustainability ratings, and select the companies within that sector that were doing the best in terms of improving their environmental impact or providing good labor conditions for employees. See RCM, SUSTAINABILITY: OPPORTUNITY OR OPPORTUNITY COST? 2 (July 2011), https://www.msci.com/documents/10199/248121/11_10717_RCMSWP_ET1907.pdf [<https://perma.cc/B27R-8W5X>] (describing the creation of a best-in-class portfolio).

may be included within the general framework of “ESG investing.”²⁷

Investment managers now use ESG factors in a variety of ways and use the term “ESG investing” to describe many different strategies. This Article uses the term “ESG integration” to signify full integration of material ESG factors into the investment decision-making process. The Article continues to use the term SRI in a general sense in order to cover the whole range of strategies. Before looking at ESG integration more closely, this Section examines two other terms used in connection with investment strategies that consider ESG factors.

B. Corporate Social Responsibility

Investors using ESG factors in decision-making may consider a company’s corporate social responsibility (CSR) rating. CSR describes a company’s policies and practices related to “governance, employee relations, supply chain relationships, customer relationships, environmental management, philanthropy, and community involvement.”²⁸ Studies show that companies with higher CSR ratings outperform lower rated companies,²⁹ and many analysts rate companies with strong CSR ratings higher than those without strong ratings.³⁰

27. RCM uses the term “sustainability investing” and its definition matches the general understanding of ESG investing: “Sustainability investing is broader than an ethically or socially responsible investment strategy. Material environmental, social and governance factors are considered alongside financial factors, identifying risks and opportunities that have not been fully priced in by the markets thus supporting enhanced stock selection and providing RCM with an information advantage.” *Id.* at 14; see also CAPLAN ET AL., *supra* note 10 (explaining that in contrast with early SRI, “ESG analysis takes a broader view, examining whether environmental, social, and governance issues may be material to a company’s performance, and therefore to the investment performance of a long-term portfolio”).

28. See THE ASSET MGMT. WORKING GRP. OF THE UNITED NATIONS ENV’T PROGRAMME FIN. INITIATIVE & MERCER, DEMYSTIFYING RESPONSIBLE INVESTMENT PERFORMANCE: A REVIEW OF KEY ACADEMIC AND BROKER RESEARCH ON ESG FACTORS 60 (2007) [hereinafter UNEP-FI & MERCER], <http://www.unepfi.org/fileadmin/documents/DemystifyingResponsibleInvestmentPerformance01.pdf> [<https://perma.cc/Y24H-44KW>].

29. Robert G. Eccles et al., *The Impact of Corporate Sustainability on Organizational Processes and Performance*, 60 MGMT. SCI. 2835 (2014). The researchers studied the effect of sustainability policies on 180 U.S. companies over an eighteen-year period. Beginning with information from 1993, they grouped the companies into High Sustainability companies (those that had integrated social and environmental issues into their business operations) and Low Sustainability

An ESG investor might use a company's self-reported CSR practices as indications of strong management, reduced risk, and enhanced ability to attract capital.³¹ Indeed, Ioannis Ioannou and George Serafeim³² explain that analysts interpret CSR "as a legitimate part of corporate strategy, minimizing operational risks and even contributing positively towards long-term financial performance."³³ Companies increasingly issue reports concerning their CSR practices, both to respond to investor interest and to encourage the company to focus on issues such as exposure to social and environmental risk.³⁴

C. *Impact Investing*

Impact investing is investing that intentionally seeks both a financial return and a specific environmental or social result.³⁵ An impact investor may want to address a local problem

companies (those that had few or no sustainability policies). Comparing the two groups, they found that High Sustainability companies outperformed Low Sustainability companies in both stock market performance and accounting performance. *Id.*

30. See Ioannis Ioannou & George Serafeim, *The Impact of Corporate Social Responsibility on Investment Recommendations: Analysts' Perceptions and Shifting Institutional Logics*, 36 STRATEGIC MGMT. J. 1053 (2015). Ioannou and Serafeim studied sell-side stock recommendations for a large sample of companies from 1993–2007. Companies with high CSR ratings received less favorable recommendations in the early years of the study and more favorable recommendations in the later years. The authors of the study suggest that the shift may reflect a change in analysts' understandings of the effect of CSR. In the early years, CSR policies were viewed as detrimental to shareholder interests, while in more recent years, analysts viewed CSR policies as beneficial with respect to long-term financial performance. *Id.* at 1054, 1056, 1071. Another study, published in 2011, found a high level of market interest in ESG information. Eccles et al., *supra* note 4.

31. Eccles et al., *supra* note 4, at 113–14; UNEP-FI & MERCER, *supra* note 28, at 50–51.

32. At the time their article was written, Ioannis Ioannou was an Assistant Professor at London Business School; he is now Associate Professor of Strategy and Entrepreneurship. George Serafeim was an Assistant Professor at Harvard Business School; he is now Professor of Business Administration, Accounting, and Management.

33. Ioannou & Serafeim, *supra* note 30, at 1058.

34. See *id.* (citing studies and scholarly articles describing the importance to companies of establishing CSR policies and practices).

35. For explanations of the history and development of impact investing, see BUGG-LEVINE & EMERSON, *supra* note 10; JUDITH RODIN & MARGOT BRANDENBURG, *THE POWER OF IMPACT INVESTING: PUTTING MARKETS TO WORK FOR PROFIT AND GLOBAL GOOD* (2014). In 2007, the Rockefeller Foundation sponsored a conference to strategize what would allow investors, entrepreneurs,

or encourage innovation to help solve an identified social or environmental issue.³⁶ For example, impact investing might be used for an enterprise that creates jobs for hard-to-employ adults with criminal records or drug problems, for a clinic that provides low-cost maternity care, or for a recycling business in an area with no recycling infrastructure.³⁷ Impact investing focuses on products or services that improve lives, the environment, or both.

An impact investment will often have multiple positive effects. An example is Ikotoilet, produced by Ecotact to address the lack of clean toilets in slums.³⁸ Ikotoilet operates using waterless technology. To create funds to maintain the toilets, Ecotact's business plan includes selling advertising on the outside of the unit and providing space for services such as shoe shines and for vendors of newspapers, drinks, or snacks. In addition to the environmental benefits, hygienic sanitation provides dignity and health benefits to the local users.

An impact investor seeks blended value, defined as a combination of economic value and environmental or social value.³⁹

and philanthropists to put more capital to work for social and environmental benefit. The term "impact investing" was coined at the conference. *Id.* at 4; see also Marguerite H. Griffin, Northern Trust, *Impact Investing: A Guide for Philanthropists and Social Investors*, LINE SIGHT (2013) (describing impact investing practices and strategies, including program-related investments, mission-related investments, social-impact bonds, low-profit limited liability companies, and benefit corporations); Mara Bolis & Chris West, *Marginalized Returns*, STAN. SOC. INNOVATION REV. (Fall 2017), https://ssir.org/articles/entry/marginalized_returns [<https://perma.cc/G62Q-RTD8>] (describing the history of impact investing starting in the 1960s); Rust, *supra* note 10 (noting that Axa IM called 2014 the beginning of the "age of impact").

36. The Global Impact Investing Network explains that sectors for impact investment include "sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education." *What You Need to Know About Impact Investing: What Is Impact Investing?*, GIIN, <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing> (last visited Nov. 17, 2018) [<https://perma.cc/E7UM-J8ZN>].

37. See RODIN & BRANDENBURG, *supra* note 35, at 37–38 (providing many examples).

38. *Id.* at 39. For more information about Ikotoilet, see WINIFRED N. KARUGU, UNITED NATIONS DEV. PROGRAM, ECOTACT: AFFORDABLE SANITATION SERVICES IN PLEASANT SURROUNDINGS (2010), <http://growinginclusivemarkets.org/media/cases/ecotactsummary.pdf> [<https://perma.cc/MD69-EJVF>].

39. The Global Impact Investing Network describes intentionality—the intention to have a positive social or environmental impact—as a core characteristic of impact investing. See *What You Need to Know About Impact Investing: Core Characteristics of Impact Investing*, GIIN [hereinafter *Core Characteristics*],

An investor using ESG integration may seek nonfinancial as well as financial benefits, but an impact investor will always seek social or environmental impacts with the investment. An impact investor will also seek financial return, with the target ranging from a return of capital to below-market (concessionary) returns to risk-adjusted, market-rate returns.⁴⁰ In impact investing, an investor might provide debt, equity, or a combination of the two.⁴¹

As interest in impact investing has grown,⁴² so too has the range of activities considered within the scope of the term. Mara Bolis and Chris West⁴³ have raised the concern that as more investors want market-rate returns with their impact investing, the increasing emphasis on financial returns may reduce the priority that early impact investing placed on the

<https://thegiin.org/impact-investing/need-to-know/#core-characteristics-of-impact-investing> (last visited Nov. 17, 2018) [<https://perma.cc/E7UM-J8ZN>]. Bugg-Levine and Emerson explain that all companies have social and environmental impacts, which may be negative or positive, in addition to their economic impacts. See BUGG-LEVINE & EMERSON, *supra* note 10, at 9–10.

40. The expectation of financial return is another core characteristic of impact investing and differentiates impact investing from grant making. See *Core Characteristics*, *supra* note 39. See ABHILASH MUDALIAR, HANNAH SCHIFF, RACHEL BASS & HANNAH DITHRICH, GIIN, 2017 ANNUAL IMPACT INVESTOR SURVEY 3 (2017) <https://thegiin.org/assets/GIINAnnualImpactInvestorSurvey2017WebFinal.pdf> [<https://perma.cc/R9MN-CZ3P>] (reporting that 66 percent of the respondents target risk-adjusted, market-rate returns); see also Griffin, *supra* note 35, at 2 (describing three categories of impact investing: *impact first*, for investors who seek to maximize impact while secondarily seeking financial return; *investment first*, for investors who seek market or above-market returns and secondarily seek a social or environmental impact; and *catalyst first*, for investors who seek to invest in collaborations to build the impact investing industry and infrastructure).

41. See BUGG-LEVINE, *supra* note 10, at 21–22; *Core Characteristics*, *supra* note 39.

42. Large asset managers like BlackRock and Bain Capital have added impact investing initiatives, and other investment companies, including Bank of America Merrill Lynch, Morgan Stanley, and Goldman Sachs, have created impact investment products. See Dennis Price, *How the ImPact is Making Impact Investing the New Normal for Wealthy Families*, IMPACTALPHA (June 16, 2016), <https://news.impactalpha.com/how-the-impact-is-making-impact-investing-the-new-normal-for-wealthy-families> [<https://perma.cc/E9LE-T2U2>] (describing the ImPact, an agreement by family foundations and individuals from wealthy families to engage in impact investing).

43. In 2017 Mara Bolis was a senior advisor in the Private Sector Department at Oxfam where she led its Women in Small Enterprise (WISE) initiative, which includes Oxfam's first impact investing fund. Chris West is a cofounder of Sumerian Foundation and the former director of the Shell Foundation.

desired social or environmental impact.⁴⁴ Bolis and West worry that large financial institutions have responded to client demand by creating impact-investing funds with a diluted idea of what impact investing was intended to do.⁴⁵ Those funds target market-rate returns and may sacrifice some of the social and environmental benefits.⁴⁶

On a smaller scale, some wealthy families have begun focusing on impact investing, particularly members of younger generations in those families.⁴⁷ An organization called ImPact seeks to encourage wealthy families to devote some of their investment assets to impact investments.⁴⁸ “The ImPact asks members to ‘Make The Pact,’ and to go beyond philanthropic giving to use the power of their private investments and the broader capital markets to solve global challenges.”⁴⁹ The organization educates members on impact investing and also provides tools for members to educate their financial advisors on the business case for impact investing.⁵⁰ An advisor of one family’s investment vehicle explains, “All we’re doing is applying absolutely normal and fundamental investment principles to a newish sector. It just so happens that this sector creates positive environmental impact.”⁵¹

D. ESG Integration

ESG integration can be described as an investment strategy that combines material⁵² ESG factors with traditional

44. Bolis & West, *supra* note 35.

45. *Id.*

46. A study by the Wharton Social Impact Initiative found that impact investing private equity funds were not sacrificing mission for return, but the sample size was small (fifty-three impact investing private equity funds). JACOB GRAY ET AL., WHARTON SOC. IMPACT INITIATIVE, GREAT EXPECTATIONS: MISSION PRESERVATION AND FINANCIAL PERFORMANCE IN IMPACT INVESTING (2015); *see infra* Section II.E.

47. Justin Rockefeller, the great-great-grandson of John D. Rockefeller and one of the cofounders of ImPact, describes a “group of young people” who wanted to create an organization to help families do more impact investing. Price, *supra* note 42.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* (quoting Ben Goldsmith, chief executive of Menhaden Capital Management).

52. “Material” is used in the sense of information that is likely to affect financial performance. The SEC requires companies to provide material informa-

financial metrics to analyze companies.⁵³ Environmental factors refer to a company's stewardship of the natural environment, including how the company addresses things like pollution, energy use, or water use. Social factors focus on labor relations, including the treatment of workers, the conditions for workers, and worker compensation. Social factors also include how a company interacts with the communities in which the company operates. Governance factors relate to how the company governs itself, including executive compensation, internal controls, audits, and transparency for shareholders and the public.

Financial analysts use ESG integration to improve stock selection because the ESG factors can identify potential opportunities and risks.⁵⁴ ESG integration expands the scope of material information considered relevant in analyzing a company's strengths and weaknesses, and therefore should result in better investment decisions. Michael Cappucci, Senior Vice President of Harvard Management Company, Inc., describes ESG integration as the "gold standard" of responsible investing because of its effectiveness in combining financial return with environmental and social benefits.⁵⁵

As evidence mounts that consideration of ESG factors can improve risk-adjusted returns, more financial analysts use some form of ESG integration.⁵⁶ Numerous studies comparing

tion to shareholders and investors. See SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (1999) (codified at 17 C.F.R. pt. 211); Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1697 n.1 (2016).

53. ESG integration is also used to mean the ways in which companies incorporate ESG factors into business decision-making.

54. ECCLES & KASTRAPELI, *supra* note 7 ("ESG factors are also seen as signaling tools for volatility and risk.").

55. Michael T. Cappucci, *The ESG Integration Paradox*, 30 J. APPLIED CORP. FIN. 22 (2018). Cappucci writes, "the best managers recognize that a wholehearted commitment to incorporating ESG principles in the investment process represents the best strategy for achieving the promise of better financial returns." *Id.* at 24.

56. See Christopher Robbins, *As Trump Rolls Back Regulations, ESG Investing Is Poised to Soar*, FIN. ADVISOR (Apr. 3, 2017), <https://www.fa-mag.com/news/as-trump-rolls-back-regulations—esg-investing-is-poised-to-soar-32134.html> [<https://perma.cc/9AU2-98LE>] ("ESG has moved from an investment philosophy coached [sic] in naïve ideals to one that addresses financial reality that companies that adopt policies addressing ESG issues tend to perform better over the long term."). The article reports:

SRI funds with non-SRI funds or with market benchmarks have found, in general, no differences in results between funds designated in some way as socially responsible and funds without such a designation.⁵⁷ When the studies look at ESG integration more specifically, the studies show a greater likelihood of improved results.⁵⁸

This Article focuses on ESG integration rather than impact investing. From a fiduciary standpoint, the argument that the prudent investor standard⁵⁹ encompasses ESG integration is relatively easy, whereas the argument for impact investing is more complicated. Fiduciaries may expect to encounter requests for more impact investing in the future, and fiduciaries will need to understand what is meant by those requests. For the purposes of this Article, the term “impact investing” is used for a strategy that is different from ESG integration because impact investing may contemplate below-market returns in exchange for nonfinancial benefits.

II. EMPIRICAL STUDIES COUNTERING THE ASSUMPTION THAT SRI NECESSITATES A FINANCIAL COST

The development of modern portfolio theory (MPT) in the mid-twentieth century led to changes in investment strategies,

The private sector is embracing sustainability based on simple economics—it’s better to reduce waste and use fewer resources because it leads to lower overhead. A company with socially responsible policies and ethical corporate governance is less likely to be fined by a regulator or targeted with litigation, and happier workers tend to be more motivated and productive with lower absenteeism, says Anthony Eames, vice president and director of responsible investment strategy at Calvert Investments, a subsidiary of Eaton Vance.

Id. According to a 2015 survey by the CFA institute, 73 percent of portfolio managers incorporate ESG factors into their investment decision-making. CFA INSTITUTE, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) SURVEY (June 2015), <https://www.cfainstitute.org/Survey/esgsurveyreport.pdf> [<https://perma.cc/3U6R-M9JD>].

57. See UNEP-FI & MERCER, *supra* note 28; Mark Fulton et al., *Sustainable Investing: Establishing Long-term Value and Performance* (2012), https://www.db.com/cr/en/docs/Sustainable_Investing_2012.pdf [<https://perma.cc/RF5B-JSWX>]; Eccles et al., *supra* note 29. For more studies, see Gary, *supra* note 10, at 281–91.

58. The Deutsche Bank Group metastudy reported that for companies with high ESG ratings, 89 percent of the studies surveyed showed market based outperformance and 85 percent showed accounting based outperformance. See Fulton et al., *supra* note 57, at 8.

59. For discussion of the prudent investor standard, see *infra* Section V.C.

and MPT continues to influence thinking about investment strategies. This Part takes a quick look at MPT and how its ideas affected thinking about early forms of SRI. The discussion then turns to empirical studies that have examined various forms of SRI, including ESG integration and impact investing. Although MPT suggests that the use of SRI strategies should result in financial cost to the investor, the studies have shown that not to be the necessary result, especially for ESG integration.

A. *Modern Portfolio Theory and the Assumption that SRI Necessitates a Financial Cost*

The assumption that any form of SRI will necessitate a cost to the portfolio seems to derive from the importance of diversification in modern portfolio theory and the assumption that SRI means negative screens.⁶⁰ In addition, administrative costs connected with an actively managed fund will result in a cost when an actively managed SRI fund is compared with a non-SRI index fund.⁶¹

Harry Markowitz, an economist who won the 1990 Nobel Prize in Economic Sciences, published his explanation of MPT in 1952,⁶² and it influenced investing strategies and changes to the prudent investor standard in the years that followed.⁶³ MPT builds on the theory of efficient markets and advocates spreading risk across a portfolio, rather than analyzing risk on an asset-by-asset basis. It emphasizes diversification as a key

60. See Dylan B. Minor, *Finding the [Financial] Cost of Socially Responsible Investing*, 18 J. INV. 54 (2007).

61. Posner & Langbein, *supra* note 12. The authors find “that the usual forms of social investing involve a combination of reduced diversification and higher administrative costs not offset by net consumption gains to the investment beneficiaries.” *Id.* at 76.

62. Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). Markowitz argued that diversification of investments in a portfolio is crucial in reducing risk. A portfolio constructed based on overall risk-return characteristics, rather than on the risk-return characteristics of individual investments, should produce returns with reduced overall risk. That is, an appropriately diversified portfolio, with investments spread across different types of assets and different types of industries and sectors, should result in lower risk for the portfolio as a whole.

63. See Langbein, *supra* note 1, at 643–45.

element in managing risk and improving returns on a risk-adjusted basis.⁶⁴

Any manager of a fund that is not an index fund makes decisions about which stocks to include and exclude.⁶⁵ A manager of a non-SRI portfolio makes decisions for reasons related to financial strategies, while some forms of SRI use negative screens to remove companies from a portfolio for moral or ethical reasons.⁶⁶ Some observers of early SRI funds concluded that because a screen restricted diversification, the portfolio would suffer financially.⁶⁷ The funds using negative screens typically

64. See JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (2d ed. 1998); Posner & Langbein, *supra* note 12, at 76 (arguing that SRI's restrictions on diversification and higher administrative costs make it "economically unsound" under the principles of MPT). Although Langbein and Posner conclude that SRI is problematic based on economic principles, they add that "there is no reason to expect a portfolio constructed in accordance with the usual principles of social investment to yield a below-average rate of return—provided that administrative costs are ignored." *Id.* (citations omitted). Indeed, the authors say, "we are not concerned that adherence to social principles will result in portfolios that yield lower average returns than portfolios designed to maximize the financial well-being of the investment beneficiaries. The average return will be the same . . ." *Id.* at 92 (citing Pacey, *Investment Do-Gooders: A Look at a Dogged Trio of Socially Conscious Mutual Funds*, BARRON'S, July 21, 1980, at 9 (comparing three SRI mutual funds with the average of non-SRI funds operating during the same period and finding that the SRI funds did better)).

65. Jon Quigley and Lyn Taylor have explained that all funds, including those using only traditional, financial metrics, make decisions that restrict the investable universe. For example, the manager of a U.S. large-cap fund has narrowed the investable universe to large-cap companies located in the U.S. The manager likely also applies other restrictions, such as avoiding certain industries as too risky or eliminating illiquid securities. Thus, like SRI, all investment strategies restrict the universe of investable securities. See Jon Quigley & Lyn Taylor, *The Impact of Negative Screening*, FIN. ADVISOR (Feb. 1, 2010), <https://www.fa-mag.com/news/the-impact-of-negative-screening-5062.html> [<https://perma.cc/PDE5-YNPV>].

66. See *id.* Domini Social Investments provides an explanation of how social investing works. See *Our Investment Process*, *supra* note 18.

67. See, e.g., Minor, *supra* note 60, at 54 (stating that if social benefits and costs are ignored, "according to fundamental economic principles, there must be a net financial cost to SRI"). However, after testing SRI and non-SRI funds, he found no statistically significant financial costs. *Id.* at 58; see also Adler & Kritzman, *supra* note 19. Adler and Kritzman describe SRI as negative screens and determine the cost by using a Monte Carlo simulation that removes, randomly, a percentage of a portfolio. *Id.* Kritzman was later quoted as saying, "I know you all accept that there's a cost [to fossil-fuel divestment], right? I'm going to tell you how you go about measuring it." Adam M. Kanzer, *Exposing False Claims about Socially Responsible Investing: A Response to Adler and Kritzman*, ADVISOR PERSPECTIVES (June 4, 2013) <https://www.advisorperspectives.com/articles/2013/06/04/exposing-false-claims-about-socially-responsible-investing-a-response-to-adler-and-kritzman> [<https://perma.cc/6JTX-TQDU>]. SRI funds do not exclude

made adjustments to their portfolios to compensate for the financial effects of the screens,⁶⁸ but the fact that the fund made decisions to exclude companies based on ethical or moral reasons—and not exclusively financial considerations—seemed antithetical to MPT.⁶⁹

The concern that SRI necessitates a cost because it imposes a restriction on diversification continues to affect the way people think about any investment strategy that sounds like SRI.⁷⁰ This concern is caused, at least in part, by continuing confusion about the definition of SRI and the lack of precision with which terms describing different investment strategies are used.⁷¹ A quick review of some of the more comprehensive studies reveals mostly neutral results when SRI and non-SRI funds are compared. The studies show that funds using ESG integration are increasingly likely to produce positive results.

B. *SRI Studies*

Academics have long been interested in understanding the effects that different forms of responsible investing have on financial returns for shareholders. In the early years of SRI, data was limited,⁷² but studies that have examined different forms of responsible investing over increasingly long time frames are now available.⁷³ These studies review different SRI

stocks randomly, and even a manager using a negative screen will construct the fund with adjustments for the excluded stocks. *Id.*

68. *Our Investment Process*, *supra* note 18.

69. *See* Minor, *supra* note 60.

70. *See* ECCLES & KASTRAPELI, *supra* note 7 (“Despite the fact that the many academic studies on this are essentially neutral, the belief that ESG integration means sacrificing financial returns is the most common theme among those who object to ESG investing.”).

71. Negative screens, ESG integration, and impact investing all operate quite differently, yet they sometimes get lumped together as “social investing,” “responsible investing,” “ESG investing,” or even “impact investing.”

72. *See* Lloyd Kurtz, *No Effect, or No Net Effect? Studies on Socially Responsible Investing*, 6 J. INV. 37 (1997) (explaining that few studies existed at that time). Kurtz reported his findings that “the universe of SRI stocks does not appear to have systematically underperformed the market portfolio in recent years” and that some studies had found that ESG factors “could be associated with positive abnormal returns.” *Id.*

73. For a review of some of the studies, see Gary, *supra* note 10, at 281–98. Julie Gorte, of ImPax Asset Management LLC, maintains a list of studies that find that some parameter of sustainability or ESG is connected in some significant way to a measure of financial outcome. As of February 2018 she had 260 studies on her list, mostly academic and some from large financial houses.

strategies, including negative screening, best-in-class positive screening, shareholder advocacy,⁷⁴ ESG integration, and impact investing. Sometimes a study focuses on one type of fund, but a study may examine “SRI funds” without differentiating strategies.⁷⁵ The studies that cover short time frames can be problematic because ESG factors affect long-term performance more than short-term performance.⁷⁶ Despite some challenges with the studies, the number of studies now available leads to several useful generalizations.

The studies that have compared SRI funds and non-SRI funds have found mostly positive or neutral results for the SRI funds.⁷⁷ The few studies that show negative results for SRI

Email from Julie Gorte, SVP, Sustainable Investing and Portfolio Manager, ImPax Asset Mgmt. (Feb. 20, 2018) (on file with author). The number of studies continues to grow, and a complete review is beyond the scope of this Article.

74. Shareholder advocacy is a strategy that involves using shareholder resolutions and proxy voting to push for changes in a company. See Joel C. Dobris, *SRI—Shibboleth or Canard (Socially Responsible Investing, That Is)*, 42 REAL PROP., PROB. & TR. J. 755, 777 (2008); Susan N. Gary, *Is It Prudent to Be Responsible? The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL'Y 106, 124–25 (2011).

75. A 2016 study by Jon Hale compared funds in the Morningstar database tagged as “socially conscious” with all funds in the database. Jon Hale, *You Don't Have to Sacrifice Returns for Sustainability*, MORNINGSTAR (Aug. 19, 2016), <http://news.morningstar.com/articlenet/article.aspx?id=765799> [<https://perma.cc/2KWS-RKB6>]. Hale found that on a global basis socially conscious funds outperformed conventional funds, and in the United States socially conscious funds performed in line with conventional funds. He opined that the shift to positive consideration of ESG factors might be the reason for improving financial performance, especially on a long-term basis. See also Todd Millay, *How Sustainable Investing Can Help You Meet Portfolio Goals Without Sacrifice*, FORBES (Jan. 4, 2017), <https://www.forbes.com/sites/toddmillay/2017/01/04/how-sustainable-investing-can-help-you-meet-portfolio-goals-without-sacrifice/> [<https://perma.cc/Q8NR-L98J>] (citing an Oxford University metastudy of 190 academic studies that found “that 90 percent of the studies demonstrated that sound sustainability standards lowered companies’ cost of capital, 80 percent of the studies observed that stock performance and good sustainability practices are positively correlated, and 88 percent of the studies showed that robust ESG practices improved companies’ operational performance”).

76. See Millay, *supra* note 75. Millay notes that “[m]uch of the short-term discrepancy in performance between SRI indices and non-SRI indices can be explained by . . . different sector allocation” Using the KLD 400 Social Index as an example, Millay explains that ESG portfolios that were underweight energy saw large outperformance in 2015 and then an erosion of those results in 2016 when energy recovered. He concludes, “Over long periods of time, however, ESG criteria lead to higher returns because ESG practices are good for business.” *Id.*

77. See Fulton et al., *supra* note 57. This study examined more than one hundred academic studies of responsible investing, fifty-six research papers, two literature reviews, and four metastudies and found outperformance for companies

funds focus on negative screens,⁷⁸ although two metastudies conclude that funds using negative screens are more likely to show neutral rather than negative or positive performance when compared to non-SRI benchmarks.⁷⁹ In some cases, SRI funds have outperformed or underperformed based on market conditions separate from the social factors considered in creating and managing the funds.⁸⁰ Most importantly, for purposes of the fiduciary duty analysis in Part V, none of the studies support the conclusion that SRI in any form necessarily leads to lower risk-adjusted returns.⁸¹

with high ratings in CSR and ESG. For SRI, the results were mostly positive or neutral, with some negative results. *See also* David M. Blanchett, *Exploring the Cost of Investing in Socially Responsible Mutual Funds: An Empirical Study*, 19 J. INV. 93, 102 (2010). The Blanchett study compared SRI and non-SRI funds for the period 1990–2008 and found slight underperformance of SRI funds when compared with non-SRI funds, and slight outperformance on a risk-adjusted basis, in both cases with results that were neither statistically nor economically significant. *Id.* The Blanchett article also describes eleven prior studies, with most finding a neutral impact on cost and performance. *Id.* at 93–94.

78. *See* UNEP-FI & MERCER, *supra* note 28. This metastudy reviewed fifteen studies focused on screening. Two of the studies showed a positive result, six were neutral, and three were negative. The three negative results were screens related to sin stocks. James Chong et al., *To Sin or Not to Sin? Now That's the Question*, 6 J. ASSET MGMT. 406 (2006); Christopher C. Geczy, Robert F. Stambaugh & David Levin, *Investing in Socially Responsible Mutual Funds* (Wharton Sch. Working Paper, 2005); Hong & Kacperczyk, *supra* note 15.

79. *See* Fulton et al., *supra* note 57; UNEP-FI & MERCER, *supra* note 28.

80. *See* Kurtz & diBartolomeo, *supra* note 15 (explaining the methodology used in creating the KLD400, the current name for the index created as the Domini Social Index, which includes negative screens and best-in-class selection). Kurtz and DiBartolomeo explained that the KLD400 had outperformed the S&P in the 1990s but then underperformed in the 2000s. They examined the KLD400 and found the differences between the two periods based on factors like overweighting in growth stocks and in industries like technology that did well in the 1990s and underperformed in the 2000s. The authors concluded:

In both the 1990s and 2000s, factor exposures accounted for virtually all of the relative performance of the KLD400. After adjusting for these, the impact of the social screens appears negligible. *We see no evidence for a distinct social factor.* This means that managers using the KLD400 as an investment universe have had neither headwinds nor tailwinds.

Id. at 100. More recently created funds, the FTSE KLD Social Select Index and the Russell 1000 Index, have performed in line with the equity market during the period from 2004 through July 2010. *Id.*; *see also* Blanchett, *supra* note 77 (finding that the Calvert Social Index and FTSE4Good U.S. Index performed less well (had negative alphas) in the 2000s).

81. Gunnar Friede, Timo Busch & Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 2104 (2015). This metastudy reviewed over 2,000 primary studies by examining prior review studies. The authors report that 90 percent of the studies reviewed found a nonnegative correlation between ESG and

ESG integration does not involve negative screening but may have some of the same benefits as best-in-class strategies. Those strategies, often used in funds denominated as sustainable or responsible, look for high E, S, or G ratings in the sectors under consideration, and the sectors themselves may be determined based on ESG factors. Studies have shown outperformance based on E, S, or G factors,⁸² and investors seek financial benefits based on these factors.⁸³

A review of one metastudy captures the shift in understanding of the benefits of SRI. In 2015, Morgan Stanley published a report exploring the financial cost of sustainable investing.⁸⁴ The research examined studies and metastudies that assessed the impact of sustainability on financial and market performance of companies, and found “a positive relationship between corporate investment in sustainability and stock price and operational performance.”⁸⁵ The study compared the performance of the MSCI 400 KLD index and found that long-term annual returns exceeded the S&P 500 by forty-five basis points for the period from July 1990 through December 2014.⁸⁶ Finally, the study assessed the performance

CSR, and that the large majority of studies reported positive findings. The report notes that one area of neutral or mixed relations between ESG and CSR appears in studies of mutual fund portfolios. The authors suspect that many of these funds use positive and negative screens, so they are using strategies other than ESG integration, and also note that portfolio funds may have embedded fees and costs that are not be reflected in other investments studied.

82. See, e.g., Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621 (2011) (showing that companies with superior employment practices have outperformed the market).

83. See, e.g., Kurtz & diBartolomeo, *supra* note 15, at 100 (discussing a December 2010 Columbia Business School conference entitled *Using Sustainability to Beat the Market: ESG and Hedge Funds*).

84. MORGAN STANLEY, INST. FOR SUSTAINABLE INV., *SUSTAINABLE REALITY: UNDERSTANDING THE PERFORMANCE OF SUSTAINABLE INVESTMENT STRATEGIES* (Mar. 2015), <https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf> [<https://perma.cc/C5W7-VF6N>].

85. *Id.* at 1.

86. *Id.* at 4. MSCI is a financial services provider that publishes a number of indexes as portfolio analysis tools. Morgan Stanley explained: “One robust measure of sustainable investment performance is the MSCI KLD 400 Social Index. The broad-based index only includes firms that meet very high Environmental, Social and Governance ratings relative to their peers. It also excludes certain sectors, such as alcohol, gambling, tobacco, weapons and adult entertainment.” One basis point equals 0.01 percent so forty-five basis points equals 0.45 percent.

of 10,228 open-end mutual funds and 2,874 separately managed accounts in the United States. Based on that review, the report concludes that “[i]nvesting in sustainability has usually met, and often exceeded, the performance of comparable traditional investments. This is on both an absolute and a risk-adjusted basis, across asset classes and over time”⁸⁷ The report also notes that “Sustainable Equity Mutual Funds had equal or higher median returns and equal or lower median volatility for 64% of the periods examined over the last 7 years, compared to their traditional counterparts.”⁸⁸ The study concludes that sustainable investing “does not necessarily require making a tradeoff in investment performance; on the contrary, sustainable investments often exhibit favorable return and risk characteristics compared to their traditional peers.”⁸⁹

C. *Passive Investing*

In addition to concerns about diversification, another aspect of financial theory that raised concerns about SRI funds relates to administrative costs. In an explanation of the basics of modern portfolio theory, Langbein and Posner, then both Professors at the University of Chicago Law School, discuss studies that show “a passive, market-matching fund is likely to outperform a conventional, actively-managed fund in terms of expected return.”⁹⁰ The studies found, in general, that money managers could not outperform the market, at least over the long term.⁹¹ Thus, once the greater administrative costs required by an actively managed fund are considered, the passive fund will yield greater net financial benefit.⁹² Langbein and Posner explain that “a portfolio constructed in accordance with

87. *Id.* at 1.

88. *Id.* at 2.

89. *Id.* at 10.

90. Posner & Langbein, *supra* note 12, at 83.

91. *See id.* at 82 (discussing studies comparing actively managed and passive funds).

92. *Id.* at 76 (“[T]here is no reason to expect a portfolio constructed in accordance with the usual principles of social investment to yield a below-average rate of return—provided that administrative costs are ignored.” (citation omitted)). For a more recent affirmation of this point, see Blanchett, *supra* note 77, at 99 (“[T]he majority of active versus passive studies have noted that active investing tends to be a losing game due to the fees and expenses associated with active management.”).

the principles of modern finance theory” will have a passive strategy, with no securities analysis, and with changes in stock holdings based only on the goal of maintaining the level of diversification needed to reduce risk to the desired level.⁹³ They conclude, “[A] social-investing portfolio will probably have the same expected return as a standard investment portfolio (of the same systematic risk),”⁹⁴ but because the administrative costs for the social-investing portfolio will be higher, the net expected return will be lower.⁹⁵

Langbein and Posner published their article in 1980, when no SRI index funds existed, and they compared actively managed SRI funds with passive non-SRI index funds. The first socially responsible index fund, the Domini 400 Social Index Fund, was launched in 1990, and more SRI index funds exist today.⁹⁶ Investors or researchers interested in comparing funds can now compare actively managed funds with actively managed funds, and passive funds with passive funds. Studies of passive SRI funds now result in better comparisons between SRI and non-SRI strategies.

One example of a study comparing different passive strategies compared passive negative screens with the S&P 500 (itself a passive index) and found minimal cost difference. Jon Quigley and Lyn Taylor compared the S&P 500 index with three alternative sets of negative screens: (1) SRI screens that eliminated companies with 5 percent or more of their revenue from alcohol, gaming, tobacco, military, or involvement with the Sudan (as measured by KLD Research & Analytics); (2) ESG screens that eliminated companies ranking in the bottom 20 percent in their sector when measured against all U.S. companies for E, S, and G criteria (as measured by ASSET4); and

93. Posner & Langbein, *supra* note 12, at 93.

94. *Id.* Indeed, the authors say, “we are not concerned that adherence to social principles will result in portfolios that yield lower average returns than portfolios designed to maximize the financial well-being of the investment beneficiaries. The average return will be the same . . .” *Id.* at 92 (citing Pacey, *supra* note 64 (comparing three SRI mutual funds with the average of non-SRI funds operating during the same period and finding that the SRI funds did better)).

95. *Id.*

96. See Kurtz & diBartolomeo, *supra* note 15 (explaining the methodology used in creating the Domini 400 Social Index, now known as the KLD400, which includes negative screens and best-in-class selection). Other SRI indexes include the FTSE KLD Social Select Index, the Calvert Social Index, and the FSE4Good U.S. Index.

(3) a combination of the screens in the first two scenarios.⁹⁷ The study analyzed risk and return attributes each month from October 2004 through November 2009 and found high correlations with the S&P 500.⁹⁸ In comparison with the unscreened S&P 500, the SRI screens had a negative impact of 0.43 percent per year, and the combined screens had a negative impact of 0.37 percent.⁹⁹ The ESG screens had a positive impact of 0.09 percent with slightly lower return volatility.¹⁰⁰ The results for the ESG screens did not reflect the benefits that might be obtained by overweighting based on high ESG scores because the study used only negative screens.¹⁰¹

In another study,¹⁰² Jon Hale, head of sustainability research for Morningstar, found that “sustainable” index funds had slightly higher administrative expenses than funds not identified as sustainable.¹⁰³ The study excluded funds that merely employed negative screens and defined sustainable funds as those that use environmental, social, and corporate governance criteria to “evaluate investments or assess the societal impact of investments.”¹⁰⁴ Hale found that the sustainable funds as a group performed better than the overall fund universe, but noted that “a sustainable fund will probably always be more expensive than the ultralow market-cap-weighted indexes that are so popular.”¹⁰⁵ He explained, “the cheapest U.S. sustainability index fund has an expense ratio of 0.11 percent and the group ranges up to about 0.40 percent. That’s not very expensive, but it’s also not the 0.04 percent that the cheapest conventional index funds charge.”¹⁰⁶

97. Quigley & Taylor, *supra* note 65, at 2.

98. *Id.* at 2–3.

99. *Id.* at 3.

100. *Id.*

101. *Id.* Quigley and Taylor work for a “quantitative U.S. equity investment boutique” that has a Sustainable Responsible LargeCap Strategy that “has topped the S&P 500 Index by better than 2 percent annualized since inception.” *Id.*

102. JON HALE, SUSTAINABLE FUNDS U.S. LANDSCAPE REPORT (Morningstar, 2018), <https://corporate1.morningstar.com/ResearchLibrary/article/846182/sustainable-funds-us-landscape-report/> [<https://perma.cc/7A4B-8EGU>] (available for download at website).

103. Jon Hale, *Sustainable Funds: More Choices in More Categories than Ever*, MORNINGSTAR (Feb. 1, 2018), <http://news.morningstar.com/articlenet/article.aspx?id=846030> [<https://perma.cc/DSJ9-HV4W>] (describing the study cited *supra* note 102).

104. *Id.*; HALE, *supra* note 102, at 3.

105. Hale, *supra* note 103.

106. *Id.*

A Swedish pension fund provides another example of the ability of large asset managers to incorporate environmental concerns into passively managed funds without compromising on financial returns.¹⁰⁷ The pension fund had billions of dollars in passively managed portfolios that tracked stock market indexes.¹⁰⁸ The fund was concerned about reducing its risk exposure, so it worked with other asset managers to develop an index fund that excluded carbon-heavy polluting companies across all sectors.¹⁰⁹ The new fund offers a hedge against climate risk, and in its first years outperformed its benchmark.¹¹⁰

With the development of SRI indexes and better reporting concerning ESG factors, administrative expenses for SRI funds, both passively and actively managed, are lower than they once were. An investor will want to compare both the risk-adjusted return and expenses of funds when making investment decisions. By comparing the net returns to benchmarks, a fiduciary investor can be confident that consideration of ESG factors does not reduce the financial position of the portfolio. The assumption that any form of SRI necessarily results in a cost to the portfolio need not block a decision to engage in ESG integration.

D. *ESG Integration and CSR*

In addition to comparing returns of SRI funds with benchmarks, another way to consider the effectiveness of incorporating ESG factors into financial analysis is to examine the performance of companies that will become investments. Numerous studies have examined the effects of corporate sustainability strategies on the performance, risk, and reputation of these companies.¹¹¹ The terms “corporate sustainability” and “corporate social responsibility” (CSR) describe a company’s

107. Lorenzo Bernasconi & Patrick Bolton, *Institutional Investing and Climate Change: Don't Worry About Ethics, Worry About Fiduciary Responsibility*, ROCKEFELLER FOUND. BLOG (Dec. 7, 2015), <https://www.rockefellerfoundation.org/blog/institutional-investing-and-climate-change-dont-worry-about-ethics-worry-about-fiduciary-responsibility/> [https://perma.cc/92GD-XJ6Y]. The pension fund is the Fourth Swedish National Pension Fund, AP4.

108. *Id.*

109. *Id.*

110. *Id.* The blog post reports that development of the fund began in 2012, and the post is from 2015.

111. For citations to many of these studies, see CLARK ET AL., *supra* note 3.

voluntary actions to manage its environmental and social impact,¹¹² and to consider stakeholders as well as shareholders.¹¹³

Researchers have wondered whether investments in sustainability initiatives would raise a company's costs, putting the company at a competitive disadvantage.¹¹⁴ A significant majority of studies have demonstrated the contrary result: companies that engage in corporate sustainability practices outperform those that do not.¹¹⁵

One of the first of the studies examining CSR practices—a fifteen-year study published in 2011—compared the performance of companies based on whether they had, by 1993, adopted sustainability policies incorporating social and environmental issues into their operations.¹¹⁶ The study created two groups of companies based on that characteristic and labeled them “High Sustainability companies” and “Low Sustainability companies.”¹¹⁷ The researchers found that High Sustainability companies outperformed Low Sustainability companies in both stock market and accounting performance.¹¹⁸

A metastudy released in March 2015 reviewed more than two hundred academic studies, industry reports, newspaper articles, and books, and found overall positive economic impacts on companies that incorporated sustainability practices.¹¹⁹ The report organizes its discussion around several major ways ESG strategies (in contrast to a lack of attention to ESG issues) can lead to a competitive advantage for a company: risk (both company specific and external), performance (through process innovation and product innovation), and reputation (human capital and consumer relations). A few exam-

112. Khan et al., *supra* note 52, at 2 n.1 (noting that the terms “sustainability” and “ESG” have been used interchangeably with “CSR”).

113. “Stakeholders” refers to employees and the communities affected by the company. See CLARK ET AL., *supra* note 3, at 12 (arguing that a company can create both financial and societal value by “focusing on profit maximization over the medium to longer term, i.e., shareholder value maximization, and by taking into account the needs and demands of major stakeholders”).

114. See Allen Ferrell et al., *Socially Responsible Firms*, 122 J. FIN. ECON. 585 (2016).

115. CLARK ET AL., *supra* note 3.

116. Eccles et al., *supra* note 29.

117. *Id.* at 2835.

118. *Id.* at 2836.

119. CLARK ET AL., *supra* note 3.

ples from the report help explain why attention to sustainability benefits companies and their shareholders.

The report explains that attention to ESG issues can help a company mitigate both company-specific risks and external costs. The report uses BP as an example of a company's failure to address environmental problems and health and safety issues resulting in a serious corresponding loss in share price. Two years before the Deepwater Horizon oil spill occurred, BP was criticized for environmental pollution, occupational health and safety issues, and negative impacts on local communities. With that information, investors using an ESG integration strategy would have avoided investing in BP. After the oil spill occurred in 2010, BP's share price dropped 50 percent, and in the period from the disaster to March 2015, BP stock underperformed a peer group of oil companies by approximately 37 percent. The ESG factors associated with BP represented uncompensated risk, and a decision to continue investing in BP had financial consequences.¹²⁰

Examples of other company-specific risks include the risk of government-imposed fines, such as fines that may be imposed on companies in the financial sector or on pharmaceutical companies. External costs are another company-specific risk; these include disruptions in supply chains caused by weather events. The report points out that the costs of natural capital assets, such as climate, clean air, and water, are often externalized and not borne by the companies using those assets. A disruption caused by a flood, hurricane, or wildfire can cause those costs to be internalized rapidly, through a disruption of supply chains or fluctuations in commodity prices. Thus, climate change, though external to a specific company, carries financial risks for companies and their shareholders.¹²¹

120. *Id.* at 14; see also Raj Thamotheram & Maxime Le Floch, *The BP Crisis as a Preventable Surprise: Lessons for Institutional Investors*, 5 ROTMAN INTERNAT'L J. PENSION MGMT. 68 (2012). It is interesting to note that BP has signed on to a climate change resolution. See Gail Moss, *BP Follows Shell to Back Climate Change Resolution*, INVS. & PENSIONS EUR. (Feb. 6, 2015), <http://www.ipe.com/news/esg/bp-follows-shell-to-back-climate-change-resolution/10006577.full> article [<https://perma.cc/3R34-8P3X>].

121. Sarah Fecht, *NYC is Suing Five Major Oil Companies Over Climate Change*, EARTH INST. BLOG (Jan. 11, 2018), <http://blogs.ei.columbia.edu/2018/01/11/nyc-climate-change-lawsuit/> [<https://perma.cc/UY46-NUC9>]. The city of New York argues that BP, Chevron, ConocoPhillips, ExxonMobil, and Royal Dutch Shell are responsible for 11 percent of the greenhouse gas emissions since the

With respect to performance, a company that innovates to reduce waste or increase energy efficiency will likely benefit from cost savings, especially over the long term. An example is Marks & Spencer, which announced that by sourcing responsibly, reducing waste, and helping communities, it has been able to save \$200 million annually.¹²² Companies innovating to produce green products may benefit directly from sales of those products. Innovation of new services and products can benefit traditional companies¹²³ or may come from entrepreneurial start-ups that create solutions to environmental and social problems.¹²⁴

Reputation is also important to a company's financial well-being, both in being able to hire and keep talented employees and to avoid boycotts by consumers concerned about social issues.¹²⁵ In different ways for different industries, sustainability practices lead to a variety of financial benefits for companies.¹²⁶ Clark, Feiner, and Viehs¹²⁷ summarize their findings as follows:

90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital of companies[,] 88% of the research shows that solid ESG practices result in better operational performance of firms[, and] 80% of the studies show that stock price performance of compa-

Industrial Revolution, that they knew their products harmed the environment and tried to cover up the problem, and that they should be responsible financially for some of the costs New York City will face as it adapts to rising seas, heavier precipitation, and rising temperatures. Paris is considering following suit. Uccilia Wang, *Paris, Inspired by New York City, Considers Climate Suit Against Oil Companies*, CLIMATE LIABILITY NEWS (Feb. 9, 2018), <https://www.climateliabilitynews.org/2018/02/09/paris-climate-liability-suit/> [<https://perma.cc/UX6W-4FMP>].

122. CLARK ET AL., *supra* note 3, at 16.

123. For example, revenues from Green Products at Phillips represent 51 percent of total revenues. *Id.*

124. Companies that work with impact investors fit in this category.

125. CLARK ET AL., *supra* note 3, at 18.

126. *See id.*; Kahn et al., *supra* note 52 (listing many studies).

127. Gordon L. Clark is Director of the Smith School of Enterprise and the Environment, University of Oxford; Andreas Feiner is Head of Values Based Research and Advisory at Arabesque Asset Management Ltd.; Michael Viehs is a Research Fellow at the Smith School of Enterprise and the Environment, University of Oxford.

nies is positively influenced by good sustainability practices.¹²⁸

Clark, Feiner, and Viehs note that sustainability practices differ across industries. Kahn, Serafeim, and Yoon¹²⁹ suggest that the reason for some of the mixed results in the studies may be that researchers have been unable to account for “the differential importance of the different sustainability issues across industries.”¹³⁰ Companies report their sustainability investments, but information about the materiality of those investments, and the differences across industries, may be missing or difficult to determine. With the development of the Sustainability Accounting Standards Board (SASB) framework,¹³¹ industry-specific guidance on materiality became available. Kahn, Serafeim, and Yoon combined the SASB data with data from MSCI KLD to focus on the question of materiality in connection with testing “the future shareholder value implications of sustainability investments.”¹³² They report that:

[F]irms with strong ratings on material sustainability topics outperform firms with poor ratings on these topics. In contrast, firms with strong ratings on immaterial sustainability topics do not outperform firms with poor ratings on the same topics. Across all our specifications, we find that portfolios formed on the basis of the materiality index outperform portfolios formed on the basis of the total KLD index or portfolios formed on the basis of the immaterial index.¹³³

Another line of research involves a focus on governance and the idea that sustainability investments reflect agency

128. CLARK ET AL., *supra* note 3, at 9.

129. When their article was written, Mozaffar Khan was the James M. Collins Visiting Associate Professor of Business Administration at Harvard Business School and the Honeywell Professor of Accounting at the University of Minnesota; George Serafeim was the Jakurski Family Associate Professor of Business Administration at Harvard Business School; Aaron Yoon was a doctoral student at Harvard Business School.

130. Kahn et al., *supra* note 52, at 7.

131. See *infra* Section III.B.

132. Kahn et al., *supra* note 52, at 3.

133. *Id.*

problems (issues related to governance) in a company. Some researchers see CSR as a diversion of a company's resources away from the duty to maximize wealth for the shareholders and attribute the decision to divert resources for CSR to agency problems.¹³⁴ Other scholars have argued that companies characterized by good governance often adopt CSR. Ferrell, Liang, and Renneboog¹³⁵ examined whether well-governed companies are more likely to be socially responsible by analyzing data from over twenty-five hundred companies, using global databases from MSCI and Vigeo.¹³⁶ They found that well-governed companies "are more likely to be socially responsible and have higher CSR ratings."¹³⁷ They noted that more CSR is not always better, but that "in general, corporate social responsibility need not to be inevitably induced by agency problems but can be consistent with a core value of capitalism, generating more returns to investors, through enhancing firm value and shareholder wealth."¹³⁸

The studies described in this Section have shown that sustainability initiatives and attention to corporate social responsibility can benefit a company.¹³⁹ The research indicates that sustainability efforts and CSR are not inconsistent with

134. See Ferrell et al., *supra* note 114, at 586 (citing Roland Benabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 *ECONOMETRICA* 1 (2010); Ing-Haw Cheng et al., *Do Managers Do Good with Other People's Money?* (Univ. of Chi. Booth School of Bus., Working Paper, 2014); Ronald Masulis & Sayed W. Reza, *Agency Problem of Corporate Philanthropy*, 28 *REV. FIN. STUD.* 592 (2015)).

135. Allen Ferrell is the Harvey Greenfield Professor of Securities Law at Harvard Law School; Hao Liang is Assistant Professor of Finance at Singapore Management University; Luc Renneboog is Professor of Corporate Finance at Tilburg University in the Netherlands.

136. See Ferrell et al., *supra* note 114, at 588. The authors explain a set of competing views in finance literature. Some scholars argue that managers at socially responsible firms have generally poor incentives, i.e., the companies have agency problems, and those problems are reflected in CSR activities. For example, managers may waste corporate resources through CSR activities or engage in CSR to benefit themselves at the expense of shareholders. Other scholars have argued that CSR is consistent with maximizing shareholder wealth because well-governed companies are likely to be socially responsible. See *id.* at 585–88.

137. *Id.* at 585–86.

138. *Id.* at 605.

139. See also Friede et al., *supra* note 81; Andreas G. F. Hoepner et al., *Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes? A Realistic Prudent Investment Test* (Working Paper, 2011), <https://ssrn.com/abstract=1930189> [<https://perma.cc/SA64-UMW5>] (available for download at website).

shareholder wealth maximization.¹⁴⁰ Indeed, improvement in CSR and higher ratings in CSR may signal opportunities for investors.¹⁴¹

E. Impact Investing

Although this Article focuses on ESG integration, a brief look at data related to impact investing is useful given its growing role in the range of SRI options. The financial results for impact investing depend on the strategy being pursued.¹⁴² Some impact investors may willingly and intentionally sacrifice some amount of financial return to obtain more nonfinancial benefit. They may be referred to as “impact-first.” Other impact investors, referred to as “finance-first,” may want to maintain financial returns that match financial benchmarks.¹⁴³ Because these two approaches to impact investing have different results in terms of financial returns, any analysis of impact investing should clarify the strategy being pursued.

140. Ferrell et al., *supra* note 114, at 605 (“Our empirical results (based on an instrumental variables estimation) suggest that good governance causes high CSR and that a firm’s CSR practice is not inconsistent with shareholder wealth maximization, which induces a positive stance on CSR . . .”).

141. *See id.* These researchers studied the integration of corporate environmental responsibility into pension fund investment processes using data from fifteen hundred firms from twenty-six developed countries. The researchers reported their results:

First, our tests provide zero indications that the integration of corporate environmental responsibility criteria into pension fund investment processes has detrimental financial performance effects, at least with respect to pension funds with a preference for corporate environmental responsibility as assessed by EIRIS. Second, our complementary risk analysis shows that from a risk management perspective specific ESG criteria have a positive effect on the downside risk protection of pension portfolios.

Id. at 30.

142. The GIIN 2017 Annual Impact Investor Survey (Executive Summary) reports that 66 percent of respondents target risk-adjusted, market-rate returns, 18 percent target below-market-rate returns closer to market-rate, and 16 percent target below-market-rate returns closer to return-of-capital preservation. MUDALIAR ET AL., *supra* note 40, at 3.

143. *See* RODIN & BRANDENBURG, *supra* note 35, at 7–13 (explaining, at 12, that the distinction between impact-first and finance-first investment “can become fuzzy” in practice).

The initial idea behind impact investing was to encourage investing that sought blended value.¹⁴⁴ Anthony Bugg-Levine and Jed Emerson have advocated that impact investors consider the nonfinancial impact part of the value of the investment and that they not insist on market-rate financial returns.¹⁴⁵ Blended value, or double-bottom-line, tries to capture the idea that both types of value—financial and nonfinancial—should be judged as returns for the investor. Greater nonfinancial impact may be possible if an impact investor is not tied to a market-rate financial return.

The term impact investing now covers a broader range of funds, with more investors looking for financial returns comparable to nonimpact funds. The Impact Investing Benchmark, created in 2015 by Cambridge Associates and the Global Impact Investing Network (GIIN), collects data from private equity and venture capital funds that target risk-adjusted, market-rate returns.¹⁴⁶ An analysis of the funds compiled when the Benchmark was announced found that returns for impact investing funds were in line with or better than returns of nonimpact investing funds.¹⁴⁷ Funds launched more recently were more likely to trail their nonimpact comparators, perhaps because the returns took longer to develop, while older funds outperformed their comparators.¹⁴⁸

Mara Bolis and Chris West worry that the report on the Impact Investing Benchmark may create unrealistic expectations for new impact investing enterprises.¹⁴⁹ The report does not identify or examine the nonfinancial impacts of the funds in the sample, and the funds listed in the Benchmark are there because they self-identified as having an intention to generate social impact.¹⁵⁰ Thus, the funds could be socially positive in a broad sense but with a primary goal of financial return. Further, Bolis and West note that the study is weighted toward

144. BUGG-LEVINE & EMERSON, *supra* note 10. Emerson was part of a group that created the term “blended value” in 2000. *Id.* at 5. *See supra* note 35.

145. BUGG-LEVINE & EMERSON, *supra* note 10.

146. JESSICA MATTHEWS ET AL., INTRODUCING THE IMPACT INVESTING BENCHMARK 1 (2015), http://www.thegiin.org/binary-data/Introducing_the_Impact_Investing_Benchmark.pdf [<https://perma.cc/6HJB-9T64>]. The Benchmark limits inclusion to funds that seek risk-adjusted, market-rate returns. *Id.* at 1–2.

147. *Id.*

148. *Id.*

149. Bolis & West, *supra* note 35.

150. *Id.* at 3–4.

funds that support financial inclusion and microfinance as their social impact, and funds in these sectors developed as investment funds only after many years of subsidies.¹⁵¹ The funds in the Benchmark provide some level of social benefit, but Bolis and West caution against reading the findings of the Benchmark study to apply to all forms of impact investing. Their worry is that social enterprises with significant social or environmental impact but lower-than-market financial returns will be seen as failures.¹⁵² They urge impact investors to return to the “original guiding purpose: to achieve social and environmental impact.”¹⁵³

Another study examined a different question with respect to impact investing. The study, conducted by the Wharton Social Impact Initiative, examined fifty-three private equity impact investing funds from around the world. The study examined whether the need to generate liquidity forced the fund to take concessions on the return or to ignore preservation of the mission.¹⁵⁴ The study answered both questions in the negative.

When a private equity fund matures, the general partner must create liquidity to pay the investors (the limited partners). At that time, the general partner could face competing pressures: maximizing return versus ensuring the preservation of the mission in the companies held by the fund. With respect to the continuation of the social or environmental mission of the fund after exit, the general partners surveyed reported that for “nearly all exits that were not write-offs” the mission continued.¹⁵⁵ The continuation of the mission occurred without mandates from the fund or the acquirer, probably because the business model of the company included the social or environmental mission.¹⁵⁶

The researchers noted that impact investing funds have “a spectrum of return expectations,” so in terms of financial concessions, the researchers focused on funds that sought risk-adjusted, market-rate returns. They used several calculations

151. *Id.* at 4.

152. Bolis and West worry that an increasing focus on market-rate returns will adversely affect the types of impact investments investors are willing to consider. *Id.*

153. *Id.* at 5.

154. GRAY ET AL., *supra* note 46, at 3.

155. *Id.* at 4.

156. *Id.*

of financial performance and found that the impact funds met their financial targets and in general performed as well as the indices used in the study.¹⁵⁷ The report concludes, “Impact funds in the sample that seek market-rate-returns demonstrate that they can achieve results comparable to market indices, while still reporting mission preservation in the vast majority of their exited investments.”¹⁵⁸

Both ESG integration and impact investing can be used by investors interested in both financial and nonfinancial returns, but the emphasis may be different. ESG integration refers to a strategy that does not anticipate a loss in financial return compared to benchmarks, and some investors use ESG integration to improve their financial risk-adjusted returns. An investor engaged in impact investing, in contrast, may prioritize the nonfinancial impact and make the investment expecting a below-market financial return. Not all impact investors, however, are able or willing to accept a below-market return. Whether an impact investor is impact-first or finance-first may affect the fiduciary analysis presented in Part V.

III. REPORTING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INFORMATION

As interest in ESG factors has grown, so has the need for better reporting.¹⁵⁹ Companies increasingly report on sustain-

157. *Id.* at 4–5.

158. *Id.* at 28.

159. In May 2017, nearly two-thirds of Exxon-Mobil shareholders approved a resolution to require the company to measure and disclose how regulations to reduce greenhouse gases and new energy technologies could impact the value of its oil assets. BINDER DIJKER OTTE U.S., 2017 BDO BOARD SURVEY 5 (2017), <https://www.bdo.com/insights/assurance/corporate-governance/2017-bdo-board-survey/2017-bdo-board-survey> [<https://perma.cc/37VN-V99B>] (PDF version available for download). In August 2017, 54 percent of the 130 directors of public companies surveyed by accounting firm BDO USA answered yes to the following question: “Do you believe disclosures regarding sustainability matters (e.g. climate change, corporate social responsibility, etc.) are important to understanding a company’s business and helping investors make informed investment and voting decisions?” *Id.* The Corporate Governance Practice of BDO USA conducts the survey on corporate governance and financial accounting issues annually, and the report describes the shift from 24 percent yes in 2016 to 54 percent yes in 2017 as a “major reversal.” *Id.*; see also ECCLES & KASTRAPELI, *supra* note 7, at 14 (noting that 92 percent of investors want companies to identify and report on the material ESG issues they believe affect financial performance).

ability or corporate responsibility.¹⁶⁰ The KPMG Survey of Corporate Responsibility Reporting 2017 found that three-quarters of the nearly five thousand companies surveyed issue corporate responsibility (CR) reports.¹⁶¹ The trend is toward integrating CR information into a company's annual financial report. The percentage of G250 companies to do so has risen from 44 percent in 2011 to 78 percent in 2017, and eighty-one of the one hundred largest U.S. companies reported integrated reporting in 2017.¹⁶²

Given the pressure from investors and shareholders for more sustainability reporting,¹⁶³ companies have incentives to report, but the lack of consistent reporting standards has limited the usefulness of some of the information reported.¹⁶⁴

160. The Governance and Accountability Institute reported in 2016 that 82 percent of S&P 500 companies prepare sustainability reports. THE GOVERNANCE AND ACCOUNTABILITY INST., FLASH REPORT: 85% OF S&P 500 INDEX® COMPANIES PUBLISH SUSTAINABILITY REPORTS IN 2017 (2017), <http://www.ga-institute.com/press-releases/article/flash-report-82-of-the-sp-500-companies-published-corporate-sustainability-reports-in-2016.html> [<https://perma.cc/86AW-Q7P4>].

161. JOSÉ LUIS BLASCO & ADRIAN KING, KPMG, CURRENTS OF CHANGE: THE KPMG SURVEY ON CORPORATE RESPONSIBILITY REPORTING 2017, AT 4 (2017).

162. *Id.* at 21. Jose Luis Blasco concludes the Executive Summary of the Report with three messages: (1) governments and stock exchanges around the world will be issuing more reporting regulations and voluntary reporting guidelines will transition to mandatory reporting requirements; (2) integrated reporting is the “new normal” and the line between nonfinancial and financial information will continue to break down; and (3) communicating impact, not just statistics, will be increasingly important in CR reporting. *Id.* at 6–7.

163. In addition to investor interest, a growing number of countries and stock exchanges now require some form of sustainability reporting. *See* Directive 2014/95, of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU regarding disclosure of nonfinancial and diversity information by certain large undertakings and groups, 2014 O.J. (L 330) 3, <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A2014L0095> [<https://perma.cc/5KWA-LBBM>] (requiring certain large companies in Europe to report information about the nonfinancial social and environmental impacts of their activities); KPMG, UNITED NATIONS ENVIRONMENT PROGRAMME, GLOBAL REPORTING INITIATIVE AND UNIT FOR CORPORATE GOVERNANCE IN AFRICA, CARROTS AND STICKS, SUSTAINABILITY REPORTING POLICIES WORLDWIDE (2013), <https://www.globalreporting.org/resource/library/Carrots-and-Sticks.pdf> [<https://perma.cc/N24A-X2SG>] (reporting on mandatory and voluntary reporting policies in forty-five countries); Initiative for Responsible Investment, Corporate Social Responsibility Disclosure Efforts By National Governments and Stock Exchanges (Mar. 25, 2015) (unpublished manuscript) (on file with The Harvard Kennedy Sch. Hauser Inst. for Civil Soc’y) (collecting information about disclosure initiatives of regulatory authorities and stock exchanges around the world).

164. Investors and shareholders want reporting on sustainability, so companies are producing sustainability reports and sustainability products, which some have described as “green washing.” *See* Cecile Lefort & Jonathan Barrett,

Measurements of social and environmental impact are difficult even for companies in the same industry. Local conditions may affect both the impacts sought and the impacts obtained. For example, a low-cost, primary care medical clinic could face different challenges in different countries. The definition of “low income” used to determine target populations could be different, access to medical education and to educated employees could be different, and even environmental issues such as pollution and access to water could affect the program. Understanding “impact” requires standards, but developing the standards has been difficult.

Former SEC Chair Elisse B. Walter said in keynote remarks at the 2016 SASB Symposium, “Whatever the changes in policy, sustainability-related issues are significant to the financial future of companies that are publicly traded in our country.” She added that whatever policy changes come, “the basic question will be the same: Is the sustainability issue material to investors in your company?”¹⁶⁵ To address the need for more and better information about E, S, and G factors, several reporting tools have been developed. If reporting becomes standardized, comparisons will become easier.

This Part examines the SEC’s increasing interest in disclosure of material information related to sustainability and then reviews the new tools for reporting that information. Two or-

Ethical Investment Tide Lifts ‘Greenwash’ Concerns, REUTERS (Apr. 1, 2017, 7:10 PM), <https://www.reuters.com/article/us-investment-ethics-idUSKBN174016> [<https://perma.cc/4RMD-85E5>] (reporting from Australia). For a review of some of the third-party ESG report and ratings providers, see Betty Moy Huber & Michael Comstock, *ESG Reports and Ratings: What They Are, Why They Matter*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (July 27, 2017), <https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/> [<https://perma.cc/GR86-ADFA>] (noting that institutional investors, asset managers, financial institutions, and other stakeholders rely on these reports and ratings). The KPMG 2017 survey reports that third-party assurance of CR reporting continues to grow: “Assurance of CR data is now accepted standard practice among G250 companies with more than two thirds (67 percent) of these companies seeking assurance. While assurance rates among the N100 are lower (currently 45 percent), KPMG expects a majority of N100 companies to have their CR data assured within the next two to five years if recent trends continue.” BLASCO & KING, *supra* note 161, at 26.

165. Elisse B. Walter, *The Future of Sustainability Disclosure: What Remains Unchanged in an Environment of Regulatory Uncertainty?*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Dec. 7, 2016), <https://corpgov.law.harvard.edu/2016/12/07/the-future-of-sustainability-disclosure-what-remains-unchanged-in-an-environment-of-regulatory-uncertainty/> [<https://perma.cc/4RA5-8CCM>].

ganizations, the Sustainability Accounting Standards Board and the Global Reporting Initiative, have developed standards for reporting on sustainability. The International Integrated Reporting Council focuses on creating an integrated report that improves information available to investors. The Climate Disclosure Standards Board seeks to increase and standardize reporting of environmental information. Two tools, the Global Impact Investing Rating System and the Impact Investment Benchmark, measure impact on environment, workers, and governance in connection with measuring financial performance. All of these tools seek to provide investors with material information that goes beyond traditional financial reporting.

A. SEC Requirements for Publicly Listed Entities

In the United States, regulations issued by the Securities and Exchange Commission (SEC) require companies to report on material business and financial factors, including any material environmental and social factors.¹⁶⁶ Determining which factors are material remains difficult for companies,¹⁶⁷ and some observers are advocating for more specificity from companies concerning ESG factors.¹⁶⁸

166. See SECURITIES AND EXCHANGE COMMISSION, RELEASE NO. 33-10064, BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K 209-10 (2016) [hereinafter SEC Concept Release], <https://www.sec.gov/rules/concept/2016/33-10064.pdf> [<https://perma.cc/D6ZK-CAH7>] (discussing the SEC's 1975 Environmental Disclosure Release and the 1975 Somner Report). The Somner Report recommended that the SEC should require disclosure of social and environmental information only if the information reflects on the company's economic and financial performance and is material to an investor's decision-making. *Id.* at 210 n.687.

167. See *id.* at 210 (“[T]he Commission has recognized that the task of identifying what information is material to an investment and voting decision is a continuing one in the field of securities regulation. The role of sustainability and public policy information in investors’ voting and investment decisions may be evolving as some investors are increasingly engaging on certain ESG matters.” (citations omitted)).

168. See *id.* (citing Bill Libit & Todd Freier, *The Corporate Social Responsibility Report and Effective Stakeholder Engagement*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Dec. 28, 2013), <https://corpgov.law.harvard.edu/2013/12/28/the-corporate-social-responsibility-report-and-effective-stakeholder-engagement/> [<https://perma.cc/Y92M-L47U>]; Matteo Tonello, *Global Trends in Board-Shareholder Engagement*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Oct. 25, 2013), <https://corpgov.law.harvard.edu/2013/10/25/global-trends-in-board-shareholder-engagement/> [<https://perma.cc/3V86-Z9P2>]).

In April 2016, the SEC issued a concept release discussing business and financial disclosure regulations in Regulation S-K and requesting public comment on specific questions.¹⁶⁹ In the concept release the SEC seeks to determine whether the current reporting requirements “continue to provide the information that investors need to make informed investment and voting decisions and whether any of our rules have become outdated or unnecessary.”¹⁷⁰

One section of the concept release, titled “Disclosure of Information Relating to Public Policy and Sustainability Matters,” notes the increasing interest in ESG information for voting and investment decisions.¹⁷¹ This Section reviews comments from those advocating more disclosure requirements and those cautioning against regulations requiring social or environmental disclosure.¹⁷²

The concept release explains that many commenters note “a growing interest in ESG disclosure among investors”¹⁷³ and cites commenters who advocate greater disclosure requirements on ESG factors.¹⁷⁴ The report points to increasing use of ESG information in financial analysis¹⁷⁵ and to a study showing more interest in shareholder action on sustainability issues than on financial results.¹⁷⁶ The report also cites comments expressing the view that societal risks are not material to

169. *Id.* at 1.

170. *Id.* at 6; *see also* Press Release, SEC, SEC Solicits Public Comment on Business and Financial Disclosure Requirements in Regulation S-K (Apr. 15, 2016) (on file with SEC), <https://www.sec.gov/news/pressrelease/2016-70.html> [<https://perma.cc/C4BH-R4EU>].

171. SEC Concept Release, *supra* note 166, at 204.

172. *Id.*

173. *Id.* at 206; *see also* sources cited *id.* at 206 nn.667 & 695.

174. *Id.* at 206 n.668 (noting comments from “UCS; Ceres; GRI; CTI; IEHN; Wallace Global Fund; Harrington Investments; ICCR; Sustainability Group (concerned with underreporting of material information related to environmental liabilities); US SIF 1; First Affirmative Financial Network Group; Allianz”).

175. *Id.* at 211 (citing BLACKROCK INVESTMENT INSTITUTE, *THE PRICE OF CLIMATE CHANGE 7* (Oct. 2015)).

176. *Id.* (citing MARC GOLDSTEIN, INSTITUTIONAL SHAREHOLDER SERVICES FOR THE INVESTOR RESPONSIBILITY RESEARCH CENTER INSTITUTE, *DEFINING ENGAGEMENT: AN UPDATE ON THE EVOLVING RELATIONSHIP BETWEEN SHAREHOLDERS, DIRECTORS AND EXECUTIVES* (2014), <https://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf> [<https://perma.cc/327N-2KCN>]).

financial performance, and therefore that disclosure should not be required.¹⁷⁷

In the concept release, the SEC reaffirmed the underlying principle of its 1975 Environmental Disclosure Release: social and environmental factors must be disclosed only if they are material to a reasonable investor. The difference between 1975 and 2015, when the concept release was issued, is that many more investors were concerned about social and environmental factors in 2015 than in 1975, for financial as well as extrafinancial reasons.¹⁷⁸ And the increase in attention to these issues for shareholder action may make them material for that reason.¹⁷⁹ The SEC requested comments on eight specific questions related to sustainability reporting.¹⁸⁰

In June 2016, the SEC's own Investor Advisory Committee submitted comments on the concept release, responding to the request for feedback.¹⁸¹ With respect to sustainability and public policy disclosures, the Investor Advisory Committee notes that "a significant, and growing number, of investors utilize sustainability and other public policy disclosures to better understand a company's long-term risk profile."¹⁸² The com-

177. *Id.* at 212 (noting concerns that increased requirements could burden companies and investors with costs for disclosures that are not material for investment or voting decisions and that "policy-driven disclosure requirements may have the goal of altering corporate behavior, rather than producing information that is important to voting and investment decisions").

178. *Id.* at 210 ("The role of sustainability and public policy information in investors' voting and investment decisions may be evolving . . .").

179. Even in 1975, a minority of the Advisory Committee on Corporate Disclosure believed "that disclosure of social and environmental information is material to an investment decision regardless of its economic impact on the financial performance of the company." *Id.* at 210 n.687.

180. *Id.* at 213–15. The report explains, in general:

We are interested in receiving feedback on the importance of sustainability and public policy matters to informed investment and voting decisions. In particular, we seek feedback on which, if any, sustainability and public policy disclosures are important to an understanding of a registrant's business and financial condition and whether there are other considerations that make these disclosures important to investment and voting decisions. We also seek feedback on the potential challenges and costs associated with compiling and disclosing this information.

Id. at 205.

181. Letter from SEC Inv'r Advisory Comm. to SEC Div. of Corp. Fin. (June 15, 2016) (on file with SEC), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-approved-letter-reg-sk-comment-letter-062016.pdf> [<https://perma.cc/L4SN-KZS6>].

182. *Id.* at 7.

ments state “that environmental, social and governance issues should be subject to the same materiality standards as other sources of risk and return under the Commission’s rules.”¹⁸³ This should already be the case, but the comments note the lack of well-developed guidance for assessing qualitative factors and recommend the development of “an analytical framework that more clearly sets out the qualitative factors that can affect the analysis in this area.”¹⁸⁴ Other organizations are attempting to create that analytical framework.

B. The Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board (SASB) developed and codified a set of seventy-seven standards, published in final form in November 2018.¹⁸⁵ The SASB explains that the standards represent “a complete set of globally applicable industry-specific standards which identify the minimal set of financially material sustainability topics and their associated metrics for the typical company in an industry.”¹⁸⁶

The standards are industry-specific and create performance metrics and a process for determining materiality of issues.¹⁸⁷ Financial materiality is a key consideration for these standards,¹⁸⁸ and the standards are designed for voluntary use in making disclosures required by the SEC.¹⁸⁹ The goal is better information for investors. SASB’s 2016 Annual Report explains, “At SASB, we believe material sustainability information is the right of every investor, and that standards are the basic market infrastructure required to yield this data. When markets have good information, they act on it.”¹⁹⁰ The

183. *Id.*

184. *Id.* at 8.

185. *Standards Board*, SUSTAINABILITY ACCT. STANDARDS BOARD, <https://www.sasb.org/standards-overview/> (last visited Dec. 22, 2018) [<https://perma.cc/P5GE-V3GS>].

186. *Id.*

187. *See id.*

188. *Id.*

189. Material issues are “those with evidence of wide interest from a variety of user groups and evidence of financial impact, the same evidence used by the SEC in determining the materiality of financial information” Khan et al., *supra* note 52, at 3.

190. SUSTAINABILITY ACCT. STANDARDS BOARD, ANNUAL REPORT, MOVING THE MARKET 6 (2016).

identification of materiality in the SASB standards has been seen as one of the drivers for increased integrated reporting.¹⁹¹

C. *GRI and the Sustainability Reporting Standards*

The Global Reporting Initiative (GRI), created in 1997, issued the first global sustainability reporting framework in 2000.¹⁹² Since then, GRI has updated the reporting framework several times,¹⁹³ while promoting its use around the world.¹⁹⁴ In 2014, GRI created a Global Sustainability Standards Board to develop the GRI Standards, based on the G4 Guidelines.¹⁹⁵ GRI released the Standards in 2016 to “enable all organizations to report publicly on their economic, environmental and social impacts—and show how they contribute towards sustainable development,” and to serve as “a trusted reference for policy makers and regulators.”¹⁹⁶ Each company using the Standards starts with three universal standards: Foundation,

191. BLASCO & KING, *supra* note 161, at 23.

192. In the early 1990s, advisors connected with the Coalition for Environmentally Responsible Economies (CERES) and the Tellus Institute began developing a framework for environmental reporting. In 1997, they created GRI and expanded the reporting framework to include social, governance, and economic reporting. In 2001 GRI became a separate nonprofit organization, and in 2002 it established its headquarters in Amsterdam and became a UNEP collaborating organization. *See Sustainability Reporting: CERES Catalyzes a Worldwide Movement*, CERES (Mar. 2014), <http://www.ceres.org/about-us/our-history/sustainability-reporting-ceres-catalyzes-a-worldwide-movement> [https://perma.cc/4AF4-2WGZ]; *GRI's History*, GLOB. REPORTING INITIATIVE, <https://www.globalreporting.org/information/about-gri/gri-history/Pages/GRI'spercent20history.aspx> (last visited Nov. 18, 2018) [https://perma.cc/ZWL2-4A87]; *see also* EY & BOS. COLL. CTR. FOR CORP. CITIZENSHIP, *VALUE OF SUSTAINABILITY REPORTING 4–5* (2016) (describing the history of GRI). This report identifies the following business benefits for sustainability reporting: improved financial performance, access to capital, innovation, waste reduction and efficiency, risk management, reputation and consumer trust, employee loyalty and recruitment, and social benefits. *Id.* at 12–14.

193. GRI issued updated guidelines in 2002 (G2), 2006 (G3), 2011 (G3.1) and 2013 (G4). *GRI's History*, *supra* note 192.

194. GRI's mission is “[t]o empower decisions that create social, environmental and economic benefits for everyone.” *About GRI*, GLOB. REPORTING INITIATIVE, <https://www.globalreporting.org/information/about-gri/Pages/default.aspx> (last visited Nov. 18, 2018) [https://perma.cc/F3S4-97MA].

195. *GRI's History*, *supra* note 192.

196. *Id.*

General Disclosures, and Management Approach.¹⁹⁷ The company then chooses from topic-specific Standards, depending on the company. The GRI Standards have six Economic Standards, including, Economic Performance, Market Presence, and Anti-Corruptions; eight Environmental Standards, including Materials, Energy, and Environmental Compliance; and nineteen Social Standards, including Employment, Child Labor, Security Practices, Local Communities, and Customer Health and Safety.¹⁹⁸ A report based on the Standards will present a picture of the company's material topics, the impacts of those topics, and how the company manages the topics.¹⁹⁹

The GRI Standards have developed into the most widely used framework for sustainability reporting.²⁰⁰ In 2015, a survey conducted by KPMG found that of the 250 largest companies globally, 92 percent report on corporate sustainability,²⁰¹ and of those, 74 percent use the GRI Standards.²⁰² Nearly three-quarters of the one hundred largest companies in each of forty-five countries (the N100 for each country) reported on CR,²⁰³ and 60 percent of those companies used the GRI Standards.²⁰⁴ The GRI standards are most commonly used by companies that publish stand-alone CR reports, because the GRI Standards were designed for stand-alone sustainability reporting.²⁰⁵ As more companies integrate CR into their annual financial reports,²⁰⁶ the principles behind the GRI Standards will likely influence that reporting.²⁰⁷

197. *GRI Standards*, GLOB. REPORTING INITIATIVE <https://www.globalreporting.org/standards/gri-standards-download-center/> (last visited Nov. 1, 2018) [<https://perma.cc/D2D4-EYQ5>].

198. *Id.*

199. *Id.*

200. ADRIAN KING & WIM BARTELS, KPMG, CURRENTS OF CHANGE: THE KPMG SURVEY OF CORPORATE RESPONSIBILITY REPORTING 2015 (2015).

201. *Id.* at 30.

202. *Id.* at 42.

203. *Id.* at 30.

204. *Id.* at 42.

205. *Id.*

206. The KPMG survey reports that 56 percent of the forty-five hundred N100 companies it surveyed included CR data in their annual reports. *Id.* at 36.

207. *Id.*

D. IIRC and Integrated Reporting

Sustainability reporting, whether using the GRI Standards or the SASB Standards, provides useful information, but an integrated report can provide a wider range of information in one report, giving investors a better overall picture of the value of a company. The International Integrated Reporting Council (IIRC) was created in 2010 by “a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs”²⁰⁸ to develop an integrated reporting framework. The goals of integrated reporting are to fill gaps in business reporting, improve accountability, and provide investors with better information to improve decision-making and improve long-term investment returns.²⁰⁹ An integrated report should communicate “the full range of factors that materially affect the ability of an organization to create value over time” and support integrated thinking by the business itself to support “the creation of value over the short, medium and long term.”²¹⁰

The IIRC released the International Integrated Reporting <IR> Framework in December 2013.²¹¹ This framework incorporates six types of capital: financial, manufactured, intellectual, human, social and relationship, and natural.²¹² The framework provides Guiding Principles and Content Elements²¹³ but does not establish measurement and reporting standards.

Although including CR data in annual reports has increased, only a few companies identify their reporting as integrated reporting using the IIRC framework. The KPMG survey reported that of the 3,267 companies that reported on CR in 2015, only 11 percent said that their reports were integrated

208. INT'L INTEGRATED REPORTING COUNCIL (IIRC), THE INTERNATIONAL <IR> FRAMEWORK 1 (2013), <https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf> [<https://perma.cc/BL8M-9NYY>] [hereinafter IIRC].

209. *Why? The Need for Change, Integrated Reporting*, IIRC, <http://integratedreporting.org/why-the-need-for-change/> (last visited Nov. 18, 2018) [<https://perma.cc/DF24-4PEP>].

210. IIRC, *supra* note 208, at 2.

211. *Id.* at 1.

212. *Id.* at 11–12.

213. *Id.* at 4–5.

and just over half of those referred to the IIRC framework.²¹⁴ Bill Murphy, a KPMG partner, notes that adoption of the IIRC framework is still at an early stage and the “ultimate path towards global adoption of integrated reporting remains unclear.”²¹⁵ Government requirements may ultimately lead to more integrated reporting. In South Africa, which mandates integrated reporting, the rate is 91 percent.²¹⁶ The SEC’s interest in public policy and sustainability disclosures²¹⁷ suggests that the SEC is considering whether a change in mandated reporting is appropriate. SEC action related to reporting on CR and sustainability will affect the use of integrated reporting by companies in the United States.

E. Climate Disclosure Standards Board

Another global reporting effort, the Climate Disclosure Standards Board (CDSB), is an international consortium of business and environmental NGOs.²¹⁸ The CDSB did not want to develop another set of standards, but instead sought to create a framework for reporting environmental information and natural capital as part of mainstream financial reports.²¹⁹ Its goals are to increase and standardize the reporting of environmental information so that companies can better understand their own long-term environmental opportunities and risks and so that investors can have better, more consistent information for decision-making. As of December 1, 2017, 374 companies in thirty-two countries across ten sectors were using the framework.²²⁰ Reporting will increase as governments impose disclosure requirements.²²¹

214. KING & BARTELS, *supra* note 200, at 38. The survey was based on the 100 largest companies in 45 countries. Of the 3,267 companies that reported on CR, only 6 percent referred to the IIRC.

215. *Id.*

216. *Id.*

217. *See supra* Section III.A.

218. *About the Climate Disclosure Standards Board*, CLIMATE DISCLOSURE STANDARDS BD., <https://www.cdsb.net/our-story> [<https://perma.cc/NG4J-T3UX>].

219. *Id.*

220. Denise Puca, *Infographic: CDSB Framework Users*, CLIMATE DISCLOSURES STANDARDS BD., <https://www.cdsb.net/cdsb-framework/750/infographic-cdsb-framework-users> (last visited Nov. 18, 2018) [<https://perma.cc/VWZ4-4BHR>]. The top five countries in terms of use of the Framework are the UK (53 percent), Japan (27 percent), South Africa (23 percent), U.S. (19 percent), and South Korea (17 percent). The sectors reporting are Consumer Discretionary (37 percent),

F. Reporting on Impact

An investor concerned with maximizing both financial return and social or environmental impact will want better data on the impact generated by individual companies or funds. In 2011, B Lab launched the Global Impact Investing Rating System (GIIRS) to create a ratings and analytics approach to assessing the social and environmental impacts of companies and funds.²²² GIIRS gives a company an overall rating and also impact ratings in four impact areas—governance, workers, community, and environment.²²³ Questions concerning the four impact areas are weighted depending on the type of impact the company seeks to make.²²⁴ That is, if the company seeks to have a social impact by training and hiring hard-to-employ workers, that category of questions would be weighted more heavily. Funds and individual investors can use GIIRS ratings as additional information in selecting companies. A fund can also obtain a rating for itself. B Analytics, which operates the GIIRS ratings, describes the ratings as “the gold standard for funds that manage their portfolio’s impact with the same rigor as their financial performance.”²²⁵

Another tool for comparing social and environmental impacts of companies is the Impact Investing Benchmark. Cambridge Associates and the Global Impact Investing Network

Consumer Staples (14 percent), Energy (14 percent), Finance (47 percent), Health Care (12 percent), Industries (59 percent), Information Technology (20 percent), Materials (36 percent), Telecommunication Services (9 percent), and Utilities (16 percent).

221. A European Union directive requires approximately six thousand companies to report ESG information annually, beginning in 2017. See *EU Non-Financial Reporting Directive—How Companies Make the Most Out of It*, CLIMATE DISCLOSURE STANDARDS BOARD: NEWS (Sept. 27, 2016), <https://www.cdsb.net/mandatory-reporting/614/eu-non-financial-reporting-directive-%E2%80%93-how-companies-make-most-out-it> [<https://perma.cc/AD4R-QYNF>].

222. RODIN & BRANDENBURG, *supra* note 35, at 58–60; Beth Richardson, *Sparking Impact Investing through GIIRS*, STAN. SOC. INNOVATION REV. (Oct. 24, 2012), https://ssir.org/articles/entry/sparkingimpact_investing_through_giirs [<https://perma.cc/39YD-GRUJ>].

223. Richardson, *supra* note 222.

224. *Id.* at 59.

225. *GIIRS Funds*, B ANALYTICS, <http://b-analytics.net/giirs-funds> (last visited Jan. 27, 2019) [<https://perma.cc/2NDB-GE88>].

(GIIN) developed the benchmark in 2015.²²⁶ The benchmark collects data from private equity and venture capital funds that target risk-adjusted, market-rate returns.²²⁷ This benchmark is one of several tools developed by the GIIN to improve impact investing practices.²²⁸ The GIIN works with investors on impact measurement and management,²²⁹ using the Impact Reporting and Investment Standards (IRIS) performance metrics, which can be used to measure social, environmental, and financial performance.²³⁰ As discussed earlier, the benchmark's focus on funds that target market-rate returns restricts the types of impact-investing activities that are included.²³¹

G. Importance of Adequate Reporting for a Prudent Investor

As discussed in more detail in Part V, a prudent investor should consider material information relevant to potential investments. The development of the reporting tools described in this Part should enable companies to provide better information for investors to consider. As more companies use the tools, standardization in reporting should improve. Although many companies currently report on sustainability in some form,²³² standardization will make the reporting more useful to investors who seek to compare potential investments. Determinations of materiality should also become more consistent, making pertinent information easier to assess.

226. AMIT BOURI ET AL., INTRODUCING THE IMPACT INVESTING BENCHMARK (2015), http://www.thegiin.org/binary-data/Introducing_the_Impact_Investing_Benchmark.pdf [<https://perma.cc/6HJB-9T64>].

227. *Id.* at 1–2.

228. The GIIN was established in 2009. See JANE REISMAN & VERONICA OLAZABAL, ROCKEFELLER FOUNDATION, SITUATING THE NEXT GENERATION OF IMPACT MEASUREMENT AND EVALUATION FOR IMPACT INVESTING 6 (2006), <https://www.rockefellerfoundation.org/report/situating-next-generation-impact-measurement-evaluation-impact-investing/> [<https://perma.cc/YG3C-F48H>].

229. *Impact Measurement and Management*, GLOB. IMPACT INVESTING NETWORK, <https://thegiin.org/imm> (last visited Nov. 18, 2018) [<https://perma.cc/Z96F-G9EM>].

230. IRIS, GLOB. IMPACT INVESTING NETWORK, <https://iris.thegiin.org> (last visited Nov. 18, 2018) [<https://iris.thegiin.org>]. See REISMAN & OLAZABAL, *supra* note 228, for more information about IRIS and a discussion of some challenges with using the IRIS metrics.

231. See *supra* Section II.D.

232. See *supra* notes 192–207 and accompanying text.

IV. THE FINANCIAL CASE FOR LONG-TERM INVESTING

Financial analysts are beginning to identify a problem with Modern Portfolio Theory and the related attention to quarterly data and short-term returns. Their concern has significance for all investors but raises particularly important issues for fiduciaries. Before turning to a discussion of fiduciary duties, this Part explains the case for a long-term approach to financial decision-making.

In 2006, Lawrence D. Fink, the CEO of BlackRock, sent a letter to the CEOs of S&P 500 companies and large European corporations, pointing to the need for long-term strategies.²³³ Fink urged these corporate leaders to create and “lay out for shareholders each year a strategic framework for long-term value creation.”²³⁴ He wrote, “Today’s culture of quarterly earnings hysteria is totally contrary to the long-term approach we need.”²³⁵ Fink added that he had heard “more and more discussion around how to foster a long-term mindset” and encouraged companies to help by changing policies and practices.²³⁶

As Fink observed, financial analysis of companies, and the companies themselves, suffer from short-term thinking. When analysts and managers focus on quarterly statistics, they may discount material, long-term information.²³⁷ Further, the compensation incentives for both analysts and managers focus on short-term returns, encouraging the short-term focus.

Short time horizons cause companies to focus less than they should on the development of long-term value. Companies face pressures to maximize short-term profit at the expense of long-term value and are pushed to emphasize short-term improvements in quarterly reports. The success of corporate executives often depends on the short-term financial record of their companies. A survey of corporate executives and board members found that 79 percent felt “pressure to deliver financial results in two years or less.” Yet 86 percent of them

233. Turner, *supra* note 4.

234. *Id.*

235. *Id.*

236. *Id.*

237. See THE NETWORK FOR SUSTAINABLE FINANCIAL MARKETS, SUBMISSION TO MEMBERS OF THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES 2 (2017) (“Dominance of short-term thinking in the financial system and society has created a dysfunctional ‘tragedy of the horizons’ phenomenon that can make even critically important information appear immaterial.”).

reported that they believed a longer time horizon for business decisions would improve corporate performance by strengthening longer-term financial returns and increasing innovation.²³⁸

Observers of financial markets have raised concerns about short-term thinking as it relates to building value in companies²³⁹ and as it relates to investment decision-making.²⁴⁰ A 2016 survey conducted by State Street Bank reported that a majority of retail investors view the ability to obtain long-term gains as more important than short-term outperformance.²⁴¹ Further, investors are increasingly aware that longer time horizons are needed for the benefits of using ESG factors to accrue. The survey reported that 75 percent of institutional investors expected outperformance from ESG factors in three years or more, and 45 percent expected outperformance in five years or more.²⁴²

Jim Hawley and Jon Lukomnik²⁴³ argue that the dominance of MPT has led to short-term trading activity and short-term evaluation of fund managers and funds.²⁴⁴ They explain that MPT focuses on “alpha” (specific risk and return) and incorporates the idea that an investor cannot affect “beta” (systemic and non-diversifiable risk and return). Systemic risks affect the market as a whole and include things like climate

238. CLARK ET AL., *supra* note 3, at 11 (quoting J. BAILEY ET AL., FOCUSING CAPITAL ON THE LONG-TERM. SHORT-TERMISM: INSIGHTS FROM BUSINESS LEADERS, MCKINSEY AND COMPANY AND CANADA PENSION PLAN INVESTMENT BOARD (CPPIB) (2014)).

239. An article posted on Harvard’s Corporate Governance Law Blog encourages corporate boards to consider sustainability policies and practices because these measures can build long-term value for companies. Steven B. Stokdyk & Joel H. Trotter, *How Directors Can Use Sustainability to Drive Value*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Apr. 5, 2017), <https://corpgov.law.harvard.edu/2017/04/05/how-directors-can-use-sustainability-to-drive-value/> [<https://perma.cc/6LVL-HDT9>].

240. Jim Hawley & Jon Lukomnik, *The Long and Short of It: Are We Asking the Right Questions?* (working paper, 2017) (on file with author) (explaining that MPT has led to an increase in shorter investment time frames).

241. *Id.* Fifty-nine percent of individual investors thought achieving long-term (more than three years) gains is very important or important, while 34 percent thought short-term (less than one year) market outperformance was important.

242. ECCLES & KASTRAPELI, *supra* note 7, at 9.

243. Jim Hawley is Professor, School of Economics and Business Administration, and Director of the Elfenworks Center for the Study of Fiduciary Capitalism at Saint Mary’s College. Jon Lukomnik is managing partner of Sinclair Capital and program director for the IIRC Institute.

244. Hawley & Lukomnik, *supra* note 240, at 24.

change, political instability, income inequality, and global financial crisis.

Hawley and Lukomnik then explain that that the success of MPT has changed the market itself. When Markowitz developed MPT, investors were predominately individuals, and institutions owned about 8 percent of the U.S. equity market. In contrast, by 2017 institutions owned more than 78 percent of the U.S. market.²⁴⁵ Hawley and Lukomnik argue that the dominance of institutional investors means that decisions by the investors will affect systemic risk (beta) in ways unanticipated by Markowitz.²⁴⁶

MPT continues to wield significant influence, but Hawley and Lukomnik argue that—contrary to the ideas of MPT—systemic risks can be addressed by investors. The MPT focus on alpha has led to short-term thinking in investment decision-making, whereas Hawley and Lukomnik posit that beta has more impact on risk and return.²⁴⁷ Raj Thamotheram and Maxime Le Floch²⁴⁸ agree, especially with respect to long-term value in funds. They explain, “[A]lthough most of a fund’s ability to meet its long-term liabilities is due to beta, most funds spend the vast bulk of their resources—financial resources but also, more importantly, management time—on alpha.”²⁴⁹

Systems-level strategies consider environmental, social, and financial resources that are shared and used to produce long-term value. These resources are things held in common, such as clean air and water, human rights, and political and financial stability. The ability of investors to generate long-term returns will depend on the stability of these systems.

245. *Id.*; see also Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014) (explaining that money managers “control most of the investments belonging ultimately to ordinary Americans who are saving to pay for their retirements and for their children’s education”).

246. Hawley & Lukomnik, *supra* note 240; see Posner & Langbein, *supra* note 12, at 77–80 (describing MPT and explaining systemic risk).

247. Hawley & Lukomnik, *supra* note 240, at 20.

248. Raj Thamotheram is CEO of Preventable Surprises and a visiting fellow at the Smith School of Enterprise and the Environment, Oxford University. Maxime Le Floch is an investment analyst specializing in ESG issues for a large asset manager, and he is the cofounder of Preventable Surprises, a project proposing ways to trigger systemic change in finance through institutional investors.

249. Thamotheram & Le Floch, *supra* note 120, at 72.

Investors can help to preserve and improve these systems while creating value and minimizing risk.

Steve Lydenberg of the Investment Integration Project has created guidelines for incorporating systems-level considerations into investment decision-making.²⁵⁰ He advocates focusing on a limited number of issues of systems-level importance that have substantial, long-term financial implications.²⁵¹ His guidelines recommend that an issue for consideration be one around which there is *consensus* about the importance of the issue, one that has *relevance* for affecting the financial performance of most investors and asset classes, one that is *effective* in that the investors will have the ability to minimize risks or maximize rewards by influencing the functioning of a system, and one that has the potential to create difficult-to-predict disruptions at a systems level and therefore involves *uncertainties*.²⁵² Lydenberg provides six examples of issues that meet these four guidelines: climate change, access to fresh water, societal well-being (poverty alleviation and access to healthcare), dignity (human and labor rights), stability and credibility of markets and financial systems, and transparency of sustainability data.²⁵³

A related aspect of systems-level thinking, but one more directly tied to individual companies' performances, is the forced internalization of costs that have been externalized in the past. For example, clean water is a systems-level issue. In the past, companies could use water in production and release contaminated water without financial consequence. The cost of cleaning the contaminated water was paid by taxpayers or by another private entity that needed to clean the water to use it. Regulations on emissions of pollutants force companies to internalize some of these costs. Water shortages will affect a company's ability to use the water it needs or will increase the cost of water.

250. Steve Lydenberg, *Systems-Level Considerations and the Long-Term Investor: Definitions, Examples, and Actions*, INV. INTEGRATION PROJECT (2017), https://tiiproject.com/wp-content/uploads/2017/03/Systems_Level_Considerations_Long_Term_Investor.pdf [<https://perma.cc/4ACW-548U>].

251. *Id.* at 5.

252. *Id.* at 6–8.

253. *Id.* at 9–14.

Many systems-level issues reflect costs that have not yet been internalized.²⁵⁴ Climate change brings with it costs of rising ocean levels²⁵⁵ and damaging weather events.²⁵⁶ Carbon emissions affect climate change, but to a large extent a company can emit carbon without direct cost to the company. The costs of emissions that are currently externalized may in the future be internalized through government regulation or taxes, but the risk of increased internalized costs may not be reflected in conventional financial metrics. The costs of climate change may also be internalized abruptly if climate events cause damage to business assets, breaks in supply chains, the destruction of resources needed for a business activity, or limitations on business activity.²⁵⁷ Understanding these risks is important for

254. See Georges Dyer, *Why Intentionally Designed Endowments Matter for Business*, GREENBIZ (Mar. 19, 2015, 1:00 AM), <https://www.greenbiz.com/article/why-intentionally-designed-endowments-matter-business> [<https://perma.cc/MH6L-4UTK>].

255. Gregory Unruh, *Coastal Cities Are Increasingly Vulnerable, and So Is the Economy that Relies on Them*, HARV. BUS. REV. (Sept. 7, 2017), <https://hbr.org/2017/09/coastal-cities-are-increasingly-vulnerable-and-so-is-the-economy-that-relies-on-them> [<https://perma.cc/SH8Z-R7FE>] (describing low-lying coastal cities as “stranded assets”). Unruh describes the effect rising sea levels will have on Miami and points out that, in addition to losses for individual homeowners and businesses, the consequences of the loss of coastal real estate in Miami and of Miami itself “will reverberate through the economy, through society and through the political landscape.” *Id.*; see also Robbins, *supra* note 56, at 2 (“In 2016, the Sustainability Accounting Standards Board released a report that 72 out of 79 of the U.S.’s industries, representing \$27.5 trillion or 93 percent of the U.S. capital markets, are significantly affected in some way by climate risk.”)

256. See Mark Carney, Governor of the Bank of Eng., Chairman of the Fin. Stability Bd., Speech for Lloyd’s of London: Breaking the Tragedy of the Horizon – Climate Change and Financial Stability 7 n.15 (Sept. 29, 2015), <https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability.pdf> [<https://perma.cc/4MC3-FCKF>] (citing a Lloyd’s report that estimated that the sea level rise since the 1950s increased insured losses from Superstorm Sandy by 30 percent in New York).

257. See Rust, *supra* note 10. Rust states: “Although having been on some investors’ minds for a while—the Institutional Investors Group on Climate Change was founded in 2001—climate change has shot up the agenda as a relevant investment consideration.” *Id.* (citing MERCER, INVESTING IN A TIME OF CLIMATE CHANGE (2015) <https://www.mercer.com/content/dam/mercerc/attachments/global/investments/mercerc-climate-change-report-2015.pdf> [<https://perma.cc/BR2J-GFW5>]). She describes many factors leading to the increased interest, including the development of the stranded-asset theory on fossil fuels and Mercer’s 2015 report, “Investing in a Time of Climate Change,” that analyzed the impact of climate change on asset class returns. *Id.*

businesses and for investors who want to understand the long-term value of the businesses.²⁵⁸

A shift from short-term, quarterly analysis of companies to longer-term analysis will benefit investors and the companies themselves. The long-term benefits of a company's E, S, and G factors seem to be the reason that studies showing positive results for ESG integration are those conducted over a longer timeframe.²⁵⁹ Executives recognize the need for longer-term thinking but feel constrained by the emphasis on quarterly reports. If investors and analysts shift to longer-term thinking, the companies' performances may improve, and external, systems-level benefits can be generated.

V. APPLICATION OF FIDUCIARY DUTIES TO ESG INTEGRATION

A fiduciary managing assets for someone else must comply with fiduciary duties,²⁶⁰ including the duties of obedience, loyalty, care or prudence, and impartiality. This Part considers how these duties apply to the use of ESG integration in investment decision-making.

A. *Duty of Obedience*

A fiduciary must be obedient to the terms establishing the fiduciary's authority.²⁶¹ For example, the person creating a trust typically executes a trust instrument that provides in-

258. See DEUTSCH ASSET MANAGEMENT, SUSTAINABLE FINANCE REPORT, ISSUE 2 (June 2017) (explaining in detail the financial risks associated with climate change). With respect to carbon prices, the report states, "Investors should be prepared for rapid policy changes and the possibility of an abrupt repricing of asset valuations." *Id.* at 13.

259. See Blanchett, *supra* note 77, at 102 (explaining that an SRI investor must take a long-term perspective because the short-term performance of SRI funds can vary materially when compared with non-SRI peers).

260. Fiduciaries hold legal title to the assets they manage, but they manage the assets for others and not for themselves. To protect the interests of the beneficiaries, the law developed fiduciary duties to guide and direct the fiduciaries. See RESTATEMENT (THIRD) OF TRUSTS ch. 15, Specific Duties of Trusteeship, intro. note (AM. LAW INST. 2007). Fiduciary duties developed in trust law and apply to anyone acting in a fiduciary capacity. See *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 (2015) ("We have often noted that an ERISA fiduciary's duty is 'derived from the common law of trusts.'").

261. RESTATEMENT (THIRD) OF TRUSTS § 76 (AM. LAW INST. 2007). For a thorough analysis of the duty of obedience, see Rob Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43 (2008).

structions for the trustee, and the trustee must follow these terms of the trust. Similarly, the governing instruments of pension plans and charities provide guidance to their fiduciaries. The fiduciaries must comply with any directions concerning the purposes of the trust, plan, or charity, and must also comply with any specific instructions concerning investment decision-making. Although directions concerning investments have not been common, people concerned with environmental and social issues may include investment guidance when they create private trusts.²⁶² If so, then the fiduciary must comply with those instructions.

B. *Duty of Loyalty*

Under trust law, a trustee must act in the “sole interests” of the beneficiaries,²⁶³ and other fiduciaries—the directors of a nonprofit corporation, for example—must act in the “best interests” of the beneficiaries.²⁶⁴ Either way, the duty of loyalty requires that the fiduciary not consider the fiduciary’s personal interests in making decisions for the beneficiaries. The trustee should have “undivided loyalty” and consider only the interests of the beneficiaries in making decisions.²⁶⁵

The duty of loyalty involves concern over conflicts of interests and self-dealing because the fiduciary controls the assets and could easily make decisions to garner a private benefit. For example, investing trust assets in a company owned or controlled by the fiduciary might benefit the fiduciary rather than the trust’s beneficiaries.²⁶⁶ Further, even if the fiduciary will not

262. Susan N. Gary, *Feel Good Doing Good: Impact Investing when Settlers and Beneficiaries Want to Do More than Make Money* 51 U. MIAMI, PHILIP E. HECKERLING INSTITUTE ON EST. PLAN. 16-2 (2017).

263. RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. LAW INST. 2007).

264. RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 2.02 (AM. LAW INST., Tentative Draft No. 1, 2016).

265. John H. Langbein, *Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005). Exceptions permit fiduciaries to engage in conflict-of-interest transactions that are in the best interests of the beneficiaries. See UNIF. TRUST CODE § 802(b) (amended 2010) (stating that transactions authorized by the terms of the trust, by all beneficiaries, or by a court do not violate the duty of loyalty).

266. Transactions with close family members or associates are restricted, and transactions with more distant family members will be considered a breach of trust if the trustee was improperly influenced by the family members. RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. e (AM. LAW INST. 2007).

benefit personally, the fiduciary cannot make decisions based on the fiduciary's personal preferences or the interests of anyone other than the beneficiaries if doing so would cause the fiduciary to make decisions not in the beneficiaries' interests.²⁶⁷ A fiduciary's decisions about investments must always be consistent with the interests of the beneficiaries, so an understanding of their interests may affect the fiduciary's duties.

In a private trust, an asset might have both financial and nonfinancial benefits. For example, a settlor (the creator of a trust) might have transferred a family farm into trust with the intention that the farm remain in the family for future generations. The farm might produce income for the trust, but the highest and best use of the property as an investment asset could be to sell the farm to a developer planning a new housing development. The trustee, however, is not required to sell the farm, even if selling and reinvesting would yield a higher financial return. If the settlor's wishes that the farm stay in the family were known and memorialized in the terms of the trust, then the trustee might be in breach of the duty of obedience if the trustee sold the farm. Even if the settlor had not specified that the farm should stay in the trust, if the beneficiaries have a special interest in the farm, perhaps because they grew up there or visited grandparents there, then the trustee can, and should, consider that interest in deciding whether to sell the farm.²⁶⁸

For a charity, the fiduciary's duty of loyalty is owed to the mission of the charity rather than to individual beneficiaries.²⁶⁹ The charity may properly consider its mission in making investment decisions.²⁷⁰ That is, the charity may

267. *Id.* at cmt. f.

268. UNIF. PRUDENT INVESTOR ACT § 2(c)(8) (1994) (directing a trustee to consider "an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries"); *see, e.g., In re Trust Created by Inman*, 693 N.W.2d 514 (Neb. 2005).

269. For an explanation of mission-related investing by charities, see Gary, *supra* note 74.

270. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. c (AM. LAW INST. 2007). The comment states:

[S]ocial considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.

engage in mission-related investing, choosing investments based on two purposes: financial return and mission-related benefits. Because the mission-related benefits are considered part of the return of the investments, a charity may choose investments that align with its mission, even if the resulting return is less than the return the charity might obtain with other investments.²⁷¹ Of course, a charity may limit mission-related investments to those that meet market benchmarks.

A Treasury Notice issued in 2015 supports the view that mission-related investing complies with fiduciary duties, even if the returns are below-market.²⁷² The Notice applies to mission-related investing by private foundations, but the analysis relies on state standards that apply to charities more broadly.²⁷³ The Notice fills the gap between investments made primarily for program purposes, and therefore qualified as program-related investments under the tax rules, and investments made solely for financial return.

The Internal Revenue Code provides a special rule for “program-related investments,” defined as investments made primarily for mission-related purposes.²⁷⁴ The exception is necessary for private foundations because a manager of a private foundation may face penalties if investments jeopardize the purpose of the foundation as a result of the manager’s “fail[ure] to exercise ordinary business care and prudence.”²⁷⁵ The jeopardizing-investment rule focuses on the financial return the investments should have yielded. The exception for program-related investments took care of investments made primarily for mission-related purposes, but uncertainty existed for investments that were related to mission but were not made *primarily* to carry out the charity’s mission. The Notice clarifies that managers of private foundations who exercise “ordinary business care and prudence” in making investment decisions will not violate the jeopardizing-investments rule if the investment carries out the purpose of the charity.²⁷⁶ Even if the return on the investment is less than the return that a non-

271. *Id.*

272. I.R.S. Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).

273. *Id.* (pointing out that the standard it sets out “is consistent with investment standards under state laws”).

274. I.R.C. § 4944(c) (2012).

275. Treas. Reg. § 53.4944-1(a)(2)(i) (1973).

276. I.R.S. Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).

mission-related investment would have produced, the investment will not be considered a jeopardizing investment.²⁷⁷

Although this Article will not discuss the implications of impact investing for all fiduciaries, for a charity, an impact investment that aligns with the charity's mission will be consistent with the fiduciary duties of the charity's managers. A charity can engage in impact investing with an impact-first strategy, looking for investments that help carry out its mission while generating some financial return. A below-market return will not cause a breach of a manager's fiduciary duties if the impact serves the purpose of the charity.

Some assets have a special relationship to the beneficiaries or the purposes of a charity, but even without that special relationship, a fiduciary may wonder whether the fiduciary can or should consider interests of the beneficiaries other than financial interests. Nothing in the statutes or the Restatements state directly that a fiduciary may consider only financial interests, yet the duty has been construed that way.²⁷⁸ Fiduciaries and beneficiaries may wonder about interests beyond financial interests. For example, an argument can be made that investing to reduce the impact of climate change will be in the best interests of all beneficiaries²⁷⁹ given predicted widespread adverse effects of climate change. Fiduciaries will have different views on the best strategies related to climate change, just as fiduciaries have different views about the best strategies to maximize financial returns, but it may be that "best interests" should be interpreted to mean more than financial interests. With respect to ESG integration, such a question need not be answered because ESG integration falls squarely within the prudent investor standard and does not implicate the duty of loyalty.²⁸⁰ For that reason, the scope of the best-interests standard will not be addressed in this Article.

The concern over whether any form of SRI is a breach of the duty of loyalty arose in the early years of SRI, when little data existed about SRI fund performance and SRI index funds

277. *Id.*

278. See Posner & Langbein, *supra* note 12.

279. A terminally ill beneficiary might not face the effects of climate change directly, but she might be concerned about her own children or the future of the country or planet more generally.

280. See *infra* Section V.C.

did not exist. The comments to the Uniform Prudent Investor Act contain a cautionary statement:

No form of so-called “social investing” is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.²⁸¹

As the reports cited in this Article have demonstrated, SRI, and especially ESG integration, do not involve a necessary cost. The choice of manager or the decision between using an index fund or an actively managed fund may affect returns, but a decision to consider ESG information does not necessarily result in accepting below-market returns. Indeed, growing evidence suggests that ESG information may improve returns, especially when a longer time horizon is considered.

C. Duty of Care or Prudence

The duty of care²⁸² is the fiduciary’s duty to manage assets with “reasonable care, skill and caution.”²⁸³ The duty encompasses the prudent investor standard, which is the duty to act as a prudent investor with respect to the investment assets managed by the fiduciary.²⁸⁴ The fiduciary must take into consideration the interests of the beneficiaries and the purposes of the fund in making investment decisions.²⁸⁵

281. UNIF. PRUDENT INV’R ACT § 5 cmt. (UNIF. LAW. COMM’N 1994).

282. This duty has been historically called the duty of care, and this Article will continue to use that term. *See* RESTATEMENT (SECOND) OF TRUSTS: DUTY TO EXERCISE REASONABLE CARE AND SKILL § 174 (AM. LAW INST. 1959). The Restatement (Third) of Trusts now refers to the general duty as the duty of prudence, and provides that the duty “requires the exercise of reasonable care, skill and caution.” RESTATEMENT (THIRD) OF TRUSTS § 77(2) (AM. LAW INST. 2007).

283. RESTATEMENT (THIRD) OF TRUSTS § 77(2) (AM. LAW INST. 2007).

284. *See* RESTATEMENT (THIRD) OF TRUSTS § 77 cmt. a (AM. LAW INST. 2007) (referring to §§ 90–92).

285. A pension plan, endowment, or trust may have assets invested in multiple funds, and different funds may be created with different purposes. If so, then the purposes of the specific fund should be considered. I will use the word “fund” to refer to all the assets held by a pension plan, endowment, or trust.

The first articulation of a fiduciary duty to act as a prudent investor came in 1830 with *Harvard College v. Amory*.²⁸⁶ The Massachusetts Supreme Court created a standard that was more flexible than the legal lists of acceptable investments used at the time, but later interpretations focused on risk avoidance.²⁸⁷ Over the following century, trustees were advised to invest primarily in government and corporate bonds to avoid any risk to principal. Investments in land and new enterprises were considered too risky.²⁸⁸

With the development of MPT in the mid-twentieth century,²⁸⁹ financial analysts created new investment strategies, and the idea of how a prudent person should invest evolved.²⁹⁰ The Restatement (Third) of Trusts adopted a prudent investor rule in 1990, incorporating the basic tenets of MPT.²⁹¹ In 1994, the Uniform Law Commission promulgated a statutory version of the rule, the Uniform Prudent Investor Act (UPIA).²⁹² Influenced by MPT, UPIA directs a prudent trustee to manage risk across the portfolio²⁹³ and emphasizes diversification “unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without

286. 26 Mass. (9 Pick.) 446 (1830). The court explained that trustees should “observe how men of prudence . . . manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.” *Id.* at 461. This famous statement became the foundation of the prudent investor standard. It was either an alternative holding or dictum. See Harvey P. Dale et al., *Evolution, Not Revolution: A Legislative History of the New York Prudent Management of Institutional Funds Act*, 17 N.Y.U. J. LEGIS. & PUB. POL’Y 377, 385 (2014).

287. For a history of the prudent investor standard, including explanations of legal lists and the shift to risk avoidance, see Langbein, *supra* note 1, at 643–45.

288. See RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. e, f (AM. LAW INST. 1959).

289. See *supra* Section II.A (describing Modern Portfolio Theory).

290. For concerns about the pre-UPIA prudence standard, see BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986); Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52 (1987); Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976).

291. The American Law Institute adopted the prudent investor rule in 1990 and published the rule as §§ 227–229 of the Restatement (Third) of Trusts in 1992. The prudent investor rule was renumbered and now appears as §§ 90–92. See RESTATEMENT (THIRD) OF TRUSTS ch. 17, forenote (AM. LAW INST. 2007).

292. UNIF. PRUDENT INV’R ACT (UNIF. LAW COMM’N 1994).

293. *Id.* § 2(b).

diversifying.”²⁹⁴ UPIA directs a trustee to consider many factors, including factors specific to the purposes of the trust and the interests of the beneficiaries, and factors considering current and future economic conditions.²⁹⁵ The statutory language was widely adopted through statutes or case law, and the prudent investor standard now applies throughout the United States. Although UPIA applies directly to trusts, the prudent investor standard applies to any fiduciary investing assets for someone else.²⁹⁶

UPIA was developed as the result of an evolution in finance norms, and the Restatement’s explanation of the prudent investor standard notes the intention to create a flexible standard that will continue to evolve.²⁹⁷ A prudent investor follows industry norms, and as the norms change, the idea of what is prudent changes. UPIA’s built-in flexibility permits the continuing evolution of what it means to be a prudent investor. That evolution now encompasses ESG integration and may also include a longer time horizon for investments.

An Interpretive Bulletin issued by the Department of Labor (DOL) in 2015 reflects the understanding that ESG integration may yield better financial results than other investment strategies and that a prudent investor may want to consider ESG factors.²⁹⁸ The 2015 Bulletin followed a 2008 Bulletin. The wording of the 2008 Bulletin had led to concerns

294. *Id.* § 3.

295. *Id.* § 2(a), (c).

296. *See id.*, prefatory note (“Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.”). For application of the prudence standard to fiduciaries managing charities organized as nonprofit corporations, see UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (UNIF. LAW COMM’N 2006). For fiduciaries managing pensions and employee benefit trusts under the Employee Retirement Income Security Act, see 29 U.S.C. § 1104(a) (2012). For more detailed explanations of the history of the prudent investor rule, see Gary, *supra* note 10, at 254–60; Langbein, *supra* note 1, at 643–45.

297. *See* RESTATEMENT (THIRD) OF TRUSTS ch. 17, intro. note (AM. LAW INST. 2007) (“[T]he rules must be general and flexible enough to adapt to changes in the financial world and to permit sophisticated, prudent use of any investments and courses of action that are suitable to the purposes and circumstances of the diverse trusts to which the rules will inevitably apply.”).

298. Interpretive Bulletin Relating to Fiduciary Standard Under ERISA, 80 Fed. Reg. 65,135 (Oct. 26, 2015) (codified at 29 C.F.R. § 2509) [hereinafter I.B. 2015-01].

that any strategy that considered ESG factors was improper.²⁹⁹ The 2015 Bulletin explains that “fiduciaries should appropriately consider factors that potentially influence risk and return” and that “[e]nvironmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment.”³⁰⁰ The Bulletin states, “In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”³⁰¹

In 2018, the DOL issued a Field Assistance Bulletin providing additional guidance.³⁰² Referring to the 2015 Bulletin, the guidance says that “the Department merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage.”³⁰³ The 2018 Bulletin then explains that “[i]n such situations, these ordinarily collateral issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary along with other relevant economic factors.”³⁰⁴ The guidance confirms that a fiduciary acting under the prudent

299. Interpretive Bulletin 2008-01 stated that consideration of “collateral, non-economic factors” in investment decision-making should be rare and well documented. Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734 (Oct. 17, 2008) (codified at 29 C.F.R. § 2509). This statement resulted in confusion about how to treat ESG factors that have financial implications. I.B. 2015-01 explained that the DOL had become concerned “that the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent.” I.B. 2015-01, 80 Fed. Reg. at 65,136.

300. I.B. 2015-01, 80 Fed. Reg. at 65,136 (explaining that “plan fiduciaries may invest in ETIs based, in part, on their collateral benefits so long as the investment is economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits”). ETIs (economically targeted investments) are investments selected for economic benefits as well as financial returns.

301. *Id.*

302. Memorandum from Bryan L. Jarrett, Acting Admin., Wage & Hour Div., U.S. Dep’t of Labor, to Reg’l Admins., Deputy Reg’l Admins., Dirs. of Enforcement, Dist. Dirs., Nonenforcement Policy with Respect to Service Advisors and the Section 13(b)(10)(A) Exemption Under the FLSA, Field Assistance Bulletin No. 2018-01 (Apr. 23, 2018).

303. *Id.*

304. *Id.*

investor standard *should* consider material ESG factors that have financial impact. Although the Bulletins apply to ERISA plans and not directly to other fiduciary situations, they are useful more broadly because they convey the understanding that ESG integration is not a per se breach of fiduciary duty. The Bulletins recognize that ESG factors may affect the economic value of investments and indicate that a fiduciary need not ignore them.

As explained in Part II, studies show neutral or improved returns for funds using ESG integration. Analysts increasingly consider material ESG factors as part of their financial analysis, and the inclusion of ESG information appears to be a growing practice. Standardized reporting of ESG factors will lead to better information, but even now analysts are using the available information. Given the financial risks inherent in systems-level issues such as climate change and political unrest, a failure to pay attention to ESG factors could result in a portfolio with uncompensated risk. Further, as the benefits of using longer time horizons in investment decision-making become more evident, a prudent investor will want to protect value by looking beyond short-term returns.

Going beyond financial considerations in investment decisions by fiduciaries, Delaware amended its prudent investor statute in 2018, adding the following language:

[W]hen considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries.³⁰⁵

Delaware now recognizes that the "interests" of beneficiaries may include personal values as well as financial interests. The Delaware amendment also added the following to the list of things a settlor of a trust can provide in the trust instrument:

(4) The manner in which a fiduciary should invest assets, including whether to engage in one or more sustainable or

305. S.B. 195, 149th Gen. Assemb., 2d Reg. Sess. § 3302(a) (Del. 2018).

socially responsible investment strategies, in addition to, or in place of, other investment strategies, with or without regard to investment performance;³⁰⁶

The amendment to the Delaware statute reflects the overlap between the duty to act as a prudent investor and the duty of loyalty. If a fiduciary must act in the “best interests” of the beneficiary, then whether “best interests” means more than financial interests will affect how the fiduciary invests. UPIA already directs the fiduciary to consider an asset’s special relationship to the purpose of the trust or the beneficiaries,³⁰⁷ so in some situations fiduciaries already consider more than financial interests. The change in the Delaware statute reflects the view that some beneficiaries may be interested in more than financial return.

D. Duty of Impartiality

A fourth fiduciary duty, the duty of impartiality,³⁰⁸ applies to all fiduciary situations but is of particular importance when funds are held for multiple generations. Most trusts and all pension plans and charities have more than one beneficiary. A fiduciary may be managing assets for multiple beneficiaries with current interests or for beneficiaries with interests that become active at different times. Pension plans, for example, have different generations of participants who will become entitled to distributions at different times. For young participants, the time horizon is long, and even for participants already receiving pension distributions, the time horizon may stretch for many years. Other trusts, both charitable and private, may be created to last in perpetuity, so the time horizon may be quite long.

The duty of impartiality requires fiduciaries to treat different generations of beneficiaries impartially.³⁰⁹ The duty is an extension of the duty of loyalty, which requires the fiduciary to act in the best interests of the beneficiaries, but it recognizes that beneficiaries have competing financial interests in the

306. *Id.* § 3303(a)(4).

307. UNIF. PRUDENT INV’R ACT § 2(c)(8) (UNIF. LAW COMM’N 1994).

308. *See* RESTATEMENT (THIRD) OF TRUSTS § 79 (AM. LAW. INST. 2007).

309. *See id.*

trust.³¹⁰ Thus, the duty does not demand that fiduciaries treat each beneficiary equally, but, depending on the purpose of the trust, plan, or endowment, requires the trustee to consider the different needs of all present and future beneficiaries.³¹¹ For a single-purpose charity, a fiduciary must consider the need for resources in the future as well as currently, because the charity may depend on distributions for its purpose over time.³¹²

The fiduciary's duty of impartiality is of fundamental importance for the investment function³¹³ because in making investment decisions, the fiduciary must consider the needs of future as well as current beneficiaries. An investment strategy that fails to consider long-term risk or that shortchanges future beneficiaries financially may implicate the duty of impartiality. For funds managed for multiple generations of beneficiaries or for a purpose that extends into perpetuity, the problem of short-term thinking raises serious concerns.

One could argue that the fiduciaries could simply maximize short-term returns, and do that over and over, with the assumption that each generation will benefit from successive, short time horizons. However, investments in each short-term time period affect the next short-term period. As Jim Hawley and Jon Lukomnik explain, "the long-term is not simply additive short-term intervals, each of which is unrelated to the previous and the next. Rather it is the linkages of various past and current events to future ones."³¹⁴ If long-term systemic risk has consequences for investors, then fiduciaries who ignore material long-term information may be violating their duty to be prudent investors. Further, if attention to sustainability and corporate governance issues can improve a company's long-term value,³¹⁵ then merely looking quarter to quarter in making investment decisions is not sufficient. Long-term value will be important to a fiduciary concerned about the duty of impartiality.

310. *Id.* § 79 cmt. b.

311. *Id.*

312. *Id.* § 79 cmt. a, h.

313. *Id.* § 90(c)(1). As part of the prudent investor standard, the Restatement directs the fiduciary to "conform to the fundamental fiduciary duties of loyalty (§ 78) and impartiality (§ 79)." *Id.*

314. Hawley & Lukomnik, *supra* note 240, at 19. For additional information on the fiduciary duty of impartiality, see James P. Hawley et al., *Reclaiming Fiduciary Duty Balance*, 4 ROTMAN INT'L J. PENSION MGMT., Fall 2011, at 4.

315. *See supra* Part IV.

In summary, a fiduciary must treat all generations of beneficiaries impartially, must act in the best interests of the beneficiaries and not for the fiduciary's own benefit, and must follow the prudent investor standard in investing assets held by the entity. These three duties interrelate, especially for long-term trusts, pension plans, and endowments.

VI. FIDUCIARY INVESTING AND ESG INTEGRATION

Much has changed in the twenty-five-plus years since UPIA was promulgated as the modern version of the prudent investor standard. New investment strategies incorporate material ESG factors,³¹⁶ and financial analysts increasingly consider ESG factors in analyzing corporate strengths and weaknesses. Studies have shown that ESG integration and other forms of SRI do not necessitate a cost to the investor,³¹⁷ and research has found that corporate responsibility can improve corporate performance.³¹⁸ Long-term investment strategies may better address systemic risk and improve the long-term value of a fund.³¹⁹

How does all of this information from the financial sector affect fiduciary duties related to investment decision-making? The duty to be a prudent investor is part of a collection of duties that affect how a fiduciary makes decisions about investments. A fiduciary must consider financial information as a prudent investor would, and in doing so must consider the interests of all beneficiaries, both current and future. A prudent investor must consider the long-term viability of the trust, pension plan, or endowment. The fiduciary must analyze invest-

316. ESG integration involves using more information, which gives analysts a more complete view of a company's risks and opportunities. As a report produced by State Street Bank explains, improvements in ESG integration as a strategy result in part from the financial industry's "tireless search for better risk and return opportunities in a highly competitive environment." ECCLES & KASTRAPELI, *supra* note 7, at 7.

317. See *supra* Section II.B.

318. See *supra* Section II.C.

319. Although smaller family trusts will have less influence on the systems, the larger pension and endowment funds can play important roles in improving their own risk-adjusted returns while also influencing systems-level issues. The letter from BlackRock's CEO explains that "working . . . to invest in long-term growth remains an issue of paramount importance for BlackRock's clients, most of whom are saving for retirement and other long-term goals, as well as for the entire global economy." Turner, *supra* note 4.

ments and investment strategies based not on what a prudent investor would have done in the 1980s, but on the information available from researchers examining financial tools and understandings today.

Two international reports have concluded that fiduciary duties may require a prudent investor to consider ESG factors.³²⁰ In 2005, the UN Environment Programme Finance Initiative (UNEP-FI) released *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, a report developed by a project team led by a British law firm, Freshfields Bruckhaus Deringer.³²¹ The law firm analyzed fiduciary duties applicable to investment decision-making and concluded that integrating ESG considerations into investment analysis was “clearly permissible” and “arguably required.”³²²

Ten years later, the UNEP-FI joined with Principles for Responsible Investment (PRI) and the Generation Foundation to create the “Fiduciary Duty in the 21st Century” project.³²³ As part of the project, a team analyzed investment practice and

320. In addition, a 2015 study conducted by Eccles and Kastropeli surveyed almost six hundred global institutional investors who were already using ESG factors in their investment process or were planning to do so. ECCLES & KASTRAPELI, *supra* note 7. The survey found that “40 percent of asset owners and 51 percent of asset managers agree or strongly agree that . . . fiduciary duty is shifting toward encouraging or even requiring ESG integration.” *Id.* at 8–9. Of course, the group surveyed represents investors who have already made a decision to use ESG factors, but the responses on fiduciary duty may reflect a growing belief that, as fiduciaries, they should be looking at this information. *See id.* at 35 nn.20–21 (citing additional studies addressing fiduciary duties in connection with ESG investing).

321. ASSET MANAGEMENT WORKING GROUP OF THE UNEP FINANCE INITIATIVE, *A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT* (2005), http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf [<https://perma.cc/XE46-8S5F>] (referred to as the “Freshfields report”).

322. *Id.* at 13. The report concluded:

Conventional investment analysis focuses on *value*, in the sense of financial performance. As we note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.

Id.

323. For an explanation of the project, see *Fiduciary Duty in the 21st Century*, FIDUCIARY DUTY, <https://www.fiduciaryduty21.org> (last visited Nov. 12, 2018) [<https://perma.cc/6PF4-VP6R>].

fiduciary duty in eight countries.³²⁴ The report, released in 2015, concludes that fiduciary duty creates “positive duties” on investors to integrate ESG issues to mitigate risk and identify investment opportunities.³²⁵ The report identifies a number of barriers to increasing the use of ESG factors by fiduciaries, including “outdated perceptions about fiduciary duty and responsible investment,” particularly in the United States.³²⁶ The report emphasizes that “fiduciary duties have played, and continue to play, a critical role in ensuring that fiduciaries are loyal to their beneficiaries and carry out their duties in a prudent manner.”³²⁷ The report then concludes that interpretations of fiduciary duty need to be modernized so that these duties will be relevant to twenty-first century investors.³²⁸ The report also concludes that “[f]ailing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty.”³²⁹

The Fiduciary Duty in the 21st Century project included the development of roadmaps for eight countries. The project released the *US Roadmap* in 2017.³³⁰ The *US Roadmap* makes the case that “the consideration of ESG factors has become one of the core characteristics of a prudent investment process.”³³¹ The *US Roadmap* then notes that “[a] lack of integration of ESG factors into investment processes is emerging as a source of significant legal and financial risk.”³³² It recommends engaging with the lawyers who advise fiduciaries “to raise awareness of ESG integration issues.”³³³ This Article seeks to give U.S. lawyers the information they need to understand ESG integration and the changing nature of what it means to be a prudent investor.

324. RORY SULLIVAN ET AL., FIDUCIARY DUTY IN THE 21ST CENTURY (2015), http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf [<https://perma.cc/TS3N-768A>].

325. *Id.* at 9.

326. *Id.*

327. *Id.*

328. *Id.*

329. *Id.*

330. BRIAN TOMLINSON ET AL., FIDUCIARY DUTY IN THE 21ST CENTURY—US ROADMAP (2017), <https://www.unpri.org/download?ac=4353> [<https://perma.cc/4B26-5VKJ>].

331. *Id.* at 8.

332. *Id.* at 11.

333. *Id.*

CONCLUSION

A fiduciary managing property for a pension, a charity, or a private trust must comply with the fiduciary duties of obedience, loyalty, care or prudence, and impartiality. The fiduciary must carry out the purposes of the trust or entity, must act in the sole or best interests of the purposes or beneficiaries, must administer the trust or entity with care, and must be mindful of the interests of future beneficiaries as well as current beneficiaries. These duties all affect the fiduciary's duty to act as a prudent investor in making investment decisions.

The developments described in this Article affect investment decision-making by fiduciaries because the duty to act as a prudent investor evolves as knowledge about finance, risk, and the factors that affect risk and return changes. Studies have shown that a strategy that uses ESG factors as part of a robust financial analysis—the strategy this Article refers to as ESG integration—does not result in a necessary cost to a portfolio when the portfolio is compared with comparable non-ESG portfolios.³³⁴ ESG integration may even result in improved returns on a risk-adjusted basis, especially over longer time horizons.³³⁵ As long as a strategy does not involve sacrificing financial returns, then even if the duty of loyalty is defined as the duty to act solely in the *financial* interests of the beneficiaries, the duty of loyalty is not compromised by a direction to invest using a strategy that incorporates ESG criteria.

If the use of strategies that consider ESG factors does not result in a financial loss to the trust or entity, the fiduciary must consider whether attributes of ESG integration influence how the fiduciary complies with other fiduciary duties. For a multi-generational trust or any fund with future as well as current beneficiaries, the duty of impartiality requires a fiduciary to consider how decisions affect the long-term value of assets. A shift from a short-term to a long-term time horizon, which ESG integration encourages, should better protect the interests of future beneficiaries. ESG factors can identify long-term risk that may not appear in traditional financial analysis. Thus, a fiduciary for current and future beneficiaries should consider how the investment strategy used protects the interests of the

334. See *supra* Section II.B, C.

335. See *id.*

future beneficiaries and whether ESG integration could provide better results.

With respect to the duty to act as a prudent investor, this Article concludes that the standard has evolved to include consideration of ESG factors as part of an overall financial analysis that uses traditional financial metrics. This evolution of the prudent investor standard is part of an ongoing evolution of a standard based on prudence norms, which have changed over time.

In the early part of the twentieth century, a prudent investor considered the risk of each investment independently and chose conservative investments that preserved the value of the principal. In some states, investments in risky assets like publicly traded stocks were forbidden. After the development of MPT, and influenced by concerns over the effects of inflation, fiduciaries determined that a higher level of risk was necessary to sustain a fund over time. The prudent investor standard evolved to include investments in the stock market, even though stocks involved more risk than bonds, because diversification allowed the fiduciary to manage risk across the portfolio. Over time, fiduciary investments expanded to include even riskier investments, such as hedge funds and venture capital funds.³³⁶

The prudent investor standard continues to adapt to changes in financial knowledge and practice, and the standard now includes consideration of material ESG factors as part of an overall financial analysis. The studies cited in this Article show the increasing interest in ESG integration and its potential for improving investment outcomes.³³⁷ Companies increasingly report on their sustainability efforts and on their corporate responsibility,³³⁸ and the SEC³³⁹ and DOL³⁴⁰ have both responded to interest in ESG factors. Indeed, the SEC concept release reaffirms that Regulation S-K already requires the reporting of *material* environmental and social factors.³⁴¹

336. See generally *supra* Section V.C; Gary, *supra* note 10, at 254–60.

337. See *supra* Section II.B, C.

338. See *supra* Part III.

339. See *supra* Section III.A.

340. See *supra* Section V.C.

341. Regulation S-K says that a company should report environmental and social factors only if material. The concept release points out that, due to greater interest, more such factors are material. See *supra* Section III.A.

ESG integration is not simply a new term for SRI, and does not describe a strategy that focuses on environmental or social impacts without regard to financial factors. Rather, ESG integration combines traditional financial metrics with information concerning a company's environmental, social, or governance behaviors or risks to improve analysis of the company's potential as an investment. When a fiduciary investor understands ESG integration, the conclusion is that prudent investing requires consideration of ESG factors.

The prudent investor standard requires a fiduciary to consider risks that affect the financial assets subject to fiduciary management, and the financial risks of climate change and social upheaval are increasingly relevant to protecting the value of those assets. Corporate social responsibility and corporate environmental responsibility affect the value of companies, so a prudent investor will consider the CR information available about investment assets. As fiduciaries learn more about the availability of information needed to make better decisions and focus on the need to protect the long-term value of the assets they manage, paying attention to ESG information has become the prudent thing to do.

EXHIBIT B

As You Sow Comment Letter
Financial Factors in Selecting Plan Investments
Proposed Regulation (RIN 1210-AB95)

Finance

ESG Stock Resilience Is Paving the Way for a Surge in Popularity

By [Claire Ballentine](#)

March 31, 2020, 9:16 AM PDT

-
- ▶ So far this year 59% of U.S. ESG ETFs are beating S&P 500
 - ▶ Outperformance could spur demand, Bloomberg Intelligence says
-

Investors who piled into ESG stock strategies have beat broader indexes this year, fueling speculation that the strategy of prioritizing companies doing social good will continue to gain adherents well after the current crisis passes.

Most exchange-traded funds focused on companies with above-average marks for environmental, social and governance practices have outperformed this year, according to [research](#) from Bloomberg Intelligence. So far in 2020, 59% of U.S. ESG ETFs are doing better than the S&P 500 Index while 60% of European ESG ETFs have beat the MSCI Europe Index.

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RBC Signs Solar-Power Agreement in a First for a Canadian Bank

BlackRock Says Investors Underestimate Risk of Water Scarcity

The results are a boon for investors who piled into ESG funds in the final few months of the longest bull market in history. Sustainable ETFs added more than \$8 billion in 2019, quadruple the previous year, and another \$4 billion in January. The idea of conscientious investing also got a boost as BlackRock's Larry Fink pledged to put climate at the center of his firm's ethos. With the strategy proving prescient as the S&P 500 swooned more than 30% amid the coronavirus panic, analysts say it's likely to gain in popularity.

"The advantage of ESG companies right now is a perception that they are more likely to take a stakeholder view of their business as opposed to a purely shareholder view of their business," said Dan Russo, chief market strategist at Chaikin Analytics. "Investors are starting to look to the other side of this initial coronavirus situation and maybe looking for the companies that did right by their employees, that did right by their supply chain."

Going Green

ETFs following ESG strategies are still taking in money despite selloff

Source: Bloomberg

On a sector neutral basis, companies with better ESG risk profiles have outperformed those with worse ESG risk profiles since the S&P 500 peaked on Feb. 19, according to analysts at RBC Capital Markets.

ESG ETFs took in \$1.5 billion in March, bringing total assets for the sector to \$19.1 billion, down from its peak of \$20.8 billion in February but still higher than at any point in 2019.

There are still some signs of trouble in the do-good universe. Six of the 10 largest ESG-focused U.S. [mutual funds](#) have underperformed the S&P 500 this year, with the Parnassus Endeavor Fund, for example, down 23% this year compared with a 19% drop for the S&P 500.

But researchers at Bloomberg Intelligence predict that resilience in ESG ETF performance will serve as a catalyst for further demand.

Matt Maley, a strategist at Miller Tabak & Co., agrees.

“It’s investors thinking, we need to do things that are better for everybody, for the whole world, so I’m going to support the companies that are going to help us do that,” Maley said. “People come together in a crisis.”

In this article

[SPX](#)

[S&P 500](#)

[3,239.41](#)

[USD](#)

[+23.78+0.74%](#)

[BLK](#)

[BLACKROCK INC](#)

[575.33](#)

[USD](#)

[+4.71+0.83%](#)

[RY](#)

[ROYAL BANK OF CA](#)

[93.40](#)

[CAD](#)

[-0.32-0.34%](#)

[PARWX](#)

[PARNAS-ENDEA-INV](#)

[36.2500](#)

[USD](#)

[-0.7700-2.0800%](#)

[INDU](#)

[DJIA](#)

[26,584.77](#)

[USD](#)

[+114.88+0.43%](#)

[CCMP](#)

[NASDAQ](#)

[10,536.27](#)

[USD](#)

[+173.09+1.67%](#)

[UKX](#)

[FTSE 100](#)

[6,104.88](#)

[GBP](#)

[-18.94-0.31%](#)

[NK1](#)

[NIKKEI 225 Future](#)

[22,680.00](#)

[JPY](#)

[-10.00-0.04%](#)
[EURUSD](#)
[EUR-USD](#)
[1.1757](#)
[USD](#)
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EXHIBIT C

As You Sow Comment Letter
Financial Factors in Selecting Plan Investments
Proposed Regulation (RIN 1210-AB95)

SUSTAINABILITY MATTERS

Sustainable Funds Weather the First Quarter Better Than Conventional Funds

These funds were helped by a focus on companies with strong ESG profiles and less exposure to energy.



Jon Hale, Ph.D., CFA

Apr 3, 2020



Mentioned: iShares Core S&P 500 ETF (IVV), iShares Core MSCI Emerging Markets ETF (IEMG), iShares Core MSCI EAFE ETF (IEFA), Calvert International Responsible Idx I (CDHIX), IQ Candriam ESG US Equity ETF (IQSU), Green Century MSCI Intl Indx Instl (GCIFX), iShares MSCI USA ESG Select ETF (SUSA)

Editor's note: *Read the latest on how the coronavirus is rattling the markets and what investors can do to navigate it.*

Like all equity funds, sustainable equity funds suffered sudden and large losses during the first quarter of 2020 because of the coronavirus pandemic, but they held up better than conventional funds. Seven out of 10 sustainable equity funds finished in the top halves of their Morningstar Categories, and 24 of 26 environmental, social, and governance-tilted index funds outperformed their closest conventional counterparts.

Sustainable Funds Lost Less Than Their Peer Groups

Based on a comparison of the first-quarter returns of 206 sustainable equity open-end and exchange-traded funds available in the United States with those of their respective categories, sustainable funds performed better on a relative basis.

Bear in mind that sustainable funds do not constitute an asset class of their own; they invest across capital markets. For purposes of peer grouping, Morningstar therefore places them into our standard categories alongside conventional funds that invest in the same parts of the market, defined for equity funds in terms of region, market cap, and investment style (value, blend, or growth).

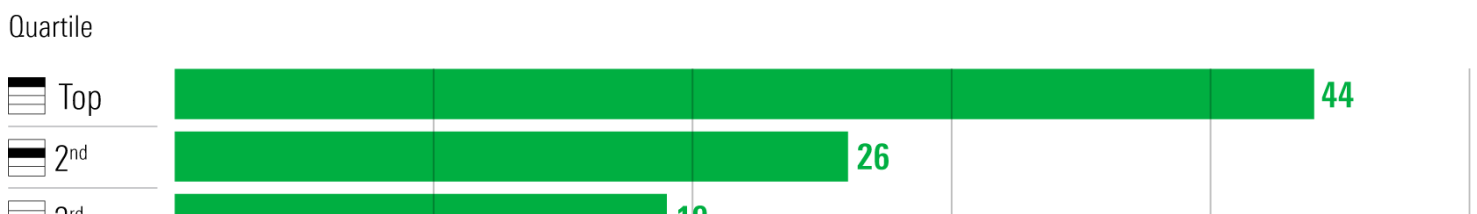
During the first quarter, the returns of sustainable equity funds were clustered in the top halves of their respective categories, and more sustainable funds' returns ranked in their category's best quartile than in any other quartile. The returns of 70% of sustainable equity funds ranked in the top halves of their categories and 44% ranked in their category's best quartile. By contrast, only 11% of sustainable equity funds finished in their category's worst quartile. That's 4 times more sustainable funds finishing in the best quartile than in the worst quartile of their categories.

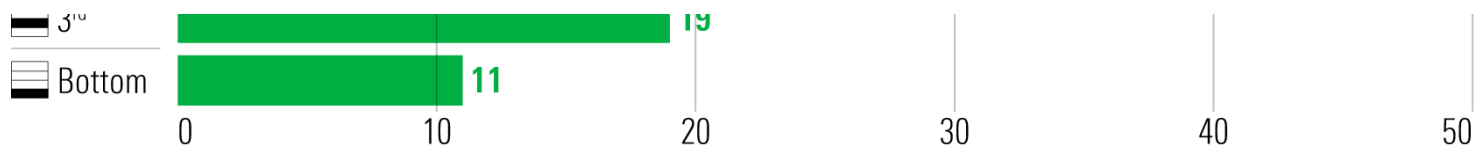


[Worried about market volatility? Morningstar StockInvestor can help.](#)

Sustainable Equity Funds

Q1 2020 Return Rank % By Morningstar Category Quartile





Source: Morningstar Direct. Data as of 3/31/2020. Note: Oldest shareclass used for mutual funds. **N=206**

Based on first-quarter returns, sustainable funds were substantially over-represented in the top quartiles and top halves of their peer groups (by definition, 25% of all funds in a category place in each of four quartiles).

Sustainable Index Funds Lost Less Than Conventional Index Funds

Sustainable index funds are designed as alternatives to conventional index funds across equity markets. Based on a comparison of 26 sustainable index funds with those of conventional index funds covering U.S. stocks, non-U.S. developed-markets stocks, and emerging-markets stocks, 24 of them outperformed the comparable conventional index fund.

U.S.: Among U.S. stock index funds, 10 of the 12 sustainable funds found in the large-blend category lost less than iShares Core S&P 500 ETF (IVV) for the quarter. While IVV lost 19.60%, the average ESG passive fund's return was negative 18.51%.

U.S. Sustainable Equity Index Funds

Ticker	Q1 2020			Sustainability Rating	Carbon Risk (Lower=Better)	Energy %	Selection Effect			
	Total Return	% Rank Category	Technology %				Energy	Technology	Stock	
IQ Candriam ESG US Equity ETF	IQSU	-16.04	5	★★★★★★	4.66	1.14	31.97	0.92	0.59	1.1
iShares MSCI USA ESG Select ETF	SUSA	-17.79	13	★★★★★★	6.25	1.57	27.24	0.41	0.17	1.4
Calvert US Large Cap Core Rspnb Idx I	CISIX	-18.26	16	★★★★★	5.85	0.23	27.53	1.26	0.26	-0.05
iShares MSCI KLD 400 Social ETF	DSI	-18.42	18	★★★★★★	6.31	1.51	30.43	0.39	0.34	0.31
iShares ESG MSCI USA Leaders ETF	SUSL	-18.43	18	★★★★★★	6.54	1.97	26.40	0.17	0.03	0.97
Xtrackers MSCI USA ESG Leaders Eq ETF	USSG	-18.45	18	★★★★★★	6.53	1.98	26.44	0.16	0.03	0.95
Fidelity® U.S. Sustainability Index	FITLX	-18.47	19	★★★★★★	6.54	3.16	24.65	0.13	0.03	0.9
Xtrackers S&P 500 ESG ETF	SNPE	-18.60	20	★★★★★	7.00	3.70	26.38	-0.06	0.16	0.77
iShares ESG MSCI USA ETF	ESGU	-18.89	22	★★★★★	7.21	2.48	26.11	0.05	0.07	0.62
Vanguard ESG US Stock ETF	ESGV	-18.95	22	★★★★★	5.50	1.23	28.06	0.92	0.29	-0.62
Nuveen ESG Large-Cap ETF	NULC	-19.82	41	★★★★★★	7.11	1.74	26.99	0.27	0.07	-0.29
Vanguard FTSE Social Index I	VFTNX	-19.96	44	★★★★★	6.07	2.18	31.01	0.52	0.5	-0.63
Sustainable Index Fund Average	—	-18.51	21	★★★★★★	6.30	1.91	27.77	0.43	0.21	0.45
iShares Core S&P 500 ETF (Conv'l Bmark)	IVV	-19.60	31	★★★★	7.83	2.56	25.45	—	—	—

Source: Morningstar Direct. Data as of 3/31/2020. Note: Oldest shareclass used for mutual funds.

These returns are net of expenses and thus take into account the higher expense ratios of the ESG funds. IVV has an ultralow expense ratio of 0.04%, while the expense ratios of the dozen ESG passive funds range from 0.10% to 0.25%, and average 0.16%.

The top-performing sustainable index funds for the quarter were IQ Candriam ESG U.S. Equity ETF (IQSU), which is based on a proprietary index developed for IndexIQ by European sustainable asset manager Candriam, and iShares MSCI USA ESG Select ETF (SUSA), based on MSCI's ESG Select index series.

Non-U.S. Developed Markets: The story looks even better for sustainable index funds investing outside of the U.S. All 11 passive sustainable funds in the foreign large-blend category outperformed iShares Core MSCI EAFE ETF (IEFA) for the quarter. While IEFA lost 23.52%, the average ESG index fund return was negative 21.63%.

Developed ex-U.S. Sustainable Equity Index Funds

	Ticker	Q1 2020		Sustainability Rating	Carbon Risk (Lower=Better)	Selection Effect				
		Total Return	% Rank Category			Energy %	Technology %	Energy	Technology	Stock
Green Century MSCI Intl Indx Instl	GCIFX	-19.51	10	★★★★★	5.49	0.00	9.86	0.66	0.14	3.15
Calvert International Responsible Idx I	CDHIX	-21.15	17	★★★★	7.63	0.45	11.56	0.58	0.24	1.4
Pax MSCI EAFE ESG Leaders Index Instl	PXNIX	-21.20	17	★★★★★	6.45	0.05	9.26	0.65	0.1	1.44
Xtrackers MSCI EAFE ESG Leaders Eq ETF	EASG	-20.96	17	★★★★★	7.20	2.81	8.34	0.18	0.03	1.76
IQ Candriam ESG International Equity ETF	IQSI	-21.43	18	★★★★	8.06	2.24	8.16	0.27	0.02	1.12
Nuveen ESG Intl Dev Mkts Eq ETF	NUDM	-21.73	21	★★★★	7.74	1.85	5.47	0.34	-0.1	1.17
Xtrackers MSCI ACWI ex USA ESG LdrsEqETF	ACSG	-21.88	22	★★★★	9.17	4.08	10.51	-0.02	0.15	1.93
Fidelity® Intl Sustainability Idx	FNIDX	-22.12	25	★★★★	9.17	4.54	9.37	-0.03	0.14	1.82
iShares ESG MSCI EAFE ETF	ESGD	-22.43	29	★★★★	8.76	4.05	7.75	-0.01	0.01	0.59
Praxis International Index I	MPLIX	-22.64	32	★★★	9.70	4.55	9.20	-0.02	0.1	0.7
Vanguard ESG International Stock ETF	VSGX	-22.91	40	★★★	8.66	1.35	11.18	0.45	0.2	0.72
Sustainable Index Fund Average	—	-21.63	23	★★★★	8.00	2.36	9.15	0.28	0.09	1.44
iShares Core MSCI EAFE ETF (Conv'l Bmark)	IEFA	-23.52	55	★★★	9.66	4.20	7.34	—	—	—

Source: Morningstar Direct. Data as of 3/31/2020. Note: Oldest shareclass used for mutual funds.

As with the comparisons of U.S. funds, these returns are net of expenses and thus consider the higher expense ratios of the ESG funds. IEFA has an expense ratio of 0.07% while the expense ratios of the 11 passive ESG funds range

from 0.14% all the way to 0.98%, and average 0.34%. Five funds have expense ratios between 0.14% and 0.20%.

The top-performing passive international ESG funds for the quarter were Green Century MSCI International Index (GCIFX), a proprietary version of the MSCI World ex USA ex Fossil Fuels Index, and Calvert International Responsible Index (CDHIX), based on Calvert's own proprietary index. While the Green Century fund is the one that has the aforementioned 0.98% expense ratio, it's worth noting that all of the profits earned in managing the Green Century fund go to its environmental nonprofit owners and can be used to support their environmental and public health campaigns.

Emerging Markets: All three emerging-markets sustainable index funds outperformed iShares Core MSCI Emerging Markets ETF (IEMG) for the quarter. They posted an average return of negative 22.82%, outperforming IEMG by 1.58 percentage points. The ESG funds also had to overcome higher expenses (0.20%, 0.25%, and 0.45% compared with IEMG's 0.13%).

Emerging Markets Equity Sustainable Index Funds

	Ticker	Q1 2020			Carbon Risk (Lower=Better)	Energy %	Selection Effect			
		Total Return	% Rank Category	Sustainability Rating			Technology %	Energy	Technology	Stock
Nuveen ESG Emerging Markets Equity ETF	NUEM	-22.42	22	🌍🌍🌍🌍	11.91	2.47	15.74	0.43	-0.04	1.25
Xtrackers MSCI EMs ESG Leaders Eq ETF	EMSG	-22.60	23	🌍🌍🌍🌍	12.50	4.83	15.47	0.20	-0.02	0.73
iShares ESG MSCI EM ETF	ESGE	-23.44	31	🌍🌍🌍🌍	12.77	5.77	18.26	0.08	0.12	1.17
Sustainable Index Fund Average	—	-22.82	25	🌍🌍🌍🌍	12.39	4.36	16.49	0.24	0.02	1.05
iShares Core MSCI Em Mkts ETF (Conv'l Bmark)	IEMG	-24.40	44	🌍🌍	13.91	5.25	16.86	—	—	—

Source: Morningstar Direct. Data as of 3/31/2020. Note: Oldest shareclass used for mutual funds.





Why Did Sustainable Funds Hold Up Better?

Sustainable funds were helped by having less exposure to energy stocks than market indexes. Energy stocks fell more, by far, than those of any other sector during the quarter. The U.S. sustainable index funds, for example, had average energy exposure of 1.9% compared with 2.6% for the S&P tracker IVV. Based on attribution analysis, U.S. sustainable index funds' energy-sector underweightings contributed an average of 0.43% to their outperformance of the S&P 500. Non-U.S. sustainable index funds were also underweight energy,

leading to 0.28% and 0.24% energy-sector selection effects for developed-markets and emerging-markets funds, respectively.

For sustainable equity funds overall, we see in the exhibit below that lower energy exposure is associated with higher returns, based on category rankings.

Impact of Globe Ratings, Energy and Tech Exposure on Q1 Performance

Quartile	% with 4 or 5 🌐's	% with 1 or 2 🌐's	Energy %	Technology %
 Top	85	6	1.89	18.99
 2 nd	71	4	2.02	19.74
 3 rd	60	20	2.01	18.44
 Bottom	64	23	2.68	17.97

Source: Morningstar Direct. Data as of 3/31/2020. Note: Oldest shareclass used for mutual funds. **N=206**

Technology had some impact on sustainable-fund outperformance but a much smaller one than energy. Information technology was the quarter's best-performing sector, and sustainable funds were generally overweight here. This had a positive effect on index fund performance, albeit not of the magnitude of the energy effect, and it applied mainly to U.S. funds. The U.S. sustainable index funds had an average 27.8% technology-sector exposure, compared with 25.5% for the S&P 500-based IVV. Those overweightings contributed an average of 0.21% to their outperformance of the S&P 500, which was about half the energy-sector effect. For non-U.S. sustainable index funds, the technology-sector effects were *de minimus* because technology has a much smaller weighting in those markets' indexes. For sustainable equity funds overall, technology exposure does not appear to be associated with higher returns for the quarter.

Perhaps the biggest reason for their outperformance is that sustainable funds appear to have benefited from selecting stocks with better ESG credentials. A feature of sustainable funds is, of course, their emphasis on companies across

sectors that have performed well on various ESG criteria. These tend to be companies that attend to their environmental challenges, treat their stakeholders well, and govern themselves in an ethical way. Many such companies are proving to be more resilient during the sudden crisis in which we now find ourselves. They are the quality companies of the 21st Century, and quality companies tend to hold up better than their lower-quality counterparts in difficult markets.

Among the sustainable index funds considered here, all but two have Morningstar Sustainability Ratings of 4 or 5 globes, indicating they hold companies with stronger ESG profiles and lower ESG risk. Moreover, we see from the attribution analysis that the average overall stock-selection effect for sustainable index funds was not only positive but also larger than the energy sector-selection effect for U.S. and non-U.S. funds. For U.S. funds, stock selection contributed an average of 0.45% to outperformance. For non-U.S. funds, the stock-selection effect was much greater: 1.44% for developed-markets funds and 1.05% for emerging-markets funds. From the previous exhibit, we also see that sustainable funds with first-quarter returns in the top halves and especially the top quartiles of their categories, tended to be those with better globe ratings.

Short-Term Performance, Long-Term Impact

The better relative performance of sustainable funds in the first quarter derives mainly from their focus on companies that have stronger ESG profiles/lower ESG risk and, secondarily, from their tendency to be underweight energy.

Given the magnitude of the stock market decline in the first quarter, the actual difference between the returns of sustainable funds and conventional funds may seem trivial. But most of the growth of sustainable investing has taken place since the global financial crisis, much of it in just the past five years. That means few sustainable funds have been through the stress test of a bear market until now. In this bear market, they have proved to be decent performers.

But the bigger-picture rationale for sustainable investing is also important to keep in mind in a time like this. It's one that I expect will be strengthened in




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the aftermath of this global pandemic. Yes, sustainable investing is about delivering competitive financial performance on an ongoing basis, aided by the insights of ESG analysis, but it's also about helping companies move toward a more long-term stakeholder-centric model of corporate behavior. That longer-term impact, not short-term performance, is the motivating factor behind sustainable investing. When all is said and done, I think we'll find that companies already moving in that direction will be the ones remembered for helping us get through this crisis, and demand will grow for others to follow suit in the future.

Jon Hale has been researching the fund industry since 1995. He is Morningstar's director of ESG research for the Americas and a member of Morningstar's investment research department. While Morningstar typically agrees with the views Jon expresses on ESG matters, they represent his own views. 

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Jon Hale does not own shares in any of the securities mentioned above. Find out about Morningstar's [editorial policies](#).

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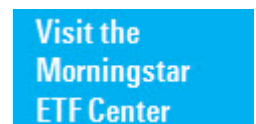


EXHIBIT D

As You Sow Comment Letter
Financial Factors in Selecting Plan Investments
Proposed Regulation (RIN 1210-AB95)

Why using ESG helps you build better portfolios

This document is for the exclusive use of investors acting on their own account and categorised either as “eligible counterparties” or “professional clients” within the meaning of markets in financial instruments directive 2014/65/EU

Welcome



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Francois Millet
Head of Strategy,
ESG and Innovation



Serge Darolles
Professor of Finance
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Why using ESG helps you build better portfolios

Increasingly, investors are integrating ESG considerations into their portfolios. However, there's still a widespread belief that investing sustainably means giving up on potential returns. In this paper, we focus on the role of ESG in portfolio construction and whether adding an exposure to ESG can be as good for a portfolio as it is for the world around us.

In this paper, we examine the following key topics.

Q1: DRIVERS - *What is driving the rise in interest in ESG? How robust is the quality of publicly available ESG-related information and what are the trends in this area? Does it make sense to invest in ESG using a passive approach? Could the rising interest in ESG have an impact on the composition of benchmarks in the future?*

Q2: DEMAND - *How much demand is there for active or passive ESG funds? What do ETF flows tell us about ESG demand?*

Q3: PERFORMANCE - *Does an investment in ESG degrade a portfolio's performance? What kind of biases does a positive ESG screening strategy introduce? Are there factors that work better than others?*

To answer those questions, we use Lyxor expertise and highlight the findings of a recent academic study sponsored by the Lyxor Dauphine Research Academy and arrive at the following conclusions:

An ESG focus does not have to mean compromising on performance

- ▶ Development of ESG is driven both by bottom-up pressure from asset owners and by top-down policy initiatives. More and more investors are now focused on maximising ESG performance subject to risk-return constraints, arguably inverting the traditional investment paradigm of prioritising risk-adjusted returns.
- ▶ Cash flows into ESG funds are accelerating, both for active and passive funds. Passive vehicles, with their strong focus on cost, transparency and a data-driven approach, are entirely consistent with a focus on ESG goals.
- ▶ ESG investors do not have to compromise on performance. A positive screening strategy based on ESG scores can raise the ESG profile of both passive and active portfolios, without reducing risk-adjusted returns.

This is the third in a series of papers from the Lyxor Dauphine Research Academy on the evolution of the asset management industry. In the first paper, published in 2017, we looked at the impact of ETF on the underlying market. In the second paper, published in 2018, we investigated on the role passive funds have left for active funds.

Q1: What's driving the rise in interest in ESG?

Investors see socially responsible investment based on ESG criteria as a way to manage risks better and to generate more sustainable long-term returns.

Financial crises and individual company controversies have shown how harmful it can be to focus on the short term and to neglect shareholder stewardship and the screening of companies based on their governance, environmental and social practices.

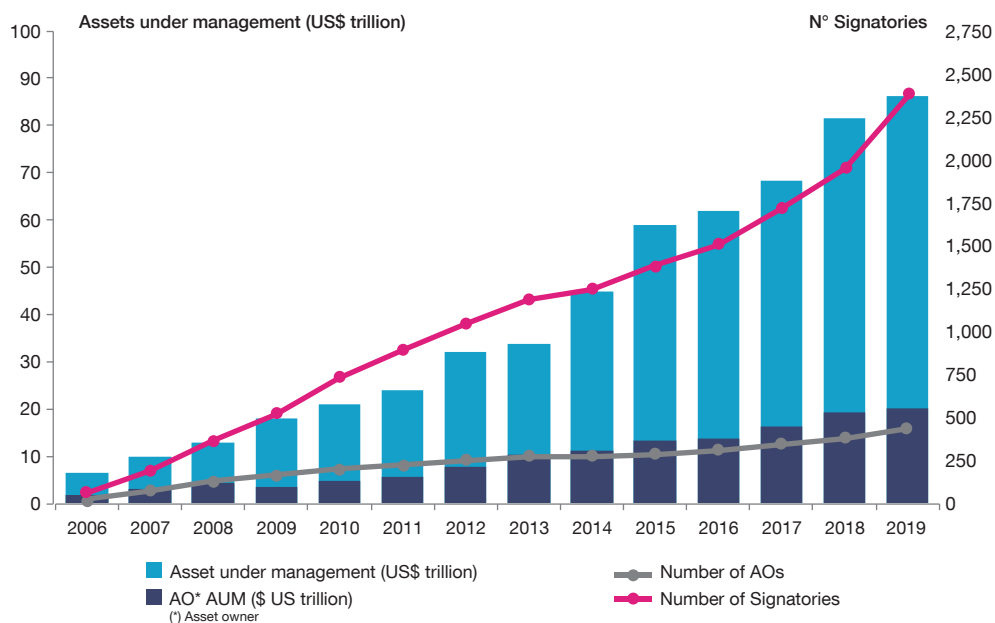
Most investors acknowledge that the devastating effect of climate change or the political and social risks resulting from increased levels of inequality are major threats to society and, ultimately, to financial stability. They understand that supporting the low carbon transition or enabling more sustainable societies is a condition to continue delivering long-term returns for the benefit of all stakeholders.

Investors are additionally being pushed by regulators, such as those in the European Union, who integrate the management and disclosure of ESG risks, alongside market and financial risks, in the fiduciary duty of investment managers and advisors.

The rising interest in ESG can be demonstrated by commitments to the United Nations' Principles for Responsible Investment (PRI), to which most of the world's largest asset managers are now signatories.

Around 2,370 investment institutions, with assets under management of \$86Trn, have demonstrated their commitment to the PRI. That's a huge increase since a decade ago.

PRI Signatory growth



Source: UN PRI, as at end of June 2019.

Important recent political initiatives on sustainability include the agreement reached at the 2015 Paris climate change conference ("COP21"), where 195 countries committed themselves to limit global warming to a maximum of 2 percent above pre-industrial levels.

In many countries, this commitment now underpins national legislations. In France, for example, Article 173 of the law on Energy Transition requires a wide range of investors to report on how they integrate environmental, social and governance factors into their investment policies and on how they are incorporating climate change considerations.

Some of the world's largest pension and sovereign wealth funds have made allocations to ESG-focused strategies during the last few years, while younger investors also prioritise sustainability in their investment allocations: the millennial generation in particular has a very high demand for ESG investment products¹.

How robust is publicly available ESG information?

Publicly available ESG information is becoming richer and more extensive, helping analysts assess the performance of companies according to environmental, social and governance criteria.

The scope of **mandatory ESG disclosure requirements** has steadily been widened in recent years.

For example, under the European Union's Non-Financial Reporting Directive, from January 2017 all listed EU companies with more than 500 employees have had to disclose in their annual reports a variety of information relating to environmental, social and employee matters, respect for human rights and corruption.

Voluntary ESG disclosure requirements, such as the Carbon Disclosure Project (CDP), the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), and the Science-Based Targets (SBT) initiative, are also attracting increased compliance. For example, over 7,000 companies with over \$3.3trn of purchasing power in their supply chains now provide voluntary reports to the CDP.

Meanwhile, **specialised ESG databases** run by governments, NGOs and academic institutions, as well as proprietary **ESG scoring and ratings systems operated by extra-financial agencies**, are also helping investors build a much more granular picture of companies' ESG performance.

Does it make sense to use a passive investment approach for ESG?

Although many ESG investors use an active stock selection approach, passive (index-based) investment approaches are well-suited for ESG. The indices underlying passive ESG strategies can be used to express a variety of different investment approaches, including ESG integration, convictions on sustainability or thematic goals.

Passive investment strategies have democratised access to the financial markets at a low cost, features that are entirely consistent with a focus on ESG goals. And both passive and ESG investment approaches are data-driven.

The overall shift to ESG indices has been massive. For example, MSCI estimates that \$180bn was allocated to its ESG indices between 2014 and Q2 2019.

A remarkable evolution in investment approach has been observed from some large asset owners. For example, institutions like Swiss Re in Switzerland² or AP4³ in Sweden have shifted their whole policy benchmark to ESG indices.

Lyxor expects the role of financial indices in the area of sustainable investing to increase further. Benchmarks are now being used by policymakers as instruments to orient investor choices and to redirect investment flows.

And rather than just serving as a way to measure ESG risks, a new generation of ESG benchmarks is being developed to have a measurable impact: such as helping to meet climate transition goals under the Paris COP21 framework.

1. A 2017 FactSet study of high net worth investors says that 90% of millennials want to direct their allocations to responsible investments in the next five years. See MSCI, 'Swipe Right to Invest: Millennials and ESG', November 2017.

2. https://www.swissre.com/media/news-releases/2018/nr_20180626_swissre_analysis_confirms_esg_benchmarks_make_economic_sense.html

3 <https://www.ap4.se/en/about-ap4/letter-from-the-ceo/>

Q2: How much demand is there for active or passive ESG funds?

Global trends

Worldwide, the Global Sustainable Investment Alliance reports that sustainable investment assets, including both actively and passively managed ESG funds and including ESG integration in traditional investment, reached more than \$31trn at the end of 2018, up 34 percent since 2016. This represents a 39 percent share of global professionally managed assets⁴.

Focusing exclusively on funds whose main objective is ESG related, the global ESG mutual fund industry at the end of June 2019 reached \$2trn, 6% of total assets.

ESG funds represent 39% of global managed assets.

ESG funds in Europe – active, passive or ETF?

Historically, many investors' approach to ESG investing has been active in nature. However, passively managed ESG funds now make up an increasing share of the total.

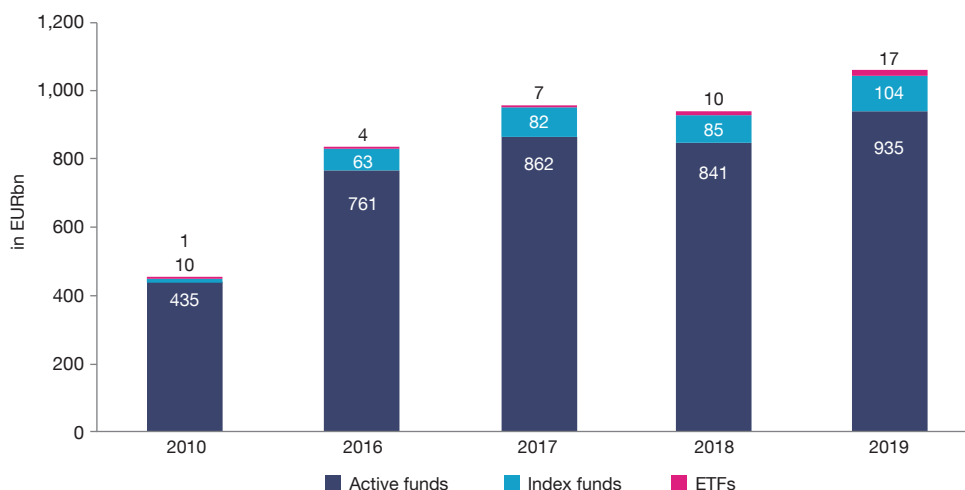
In Europe, for example, assets invested in ESG funds reached €1.1trn at the end of June 2019, based on data from Morningstar. This represented a 12 percent per annum growth rate over the previous 5 years, compared with an 8 percent growth rate for the overall funds industry.

The European fund total can be subdivided into €935bn for active investments in ESG, €104bn for ESG index funds and €17bn for ESG ETFs. Over all, this represents more than 10 percent of total assets under management in Europe, according to Morningstar.

However, while passive funds still have a minority share of overall European ESG fund investments, their growth rate is significantly above that of active funds. Passive ESG fund assets have grown at a rate of 33 percent per annum over the past 5 years, compared with 11 percent for active funds.

In Europe ESG fund assets reached €1.1trn at the end of June, 12% of all assets managed. It is split between 89% active funds and 11% passive funds.

Assets in European ESG funds by management style (€bn)



Source: Morningstar data from 01/01/2010 to 30/06/2019.

Passive funds have grown significantly, at 33% per annum over the past 5 years vs 11% of active funds.

European ESG fund flows

European ESG funds have gathered €306bn of inflows during the past 10 years (ending June 2019): €236bn for active ESG funds, €55bn for ESG index funds and €14bn for ESG ETFs.

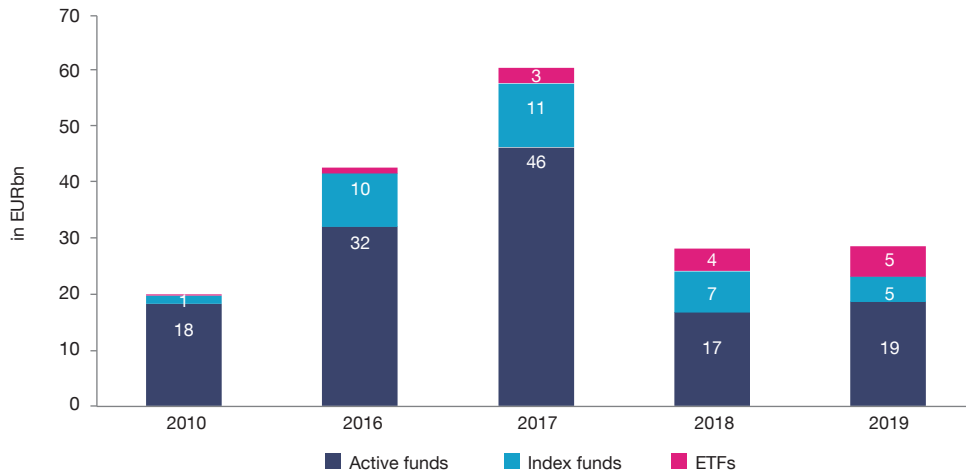
Flows into ESG funds were inconsistent until 2014, when inflows escalated quickly. Starting mid-2014, the annualised 5-year growth rate of net new assets was 90 percent for ESG ETFs, 33 percent for ESG index funds and 30 percent for active ESG funds.

4. Global assets under management totalled \$79.2trn in 2017, according to Boston Consulting Group.

2018 was not the best year for ESG inflows, with only €28bn in inflows, compared to the €50bn yearly average from 2014 to 2017. But so far in 2019, €29bn has already been collected by active and passive investments in ESG.

In summary, the trend of increasing flows into ESG funds is recent, but the growth rate is significant again after a pause in 2018.

Inflows into European ESG funds by management style (€bn)



Source: Morningstar data from 01/01/2010 to 30/06/2019.

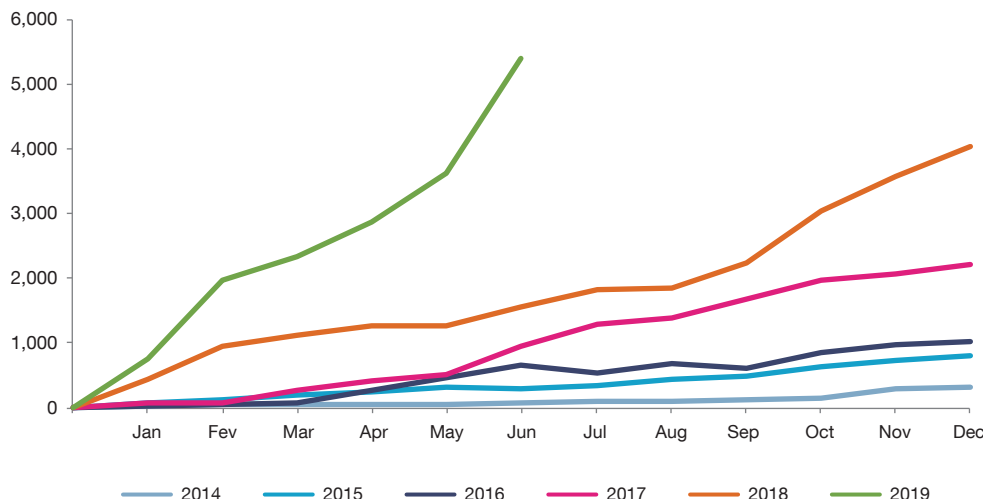
Flows have accelerated, with €29bn in H1 2019, more than the whole of 2018.

Focus: ESG ETF flows in Europe

Responsible investing also commands an increasing share of the European ETF market. In 2018, we saw €4bn of inflows into Europe-listed ESG ETFs, which is equivalent to 9 percent of all flows into the region’s ETFs. The total net purchases were almost double 2017’s inflows of €2.2bn.

So far in 2019, flows have increased even further: H1 inflows into ESG ETFs in Europe were 3 times higher than in the same period a year earlier. By the end of June 2019, ESG ETF net new assets reached €5bn, a record high in the European ETF market.

Cumulative net new assets invested in ESG ETFs in Europe (€m, by year)



Source: Lyxor ETF, Bloomberg, data from 01/01/2014 to 30/06/2019.

At the end of H1 2019, European ESG ETF flows reached a record high of €5bn.

Lyxor expects both active and passive flows into ESG funds in Europe to be sustained, supported by investors’ increasing interest in ESG, as well as by regulation.

For example, in March 2018 the European Commission announced an action plan to finance sustainable growth. Among other considerations, this will compel all investors to include ESG criteria in their investment decisions.

Q3: Do ESG investors have to compromise on performance?

Instead of maximising financial performance from ESG criteria, more and more investors are now focused on maximising ESG performance subject to risk-return constraints.

But does investing sustainably necessarily mean giving up on potential returns? Some researchers have claimed in the past that excluding so-called sin stocks (typically, companies involved in alcohol, tobacco and gambling) from portfolios has exactly this effect.

The Lyxor Dauphine Research Academy sponsored Fabio Alessandrini and Eric Jondeau of the University of Lausanne to look at the link between ESG investing and broader investment performance. Their results are published in a new paper, called 'ESG Investing: From Sin Stocks to Smart Beta'.

What questions did the researchers study?

- ▶ Does an investment in ESG degrade a portfolio's performance?
- ▶ What kinds of biases does a positive ESG screening strategy introduce?
- ▶ Are there some factors that work better than others?

What conclusions did the researchers reach?

- ▶ ESG investors do not have to compromise on performance. A positive screening strategy based on ESG scores can raise the ESG profile of both passive and active traditional and smart beta portfolios, without reducing risk-adjusted returns.
- ▶ A screening strategy based on ESG scores, applied over the past 10 years, has led to substantial geographical and sectoral bets.

How did the researchers reach these conclusions?

- ▶ Using the ESG scores of firms belonging to the MSCI All Country World universe, Alessandrini and Jondeau measured the impact of exclusion strategies on both passive investment and smart beta strategies.
- ▶ They looked at the geographical and industry bets implied by ESG filtering and examined the effects of screening on portfolios' exposure to factors and on the performance of traditional and smart beta portfolios.

The researchers defined the stock universe and the ESG scoring approach

The researchers analysed a broad set of risk and return characteristics for up to 7000 global stocks from the MSCI All Country World Index over the period from January 2007 to December 2018.

Each firm was awarded a score from 0-10 in each of the three ESG 'pillars' or 'dimensions'—environmental, social and governance—as well as a composite ESG score.

These scores showed quite wide variations in different regions and over time.

They then looked at the effect of excluding stocks according to ESG criteria

Alessandrini and Jondeau then looked at the effect of excluding progressively more stocks from the starting universe, depending on their ESG scores.

They did this by reporting the performance statistics of value-weighted portfolios of global, US, European, Pacific, and Emerging country equities, with companies excluded at the following intervals:

- ▶ No exclusions
- ▶ 10 percent of stocks with the lowest overall ESG scores excluded
- ▶ 25 percent of stocks with the lowest overall ESG scores excluded
- ▶ 50 percent of stocks with the lowest overall ESG scores excluded

Taking a portfolio of global stocks as an example, the researchers found (unsurprisingly) that a policy of progressively excluding the worst ESG performers led to an improvement in the average ESG score of the remaining portfolio constituents. However, the risk-return characteristics showed neither an improvement or a deterioration.

The researchers then looked at the effect of screening portfolio constituents according to their environmental, social or governance scores and arrived at a broadly similar conclusion: the improvement observed in the ESG profile of portfolios does not seem to happen at the expense of risk-adjusted performance.

The improvement observed in the ESG profile of portfolios does not seem to happen at the expense of risk-adjusted performance.

They analysed the geographical and industry bets implied by ESG filtering

Alessandrini and Jondeau deliberately used a bottom-up approach unconstrained by industry or by country. This differs from most current approaches by index providers that use industry-relative ratings, and global indices aggregating regions. This allows to highlight key biases resulting from an ESG selection.

We must take care to notice the geographical and industry bets that can arise from such a screening approach, say Alessandrini and Jondeau.

For example, the researchers say, when a progressively higher percentage of firms are excluded from the ESG portfolios, the overall weights of companies based in the US and emerging markets decrease, while more European firms are included.

This reflects the lower absolute ESG scores of firms in the US and emerging markets relative to those based in Europe and the Pacific region, say Alessandrini and Jondeau.

Put another way, the more aggressive the ESG screening approach, the larger the resulting bias towards European and Pacific region stocks, and against US and Emerging markets stocks.

Similarly, progressively excluding stocks with the lowest ESG scores leads to an underweighting of stocks in the financial and energy sectors and an overweighting of stocks in the information technology and industrial sectors, measured relative to the starting portfolio (the MSCI ACWI index).

A more aggressive approach to ESG scores in a global portfolio means: (1) overweighting Europe and underweighting the US and emerging markets; (2) overweighting the IT and industrial sectors and underweighting the financial and energy sectors.

Impact on portfolio performance of excluding firms with the lowest ESG scores, by region*

	ACWI	EM	US	Europe	Pacific
ESG	=	++	+	++	=

*measured by the evolution of the Sharpe ratio when excluding from between 0 to 50% of firms with the lowest ESG Scores: = Neutral impact, + positive impact, ++ very positive impact. Source: ESG Investing: From Sin Stocks to Smart Beta, Alessandrini, Jondeau, June 2019.

For example, excluding 50% of firms with the lowest ESG ratings from a European equity portfolio (represented by the MSCI Europe index) added 0.8% a year in returns over 10 years, while decreasing volatility by around 0.7%. This had the effect of increasing the Sharpe ratio by 0.05 points.

Impact of ESG screening on MSCI Europe index

	MSCI Europe	50% excluded
Annualised returns	3.63%	4.42%
Annualised volatility	18.93%	18.23%
Sharpe ratio	0.15	0.20

Source: ESG Investing: From Sin Stocks to Smart Beta Alessandrini, Jondeau, June 2019.

Thirdly, they examined the effect of ESG screening on portfolios' exposure to factors

The researchers also found that excluding more companies from portfolios according to their ESG scores results in two important factor biases: the average market capitalisation and the average price-to-book value ratio of the firms included in the portfolio usually increase.

Expressed in the language of factors, ESG screening tends to lead to a lower exposure to the size factor premium and to the value factor premium.

Generally speaking, becoming more aggressive on ESG scores means loading on large, profitable, and conservative companies, Alessandrini and Jondeau conclude.



A more aggressive approach to ESG scores in a global portfolio means loading on large, profitable, and conservative companies.



Finally, they examined the effect of ESG screening on smart beta portfolio performances

The researchers also examined the impact of using an ESG filter on the performance of risk factor portfolios. Their observations showed that, in most cases, ESG filtering results in an improvement in portfolio performance, even on a risk-adjusted basis. This is shown by an increase in the Sharpe ratio of most of the smart beta strategies (as shown in the table below).

Impact of excluding firms with lowest ESG score on factor portfolio performance*

	ACWI	EM	US	Europe	Pacific
Quality	+	+	+	+	-
Momentum	+	+	+	+	+
Value	+	-	+	+	+
Size	+	-	+	+	+
High yield	+	+	+	+	+
Low beta	+	+	+	+	+

*measured by the evolution in the Sharpe ratio when excluding from 0 to 50% of firms with the lowest ESG Scores. Scores: = Neutral impact, + positive impact, - negative impact. Source: ESG Investing: From Sin Stocks to Smart Beta, Alessandrini, Jondeau, June 2019.



A more aggressive approach to ESG scores in a global portfolio means an improvement in the performance of most risk factor portfolios.



For example, excluding 50% of firms with the lowest ESG ratings from a European equity size portfolio added 0.19% per annum of return over 10 years, while removing 0.9% of volatility, therefore increasing the Sharpe ratio by 0.05 points.

Impact of ESG screening on MSCI Europe size portfolio

	MSCI Europe 0% excluded	50% excluded
Annualised return	3.20%	4.39%
Annualised volatility	23.56%	22.65%
Sharpe ratio	0.11	0.16

Source: ESG Investing: From Sin Stocks to Smart Beta, Alessandrini, Jondeau, June 2019.

Conclusion

What are the key takeaways for investors?

ESG investing is on the rise worldwide, driven by top-down policy initiatives and bottom-up demand from investors of all sizes.

The global ESG mutual fund industry, focusing exclusively on funds whose main objective is ESG related, reached \$2trn at the end of June 2019, 6% of total assets.

In Europe, those assets reached €1.1trn at the end of June 2019, 12% of all assets. Although passive flows still represent a minority, they are growing quickly: 33% per annum over the past 5 years vs 11% of active funds.

Lyxor expects both active and passive flows into ESG funds in Europe to be sustained, supported by investors' increasing interest in ESG, as well as by regulation.

As the availability and reliability of ESG information improves, more and more index-based strategies are being created with embedded ESG characteristics. Lyxor views ETFs and ESG as a natural fit and expects this segment of Europe's ETF market to grow substantially.

A key question for investors is whether a preference for sustainable, socially responsible investing means giving up on opportunities for portfolio performance.

The project sponsored by this year's ETF Research Academy answers this question in the negative: based on an analysis of the past performance of a universe of stocks from the MSCI All Country World index, a policy of exclusion based on companies' ESG scores did not impact portfolio performance negatively. In some cases, it led to superior risk-adjusted returns compared to the starting universe.

However, ESG screening tends to result in pronounced geographical, sector and industry biases. It also tends to generate increased exposure to large, profitable, and conservative companies.

There is fertile ground for further research on the integration of smart beta and ESG, in particular with respect to the single ESG dimensions, and in building algorithms that optimise the ESG profile of portfolios while keeping exposures to various risk factors under control.

LYXOR'S VIEW

Lyxor expects both active and passive flows into ESG funds in Europe to be sustained.

Lyxor views ETFs and ESG as a natural fit and expects this segment of Europe's ETF market to grow substantially.

Improving the ESG profile of a portfolio does not happen at the expense of risk-adjusted performance. In some cases, it can even lead to superior risk-adjusted returns.

About Lyxor ETF

Lyxor has been running ETFs since 2001, longer than any other European provider. Our pioneering spirit helped shape the market as you know it today. Over the last 18 years, we've become one of Europe's three largest ETF managers. And we've built one of its most far-reaching ranges, which spans all asset classes, and includes some of the lowest cost, largest and most efficient* ETFs.

We now offer more than 220 ways to explore the markets. So, whether investors are seeking essential, low cost core index exposure, or reaching out for more tactical opportunities in specific sectors or markets, we have a product to match their needs. Staying true to our pioneering heritage, we continue to expand the frontiers of fixed income ETFs, and develop new solutions for ESG, Smart Beta or income investors.

Our aim from the start has been to create ETFs of the highest calibre that can be trusted in any market. In 2011, we introduced our ETF Quality Charter to ensure that every one of our 220+ funds meets the same exacting standards for tracking precision, product liquidity, risk management and transparency.

*Source: Lyxor International Asset Management. Efficiency data over one year as at 30/06/2019. Performance data based on the efficiency indicator created by Lyxor 's research department in 2013. It examines 3 components of performance: tracking error, liquidity and spread purchase/sale. Each peer group includes the relevant Lyxor ETF share-class and the 4 largest ETF share-classes issued by other providers, representing market-share of at least 5% on the relative index. ETF sizes are considered as an average of AUM levels observed over the relevant time period. Detailed methodology may be found in the paper 'Measuring Performance of Exchange Traded Funds' by Marlène Hassine and Thierry Roncalli. Past performance is no guide to future returns.

Discover the Lyxor/Dauphine Research Academy

A NEW FRAMEWORK FOR THE ETF INDUSTRY



LYXOR DAUPHINE RESEARCH ACADEMY FOUNDED BY DAUPHINE & LYXOR

The idea for the Research Academy originally came about because of the lack of regular, high-quality academic research on passive management, especially in comparison with that produced on the active management segment. It was necessary to carry out in-depth analyses and hold discussions to tackle some of the issues facing the market, especially those linked to the world of ETFs and, ultimately, to provide some answers addressing investors' needs.

At Lyxor, we have a strong culture of innovation and a solid financial engineering track record. As one of the leaders within the European ETF market, it was only natural for Lyxor to get involved in these discussions, at the juncture between academic research and genuine investor concerns.

That's why in 2015 we created the Research Academy in partnership with the Paris-Dauphine University's House of Finance. We wanted to encourage top international researchers from the most renowned universities to work on subjects related to passive management. Since then, the Academy's subjects have been extended to cover broader topics surrounding portfolio construction.

The Academy's objective is to promote high-quality academic research on issues associated with changes in asset management. The idea behind the initiative was to establish links between universities and the asset management industry to provide concrete academic answers and offer a perspective on some of the real issues that investors face.

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EXHIBIT E

As You Sow Comment Letter

Financial Factors in Selecting Plan Investments

Proposed Regulation (RIN 1210-AB95)



ETFs for ESG: Why passive makes sense for ESG

BY [FANNIE WURTZ](#) | ETFS GUIDE 2019

Sponsored content from Amundi

ESG investing – the incorporation of environmental, social and governance (ESG) factors into investment criteria – has grown rapidly in recent years.

With it, approaches to ESG investing have also evolved considerably. In the past, investors and asset owners viewed ESG as a constraint to portfolio performance. Now they see it as a way to enhance performance and add alpha.

Banks and asset managers have created a wide range of passive ESG solutions for investors of differing sizes, maturities and risk appetites. The early adopters may have been in Europe and North America, but there is also considerable growth now in Asia.

IPE Quest
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for all sizes and types of
asset owner for mandates
of any size and asset class

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The image shows a promotional graphic for IPE Quest. At the top is the IPE Quest logo, with 'IPE' in black and 'Quest' in blue. Below the logo is the text 'MANAGER SEARCH • PRE-RFI • RFI • RFP'. The main part of the graphic is a dark blue rectangle with white text that reads 'Mandate service for all sizes and types of asset owner for mandates of any size and asset class'. At the bottom right of this rectangle is the website 'ipe-quest.com' in orange text.

Why are investors taking a more responsible approach to investing?

Investors have a number of reasons for integrating ESG factors into their portfolios. Some are motivated by a sense of responsibility, and deploy their assets to encourage companies to adopt

responsible business practices. Others believe this approach could help enhance performance by reducing the impact of climate change or poor governance.

Whatever the motivation, professional investors around the world are increasingly committing to ESG. Some 1,900 institutions worldwide have signed up to the UN-backed Principles for Responsible Investing. This represents over \$70trn of assets under management.

Why data provides the key for further growth

While the relationship between higher ESG scores and better performance sounds plausible, proving it requires high-quality and consistent data. Traditionally, ESG data has been fraught with inconsistency as the defining characteristics were too new, or were not clearly defined.

However, the amount and quality of data has improved dramatically over the last five years. [Amundi](#), for example, has a long history in responsible asset management, and is keenly aware of how a particular ESG risk can translate into a long-term financial risk for a company: for example, managing carbon emissions for a utility company, or governance issues for a bank.

To better assess ESG risk, we have analysed more than 5,500 global companies and hold data going back to 2010. By marking each company according to each ESG characteristic, we can provide an overall ESG score for every company in its database. This gives us a robust platform to assess the true impact of ESG criteria on the performance of a portfolio.

Positive relationship between ESG factors and performance

Our analysis (see figure 1) found that between 2010 and 2013, tilting a portfolio towards stocks with a high ESG rating had a slightly negative impact on performance, whatever the region. However, from 2014–17, ESG factors were a source of outperformance in both Europe and North America.

If an investor had bought the top quintile of ESG stocks and sold the bottom quintile, they would have generated an annualised return of 3.3% in North America and 6.6% in the euro-zone during this period. But between 2010 and 2013, they would have underperformed by –2.7% and –1.2%, respectively.

The data also shows that the environmental factor was most responsible for outperformance in North America and the governance characteristic performed the strongest in the euro-zone. In general, ESG characteristics were a greater contributor to outperformance in the euro-zone than in the US.

The analysis shows ESG has become a risk factor, particularly in Europe. In other words, those companies with high ESG scores tend also to be characterised as ‘high-quality’ stocks. Over the long run, these stocks tend to deliver excess returns. At the same time, there has been increased

allocation of capital in recent years to equities with a high ESG score, so this could also help to explain the strong performance of these stocks.

Integrating ESG into a passive portfolio

While investors have often preferred an active approach to ESG, as they believe it is better at selecting the required investment characteristics, research from Amundi shows that a passive approach can be just as effective.

There are two options available to investors in passive funds or products: they can either buy a product which tracks an index that is specifically designed around ESG criteria, or they can ask a passive manager to integrate ESG screens into a standard index. In other words, the index manager will tilt the portfolio towards a specific ESG outcome. This allows the client to take a bespoke approach to these factors.

For example, the portfolio could exclude certain stocks to reflect the investor's stated philosophy when replicating the index. Or it could have a more complex objective, such as, for instance, improving the overall ESG score while also reducing the carbon footprint of the portfolio and improving the overall exposure to green technologies.

The bespoke ESG approach to passive investment

Improved accuracy and increased datasets give Amundi and other asset managers the ability to offer more customised solutions to clients. However, investors need to be aware that the more complex they make their requirements, the greater the tracking error to the benchmark market index will be. If the goal of the passive portfolio is to match the performance of a particular index, then investors will want to match the benchmark as closely as possible.

It is, however, possible to achieve a significant improvement in the ESG characteristics of a passive portfolio. With limited additional tracking error, investors can improve the portfolio's overall ESG scores, reduce its carbon footprint and increase the influence of green technologies.

Some investors have specific ESG requirements to ensure their portfolios fit with their individual strategies. Amundi's approach to this is to gradually layer ESG criteria into the passive elements of the portfolio.

For example, this involves the phased implementation of an exclusion policy towards companies that produce prohibited anti-personnel mines and cluster bombs. This usually adds a small amount of tracking error. The next step is to incorporate other layers of ESG. We can either work with the client's list of companies it wishes to exclude or we can use Amundi research to analyse the client's ESG policy, excluding companies on that basis.

As an additional layer of customisation, Amundi can work with the client's own tracking error budget. We will work within this range to help the client reach its ESG targets. The latter may involve reducing the portfolio's fossil fuel footprint by removing coal mining companies, for example. A social target could be the exclusion of tobacco firms or arms producers. There are many optimisation techniques that we can apply using the ESG data now available.

Taking a more off-the-shelf approach

For those who do not have their own specific criteria to follow, the off-the-shelf approach may be more suitable. The breadth and quality of ESG data in the market means that index providers can now respond to investor demand by producing more sophisticated indices.

For example, MSCI has used its large ESG data services to develop its socially responsible investment (SRI) index range, which was selected by Amundi as the benchmark for its equity (MSCI US SRI, MSCI Europe SRI, MSCI World SRI and MSCI Emerging Markets SRI indices) and fixed income SRI ETF range.

The methodology of the MSCI SRI index excludes stocks which are known as 'ESG controversies'. That includes those firms which are in breach of international norms, such as the UN Global

Compact. The benchmark also excludes stocks participating in 'controversial activities', such as firms involved in the manufacturing of civilian firearms, conventional weapons, gambling, genetically modified organisms, nuclear power, tobacco, alcohol, thermal coal or adult entertainment.

The remaining stocks are only included in the index if they meet the minimum ESG rating criteria. Taking the remaining stocks, each sector is then built using only the top scoring 25% of stocks. As a result, the index narrows the investable universe to around 400 stocks with the highest ESG ratings, from a starting total of 1,600 in the case of the MSCI World index.

A more responsible approach to bond investing

It's possible to apply similar investment criteria to corporate bond indices. Not only does this make sense as it helps to identify more specific factors which could impact a company's credit risk, but it also allows investors to take a consistent approach across their portfolio.

Amundi's SRI ETF range includes three bond ETFs using the Bloomberg Barclays MSCI US Corporate SRI, Bloomberg Barclays MSCI Euro Corporate SRI and Bloomberg Barclays MSCI Euro Corporate ESG BB+ Sustainability SRI 0-3 indices. These benchmarks combine Bloomberg's and

Barclays' expertise in corporate bonds with MSCI's ESG research capabilities, offering investors a way to invest responsibly in the corporate bond markets of Europe and the US.

Like their equity counterparts, these indices do not invest in companies involved in alcohol, civilian firearms, gambling, military weapons, nuclear power, tobacco, thermal coal, adult entertainment, and genetically modified organisms. They also use a 'controversial activities' filter and a minimum ESG score to filter out unwanted companies. Despite excluding companies, MSCI's approach has a very low level of tracking error compared to reference benchmarks. This makes it possible to use these ETFs as a core allocation.

Is passive just too passive?

In the different passive solutions it provides, Amundi has found that voting and engagement are two important levers it can use to deliver both ESG adherence and portfolio growth. In passive investing, a portfolio manager does not have the same power as an active manager to influence how the companies they invest in are managed. Voting is one of the opportunities passive managers have to exert such influence.

Amundi's approach is to have a dedicated team to manage voting and engagement in both active and passive portfolios. Managers of invested companies become more open to outside views when they see Amundi bringing both active and passive teams into the discussion.

All these developments – especially the ability to incorporate ESG data into portfolios – mark a turning point in passive approaches to ESG investing. When we see how passive investing has grown in the US and Europe, it's clear what's ahead. We've proven that we're able to significantly improve the ESG score of a portfolio, while reducing the tracking error. This is helping to create a virtuous circle of ESG investing.