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# Impact Investing for Trusts

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# Making Money While Here for Good:
# Impact Investing from the Fiduciary's Viewpoint

## I. Getting Started – What are the Issues?

The directors of a charity may want to align investment of the charity's endowment with the mission of the charity. Can they do that and still comply with their fiduciary duties to the charity? Does the expected return on the investments matter? If all directors agree, what should they do to make this happen?

Beneficiaries of a trust created in 1980 when their grandmother died worry about climate change. They ask the corporate trustee to take environmental factors into account in investing the assets of the trust. What can or should the trustee do so?

A new client wants his estate planner to draft a will with trusts for his children. The client wants the trustees of the trusts to invest only in companies with good labor practices and with good ratings on corporate governance. What can or should the estate planner do in drafting the will?

Clients ask these questions, and more like them, with increasing frequency. Estate planning lawyers, financial advisors, people who manage charities or serve on their boards, corporate and professional trustees, and anyone else working with private trusts or charities need to be aware of a range of issues related to investment decision making. The terminology is confusing and the rules are changing. These materials address the following questions:

- What terms are used and how has the terminology changed over time?
- What are some of the different types of investment strategies that consider social and environmental factors in addition to traditional financial analysis?
- What is the financial effect of these strategies on a portfolio?
- Can a fiduciary use these strategies when investing for a private trust or a charity?
- How can a planner draft a trust to authorize this sort of investing?

## II. Terminology

### A. Socially Responsible Investing (SRI)

Socially responsible investing (SRI) is a type of investing that combines financial goals with social goals. Initially, the strategy involved negative or exclusionary screens, although the term now covers a variety of strategies. Current advocates of using environmental and social information in investment decision making may consider the term SRI problematic these days, because of its history. In its early years, some people assumed

that SRI meant an investment strategy that sacrificed financial gain for fuzzy, feel-good, social ideas. Although SRI has moved beyond its early strategies (which did not necessarily result in financial sacrifice), newer terms may be used instead of the term SRI as a way to emphasize that these strategies do not result in financial sacrifice.

SRI continues to be used to cover various types of investing strategies that use extra-financial factors, and the similar terms "responsible investing" and "sustainable investing" are also used.[2]

### B. Impact Investing

The term impact investing is now often used in place of SRI, as a generic term to encompass various types of investing that combine traditional financial goals with social and environmental goals. The title of these materials uses impact investing in that sense, and increasingly financial institutions use the term in this way.

The term impact investing has a second meaning. As used in its more specific sense, the term means investing in selected projects or companies to have an impact on a particular social or environmental issue.[3] An impact investor invests in a project or a company with two goals: the social or environmental benefit the project will create and the financial return on the investment. The investor considers the social or environmental benefit as part of the investment, to be considered together with the financial return to determine whether the investment has generated value for the investor.[4]

The financial results for impact investing with this more specific meaning depend on the strategy being pursued.[5] Some impact investors may willingly and intentionally sacrifice some amount of financial return to obtain more non-financial 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.[6]

Both ESG integration and impact investing can be used by investors interested in both financial and non-financial returns, but the emphasis may be different. ESG

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[2] *See Demystifying Responsible Investment Performance*, THE ASSET MANAGEMENT WORKING GROUP OF THE UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE AND MERCER (Oct. 2007), http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf [hereinafter UNEP-FI & MERCER]. For an excellent explanation of the development of SRI and the terminology used, see Commonfund Institute, *From SRI to ESG, The Changing World of Responsible Investing* (2013).

[3] *See* Commonfund Institute, *From SRI to ESG: The Changing World of Responsible Investing* (2013); ANTONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE (Jossey-Bass, 2011).

[4] For an explanation of impact investing, see ANTONY BUGG-LEVINE & JED EMERSON, *supra* note 3.

[5] The GIIN 2017 Annual Impact Investor Survey (Executive Summary) reports that 66% of respondents target risk-adjusted market-rate returns, 18% target below-market-rate returns closer to market-rate and 16% target below-market-rate returns closer to return of capital preservation.

[6] *See* JUDITH RODIN & MARGOT BRANDENBURG, THE POWER OF IMPACT INVESTING: PUTTING MARKETS TO WORK FOR PROFIT AND GLOBAL GOOD, 7-13 (2014) (explaining, at p. 12, that the distinction between impact-first and finance-first investment "can become fuzzy" in practice).

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 non-financial 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.

### C. Values Based Investing, Triple Bottom Line Investing, Ethical Investing, Green Investing

A variety of additional terms convey the idea of combining traditional financial goals with social or environmental goals. The terms values based investing, triple bottom line investing, ethical investing, and green investing (with the obvious focus on environmental concerns) are used without precision and somewhat interchangeably with SRI and impact investing. These materials will not use these terms, except in citations to resources that use the terms, but anyone trying to learn more about impact investing will likely encounter these terms.

### D. Blended Value

In their book on impact investing, Antony Bugg-Levine and Jed Emerson explain that all companies create three forms of value: economic, social, and environmental.[7] Although traditionally investors have considered only economic value, any company that creates economic value will also generate or destroy social or environmental value.[8] The term "blended value" refers to an investment strategy that seeks all three forms of value. Targeted impact investing seeks blended value, as do mission-related investing and program related investing.

### E. Mission-Related Investing (MRI)

Mission-related investing or mission-related investments (MRIs) are terms used to describe investments that carry out a charity's mission.[9] A charity may want to invest its endowment assets in a manner that furthers its mission. The investments will generate financial return for the charity to use in its programs, and in addition the investments will support the charity's programs through social or environmental impacts related to the mission. Mission related investing uses the concept of blended value, and may result in financial return comparable to a non-MRI portfolio or may result in a somewhat lower financial return balanced by the social or environment benefits of the investments.

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[7] BUGG-LEVINE & EMERSON, *supra* note 3, at 10.
[8] *Id.*
[9] For a discussion focused on mission-related investing see 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 (2011).

Recent IRS guidance on MRIs clarifies that private foundations can engage in mission related investing without having the investments be treated as jeopardizing investments. The IRS guidance is discussed in Section VIII.B.4.

### F. Program Related Investments (PRIs)

Program related investments are investments entered into by a private foundation primarily to carry out a purpose of the private foundation.[10] Under Internal Revenue Code (IRC) § 4944, private foundations cannot hold investments that jeopardize their ability to carry out their exempt purposes.[11] A PRI is an exception to the general prohibition on jeopardizing investments. A PRI is an investment entered into primarily for a program-related reason, but one that will generate some amount of financial return.[12] The existence of some financial return means that it is in some respects an investment, and thus could be subject to the rule against jeopardizing investments given low financial return. Treatment as a PRI allows the private foundation to use the investment carry out the foundation's exempt purposes.

The IRC's authorization of program-related investments (PRIs) for private foundations reflects the idea that an investment may serve a dual purpose. PRIs are more narrowly defined than the general concept of mission-related investing, however, because the primary goal must be to further the charity's mission and the production of financial return cannot be a significant purpose.[13]

### G. ESG Investing

ESG investing, also called ESG integration, combines traditional financial analysis with material information about environmental, social and governance factors that may not be reflected in usual market data. The goals are (1) to improve stock selection by expanding the information considered and (2) to invest in a sustainable and responsible manner. ESG factors are sometimes referred to as "non-financial factors" but in fact, they have financial impact on the value of stocks and the success of companies. They may have particular importance in assessing long-term risk.

ESG integration is one of several strategies used in connection with SRI or impact investing (using the latter term in the broad sense). Use of ESG integration has grown in recent years, with greater recognition among financial analysts that consideration of ESG factors may improve risk-adjusted returns. Other strategies used in developing SRI or impact investing portfolios include negative/exclusionary screens, positive/best-in-class screens, shareholder advocacy, and community investing.

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[10] I.R.C. § 4944(c).
[11] Section 4944 imposes a penalty on a charity and its managers for a "jeopardizing investment," defined as an investment for which the foundation managers "have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes." Treas. Reg. § 53.4944-1(a)(2)(i).
[12] I.R.C. § 4944(c).
[13] *Id.*

## III. History Related to Impact Investing

### A. Socially Responsible Investing (SRI)

SRI has roots in the anti-slavery efforts of Quakers in the 18th century,[14] and grew in public awareness in the 1960s and 1970s with the divestment movement that targeted South African apartheid.[15] A general definition that developed was that an SRI fund was a fund that considered social or ethical issues as well as financial information in building its portfolio, and an SRI investor was someone who sought to effect positive social change as well as generate financial gain.[16] Over time SRI expanded to include a variety of social, ethical, and environmental issues.

Early SRI funds used negative or exclusionary screens, refusing to invest in companies that did not fit a fund's guidelines. In addition to screening out companies doing business in South Africa, popular screens focused on the "sin stocks": tobacco, gambling, alcohol, and guns. Some funds continue to use these screens.

Over time, other SRI strategies developed, including the use of positive screens or best-in-class, a strategy that involves identifying companies with practices that support the fund's goals. Funds also use shareholder advocacy to further the social or ethical goals, engaging in proxy voting to encourage or force changes in behavior by the companies in the fund's portfolio. SRI funds continue to use these strategies, sometimes in combination.

### B. After Apartheid

SRI funds gained attention and assets during the anti-apartheid era, so when South Africa ended apartheid some analysts wondered whether SRI funds would disappear. To get some sense of where SRI was headed, the Social Investment Forum surveyed SRI funds to determine the extent of assets held in SRI funds and to gain an understanding of the strategies funds were using. The Social Investment Forum issued the first Trends report, called *After South Africa: The State of Socially Responsible Investing in the United States*, in 1995.[17] That report discusses the aftermath of the end of apartheid and the end, in 1993,

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[14] Benjamin J. Richardson, *Putting Ethics into Environmental Law: Fiduciary Duties for Ethical Investment*, 46 OSGOODE HALL L.J. 243, 245 (2008).

[15] *See* Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986); John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980).

[16] *See* Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U.L. REV. 1, nn.2–3 (1993) (citing several attempts at defining socially responsible investing).

[17] *1995 Trends Report: After South Africa: The State of Socially Responsible Investing in the United States, The Social Investment Forum (1995), available at http://www.ussif.org/files/Publications/95_trends_Report.pdf (describing issues addressed in early negative and positive screens) (hereinafter 1995 Trends Report).*

of negative screens applied to businesses located in or doing business with South Africa. The report found that SRI funds operating in 1995 used negative screens (tobacco, alcohol and weapons) and had increased the use of positive screens (human rights, environment, animal rights, and employee rights).[18]

Ten years after the first Trends report, the Social Investment Forum issued a ten-year review.[19] This report discussed the growth in funds under SRI management "using one or more of the three core socially responsible investing strategies—screening, shareholder advocacy, and community investing."[20] The report talks about the growth in the use of SRI funds, and increases in shareholder advocacy and community investing.

### C. Current Trends, Strategies, and Terminology

In the years between 2005 and the present, the socially responsible investing universe has exploded in size, terminology, and strategies. Because perceptions about SRI included an assumption that the use of SRI necessitated a cost to the portfolio,[21] new terms emphasize different strategies. Impact investing has become a term used to convey the variety of strategies that seek social or environmental benefits as well as financial benefits. In addition, ESG investing as a particular strategy, is used by financial analysts focusing on financial return as well as by fund managers seeking both financial and non-financial benefits.

The 2014 Trends Report reflects the changes since 2005.[22] By 2014, The Social Investment Forum had changed its name to The Forum for Sustainable and Responsible Investment. In the 2014 Trends Report, the word screening has disappeared. The report talks about ESG incorporation and shareholder advocacy as the two general categories. ESG incorporation includes the following strategies: negative/exclusionary, ESG integration, positive/best-in-class, impact investing, and sustainability themed investing. The Executive Summary of the report notes, "the incorporation strategy that affected the highest number of assets, $4.74 trillion, was ESG integration."[23] The assets devoted to "sustainable and responsible investment" had grown substantially, and the term SRI is no longer used in the report.

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[18] *Id.* at Executive Summary.
[19] *2005 Report on Socially Responsible Investing Trends in the United States, Social Investment Forum*, THE SOCIAL INVESTMENT FORUM (Jan. 24, 2005), *available at* http://www.ussif.org/files/Publications/05_Trends_Report.pdf.
[20] *Id.* at Figure 1.1.
[21] *See, infra*, Section V.
[22] *Report on US Sustainable, Responsible and Impact Investing Trends 2014*, THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTING (2014), *available at* http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf.
[23] *Id.*

A similar report on a global scale, the 2014 Global Sustainable Investment Review,[24] explains that sustainable investment includes the following strategies: negative/exclusionary screening, positive/best-in-class screening, norms-based screening, integration of ESG factors, sustainability-themed investing, impact/community investing, and corporate engagement and shareholder action.[25] The report notes that sustainability-themed investing and ESG integration were the fastest growing strategies, and that the U.S. and Europe were the biggest contributors to ESG integration growth, in percentage terms.[26]

SRI has changed dramatically since the 1970s and 1980s, and now the terms impact investing or ESG investing are more likely to be used to refer to investment decision making that combines financial goals with social and environmental goals.

## IV. ESG Investing/ESG Integration

### A. Development of ESG Investing

A strategy for impact investing, and one that continues to grow rapidly, is ESG investing or ESG integration. ESG investing uses material environmental, social, and governance factors related to a potential investment as part of a decision-making process that includes traditional financial analysis. The goals are to improve stock selection by expanding the information considered about a company and to invest in a sustainable and responsible manner. ESG investing is also seen as a way to improve financial analysis.

ESG investing seeks to identify material risks and opportunities related to investment performance that may not be reflected in traditional financial data. The term "ESG investing" is used to distinguish this strategy from some other forms of impact investing and to emphasize an overall investment strategy that seeks to maximize financial gain. An investor with no interest in addressing social or environmental problems could use ESG investing as a strategy to seek better returns.

If integrated reporting becomes the norm, market prices may reflect more of the ESG factors than is currently the case. Some of the current financial benefits in ESG investing lie in identifying undervalued or overvalued stocks. If market value more accurately reflects the ESG risks and opportunities, then some of the current financial benefit of ESG investing may be reduced. However, given that ESG investing emphasizes long-term value over short-term returns and given that the market is not completely efficient, ESG investing should continue to produce benefits.

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[24] *2014 Global Sustainable Investment Review*, GLOBAL SUSTAINABLE INV. ALLIANCE (2014), *available at* http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf.
[25] *Id.* at 3.
[26] *Id.* at 8. The report uses five regions: Europe (63.7% of global SRI assets), U.S. (30.8%), Canada (4.4%), Australia/NZ (0.8%), and Asia (0.2%). *Id.* at 7.

### B. Examples of ESG Factors

Environmental factors could include a company's carbon footprint, a company's plans to reduce its carbon footprint, a company's work on developing alternative energy sources, pollution generated by a company and attempts to reduce the pollution, and safety protections in place to prevent environmental disasters such as oil or radiation leaks. Social factors focus on employee work conditions and could include impacts on local communities, both positive and negative.

Although ESG factors may not be reflected in traditional financial analysis, they may have financial effects. For example, a company that focuses on using less energy may save costs. A company with good employee relations may have good employee performance. An oil company may lose value if new regulations limit its ability to extract oil. A company that uses sweatshop labor may have negative financial impacts if a fire kills workers, causes a break in the supply chain, and results in a consumer boycott. A comparison of two hypothetical companies demonstrates the types of information that traditional financial metrics miss if the analysis does not include ESG factors.

Assume that Company A uses international suppliers that keep costs down by requiring employees to work long hours under unsafe conditions. The suppliers have had no dramatic problems, and the supply chain has never been broken. Company B uses suppliers that conform to production standards it imposes. Factories are safe and employees work under conditions that minimize on-the-job accidents. Company B has also faced no dramatic problems. Company B may have a slightly higher cost for the goods produced by its suppliers, and that information could make Company B's traditional financial data look slightly less favorable than Company A's data. What the data will not reflect is the possibility that a catastrophic fire in a factory used by one of Company A's suppliers could kill hundreds of workers. The repercussions for Company A could include a break in the supply chain, loss of consumer goodwill if the company is linked to the supplier, and even a consumer boycott. The financial impact on Company A could be significant, but traditional analysis probably will not reveal that risk. The risk is a long-term risk, and merely a risk, not a certainty, but in a process that purports to evaluate financial risk, the risk to Company A may be missing if the evaluator uses only traditional financial data.

### C. Process

Analysts and fund managers use ESG factors in different ways. Two examples may help explain how it works for funds that self-identify as sustainable funds. There are many models for using ESG factors, and some analysts use the factors in analyzing companies when creating conventional funds.

### 1. G.M. Heal Explanation

In his book, *When Principles Pay: Corporate Social Responsibility and the Bottom Line*, G.M. Heal describes one strategy.[27] A fund manager using ESG factors might start with her usual process to create a list of potential stocks. For example, a manager whose strategy is to look for undervalued stocks could do so, in whatever sectors the manager or the fund favors (large cap, small cap, etc.). The manager could create a list of stocks that meet her goals in terms of financial data. Then the manager would narrow the initial list by analyzing the companies' ESG ratings. The ESG factors add information that can help the manager identify stocks more likely to perform well. In this scenario no stock is screened out, except based on financial quality.

### 2. Domini Social Investments

Domini Social Investments, LLC, an investment company created in 1991 to engage in socially responsible investing, has created 24 industry classifications and four to seven subcategories within each industry.[28] Domini analysts use Key Performance Indicators for each industry and subindustry to guide the research with respect to business alignment and stakeholder relations. Each industry is classified as fundamentally aligned, partially aligned, partially misaligned, or fundamentally misaligned with Domini's standards. Companies are evaluated on where their business model fits within the industry alignments and on their stakeholder relations—how they treat employees and customers and how they address their environmental impacts.

To rate companies, Domini uses a matrix, so that a company that is fundamentally aligned (e.g. a solar energy company) would have more leeway on stakeholder relations than a company that is partially misaligned (an oil and gas company). A company that is fundamentally misaligned (a tobacco company) would not be eligible for inclusion in the funds. The website explains that Domini seeks "to identify companies that are responsibly addressing the key sustainability challenges and rewards presented by their business model."[29] Domini does not look for "socially responsible companies," because all companies face some challenges.

Domini tries to find the companies that are making the best efforts given their challenges. Most companies fall within the middle of the matrix, and Domini looks for companies that are trying to address the challenges they face. Domini also uses shareholder

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[27] *See* G.M. HEAL, WHEN PRINCIPLES PAY: CORPORATE SOCIAL RESPONSIBILITY AND THE BOTTOM LINE (2008).
[28] DOMINI, *About Domini,* https://www.domini.com/why-domini/about-domini. Domini's website explains its research process.
[29] DOMINI, *See Socially Responsible Companies*, Domini, https://www.domini.com/responsible-investing/socially-responsible-companies.

advocacy in some situations to move companies toward actions that are, in Domini's view, more responsible.[30]

Domini further explains that its internal research process creates a list of companies that meet its standards based on extra-financial criteria. Domini's analysts create a profile for each company being considered, and inclusion on the list depends not on a finding that the company is "perfect," but instead on whether the company is working to address sustainability challenges it faces. Domini then provides the list to Wellington Management, an investment company that constructs the portfolios using its usual financial analysis tools.[31]

### D. ESG Integration for Non-SRI Funds

These days, even managers of funds not designated as "sustainable" or "socially responsible" may consider E, S and G factors as part of their overall analysis. Shreenivas Kunte, writing for Enterprising Investing, an online forum of the CFA Institute, notes that ESG considerations continue to be underappreciated, which creates a potential opportunity, especially in emerging markets.[32] He explains that "the environmental and social aspects in particular are a source of significant liability and potential value destruction."[33] He adds, "Almost every couple of years, companies with shallow ESG records end up as case studies in value destruction."[34] Kunte finds opportunities as well, in companies that are improving their ESG ratings. He concludes: "Still, avoiding unsustainable investment choices is not a theoretical fad but a robust downside protection mechanism *and* an attractive outperformance opportunity that deserves attention."[35]

## V. Is There a Cost to the Portfolio?

### A. Diversification and Historical Assumptions about SRI

#### 1. Modern Portfolio Theory and Diversification

Modern portfolio theory, which took hold in the mid-twentieth century and became a significant influence in the drafting of the Uniform Prudent Investor Act (UPIA), emphasizes the importance of diversification as a way to reduce risk in a portfolio. In

[30] *See* DOMINI, *How We Invest, available at* https://www.domini.com/why-domini/how-we-invest.
[31] *See* DOMINI, *Evaluating Corporations-Our Research* Process, *available at* https://www.domini.com/responsible-investing/choosing-our-investments/evaluating-corporations-—-our-research-process. *See also* DOMINI, *Approving Corporations for our Funds, available at* https://www.domini.com/responsible-investing/choosing-our-investments/approving-corporations-our-funds.
[32] Shreenivas Kunte, *ESG in Emerging Markets and Beyond: Where Is the Alpha?* ENTERPRISING INVESTOR (CFA Institute: Aug. 11, 2016) https://blogs.cfainstitute.org/investor/2016/08/11/esg-in-emerging-markets-and-beyond-where-is-the-alpha/.
[33] *Id.*
[34] *Id.*
[35] *Id.*

explaining modern portfolio theory, Harry Markowitz argued that any restriction on the universe of potentially available stocks could reduce the risk-adjusted return of a portfolio.[36]

Of course, many financial strategies limit selections for a particular fund by asset type or category, but non-financial restrictions were viewed differently. Because early SRI funds were based on negative screens, and negative screens limit the universe of available stocks, a financial penalty seemed inevitable. John Langbein, the Reporter for UPIA, and Richard Posner wrote that they were "skeptical that a portfolio constructed in accordance with consistent, and consistently applied, social principles could avoid serious under-diversification."[37] However, they concluded "that a social-investing portfolio will probably have the same expected return as a standard investment portfolio (of the same systematic risk)" but with higher administrative costs as compared to a passive fund, although "it need not generate higher administrative costs than an investment strategy that involves research and active trading."[38]

#### 2. Adler and Kritzman's Monte Carlo Simulation

Commentators have continued to argue that any negative screen would necessarily result in costs to the portfolio.[39] A 2008 article by Timothy Adler and Mark Kritzman makes this point by using a Monte Carlo simulation to test the consequences on a portfolio if a percentage of otherwise available stocks are randomly excluded.[40] The simulation resulted in a lower return than a portfolio without the exclusion, but the simulation does not reflect the way SRI or impact investing works. First, in many such funds no stock is automatically excluded. Even for funds that use a negative screen (for example, a decision not to invest in tobacco companies), the manager will make other decisions about the fund knowing which stocks have been excluded, so compensating choices can be made.

In their paper, Adler and Kritzman say that their model does not apply to actively managed funds, but most impact investing funds are actively managed. Some passive funds exist, but they track indices that are actively managed. Nonetheless, **a**lthough the Adler-Kritzman study does not apply to impact investing funds as currently managed, the idea that "social investing" involves negative screens and the assumption that social investing necessarily results in a cost to a portfolio persist. Those persistent assumptions explain why the term SRI is used less often currently, but any fund that includes social factors as part of the decision-making process raises questions about cost in some investors' minds and restrictions on diversification continue to be a concern.

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[36] Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). *See also* UNIF. PRUDENT INVESTOR ACT, Prefatory Note (1992), for articles cited therein.
[37] *See* Langbein & Posner, *supra* note 15.
[38] *Id*. at 93.
[39] *See* Christophe Revelli & Jean-Laurent Viviani, *Financial Performance of Socially Responsible Investing (SRI): What Have We Learned? A Meta-Analysis*, 24 BUSINESS ETHICS: A EUROPEAN REVIEW 158, 161 (Apr. 2015) (citing a number of articles on both sides of the argument).
[40] Timothy Adler & Mark Kritzman, *The Cost of Socially Responsible Investing*, 35 J. PORTFOLIO MGMT. 52 (2008).

### 3. Hoepner Study

Andreas Hoepner analyzed portfolio diversification in connection with the use of ESG criteria and found that although using negative screens reduces the number of stocks available, a firm's ESG rating reduces its specific risk and therefore improves portfolio diversification by reducing specific stock risk.[41] Hoepner found that negative screening produced a diversification penalty, but best-in-class screening produced a diversification bonus.

### 4. Renneboog, Horst, and Zhang Study

Luc Renneboog, Jenketer Horst, and Chendi Zhang studied the question of diversification by measuring net selectivity.[42] They found that the SRI and non-SRI funds they analyzed did not differ significantly in net selectivity, and therefore did not differ in costs of diversification.[43] They noted that this finding is consistent with "the classic view that a well-diversified portfolio does not require a large number of stocks . . . ."[44] Comparing SRI funds with each other, the authors found that returns increased with the number of screens – more screens led to better returns.[45] The authors conclude: "This finding supports the hypothesis that SRI criteria help fund managers to pick stocks."[46]

### 5. Minor Study - "There Must Be a Cost"

Researcher Dylan Minor set out to measure the financial cost to a portfolio of engaging in SRI, explaining, "[t]his study's purpose is to show while there may be no net *total* cost (i.e., financial *and* social costs and benefits) with SRI, according to fundamental economic principles, there must be a net *financial* cost to SRI."[47] Despite his assumption that he would find a financial cost, when he analyzed SRI and non-SRI funds he found no statistically significant difference. He noted that the difference between his assumption

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[41] Andreas Hoepner, *Portfolio Diversification and Environmental, Social or Governance Criteria: Must Responsible Investments Really Be Poorly Diversified?*, UNIV. OF ST ANDREWS (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1599334.

[42] Luc Renneboog, Jenketer Horst, & Chendi Zhang, *The Price of Ethics: Evidence from Socially Responsible Mutual Funds*, ECGI FINANCE, (Working Paper No. 168/2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=985265 (2007).

[43] *Id.* at 20.

[44] *Id.* The study explains: "A number of studies show that 5 to 30 stocks are needed to make a well-diversified portfolio" (citing J. Evans & S. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761(1968); M. Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANTITATIVE ANALYSTS 353 (1987); M. Brennan & W. Torous, *Individual Decision Making and Investor Welfare*, 28 ECON. NOTES 119 (1999)).

[45] Renneboog *et al., supra* note 42, at 25. The study found that the returns of funds employing a corporate governance and social screen increased while those of funds employing environmental screens decreased. The study found that using in-house research increased returns, which they thought "supports the hypothesis that the screening process generates value-relevant non-public information." *Id.* at 26.

[46] *Id.* at 25.

[47] Dylan B. Minor, *Finding the Financial Cost of Socially Responsible Investing*, 18 J. INVESTING 55 (2007).

and his findings could be that the SRI funds had better managers or that managers working in a smaller universe could identify companies that others had ignored.

### 6. Efficient Market Theory

The importance of diversification derives from efficient market theory, the idea that the market reflects all relevant information.[48] If the market is efficient, then broad diversification should reduce risk. In the years since the adoption of UPIA, with its emphasis on diversification, a number of studies have challenged the efficient market theory.[49] Diversification becomes less important if the market is shown to be less efficient.

## B. Research on Performance of SRI Strategies

### 1. Generalizations and Caveats

Academic researchers as well as finance industry analysts have sought to determine whether the use of SRI strategies will have positive, negative, or neutral effects on the performance of investment portfolios. In very general terms, the studies show that the use of ESG factors in analyzing stocks independently or in building portfolios may improve investment results[50] and that performance of SRI funds compared with non-SRI funds has been, in most cases, neutral or positive. Few of the studies show negative results when comparing SRI funds with non-SRI funds,[51] and none of the empirical studies support the idea that SRI necessarily leads to lower returns.[52]

Several challenges exist in considering the results of the studies. The studies review different SRI strategies (e.g., screening, shareholder advocacy, ESG investing), often without differentiating among the strategies. The time frame for some of the studies is short (e.g. five years) and ESG factors are more likely to affect long-term performance than

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[48] Markowitz, *supra* note 36, at 7.

[49] In 1987 Merton demonstrated that a perfectly diversified market portfolio was no longer efficient given the presence of incomplete information. He argued that assets with concentrated information should show increased returns. *See* Revelli & Viviani, *supra* note 39, at 161 (citing R.C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information,* 42 J. FIN. 483 (1987)). *See also* Hylton, *supra* note 16, at 92-113 (1993) (discussing theoretical and empirical work that has eroded the efficient markets hypothesis and citing, at n. 97, a number of those articles).

[50] Among other studies, the two meta-studies described in this section reach this conclusion. In addition, Commonfund notes, "Studies identify issues such as energy efficiency, carbon emissions, toxic waste treatment, workplace safety, employee relations and corporate governance as materially affecting traditional financial indicators such as price/earnings ratio and reputation with investors." *Commonfund White Paper*, COMMONFUND (2013), https://www.commonfund.org/InvestorResources/Publications/Pages/WhitePapers.aspx, at 2. *See also* SUSTAINABLE INVESTING/ESTABLISHING LONG-TERM VALUE AND PERFORMANCE, DEUTSCHE BANK GROUP (June 2012); Hoepner, *supra* note 41 (best in class leads to better returns).

[51] Both the Deutsche Bank meta-study and the UTEP-FI & Mercer meta-study conclude that the performance of funds that use negative screens is more likely to be neutral than negative or positive when compared with benchmarks.

[52] Adler and Kritzman base their assertion that this is the case on a simulation and do not back their assertion with empirical evidence. *See* Adler & Kritzman, *supra* note 42.

short-term performance. The strategies continue to evolve so information gained from reviewing one set of funds or factors has to be considered in light of changing strategies. As more investors and analysts become familiar with ESG investing and as more information about companies' ESG factors becomes available, the potential benefit from capturing information others are missing may disappear.

An additional point is that some of the studies focus on the strength of the companies in the study rather than on current returns to investors. Although a determination of out-performance may not translate into immediate benefits to investors, the long-term strength of companies may benefit investors over the long-term by reducing risk.

In addition to these challenges, a difference in performance between an SRI fund and a conventional fund may relate to any of a number of variables, including the skill of the fund manager, investment style, time period, and decisions about when to be in cash and when to be in the market.[53] Even if an SRI fund outperforms a conventional fund during the particular period under study, the SRI investment policy may not be what caused the difference.[54]

#### 2. Morningstar Report (2016)

Jon Hale, head of sustainability research for Morningstar, the investment research firm, used Morningstar's Analyst Rating system to compare funds tagged as "socially conscious" in Morningstar's global database with all funds in that database.[55] The socially conscious tag is one Morningstar uses to refer to funds "that have a prospectus-based reference to what we now call sustainable or responsible investing." The rating system is a relative-to-category measure of risk-adjusted return.

Hale noted that prior studies had found that sustainable or responsible funds preformed in line with conventional funds, neither underperforming nor outperforming. In his test he found that on a global basis socially conscious funds outperformed conventional funds, while in the U.S. the funds performed in line with conventional funds. He noted that the shift from exclusionary screens to positive consideration of ESG factors seemed to be improving financial performance, especially over the long run. He also noted that past studies had not found evidence to support the assumption that socially conscious funds would underperform conventional funds, contrary to popular assumptions.

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[53] HEAL, *supra* note 3. *See* UNEP-FI &MERCER, *supra* note 2, at 8.

[54] HEAL, *supra* note 3. Heal notes that several SRI funds outperformed benchmark indices in the period 1995-2000. A possible reason, he suggests, is that SRI funds would be underweighted in companies that pollute or deal in alcohol, guns or tobacco. As a consequence, they would likely be overweighted in tech stocks, which are less likely to be screened out for environmental or social reasons. The tech stocks did particularly well during that five year period, so perhaps the overweight position improved returns for the fund. If so, that relatively better performance might not be repeated in another time period. Similarly, oil stocks experienced a surge in 2004. Funds that were underweighted in oil stocks might have had below-benchmark results for a period that included 2004.

[55] Jon Hale, *You Don't Have to Sacrifice Returns for Sustainability,* MORNINGSTAR (Aug. 19, 2016) http://news.morningstar.com/articlenet/article.aspx?id=765799.

### 3. Moving Toward Alpha (2016)

A recent study by Harvard Business School Professor George Serafeim and researchers from the responsible investing firm Calvert Investments, demonstrates the utility of ESG integration in creating "alpha"—improved returns without increased risk.[56] The study points out that because the market and the traditional financial indicators do not reflect all of the potential social and environmental harms or benefits that could affect a company, the ESG factors will give an investor considering that additional information an edge. The authors note that "[w]idespread access to insightful ESG data remains cloudy" due to inconsistent and selective reporting.

### 4. Cambridge Associates and Global Impact Investing Network - Private Equity and Venture Capital Funds (2015)

In June 2015 Cambridge Associates and the Global Impact Investing Network (GIIN) announced that they had collaborated to create the Impact Investing Benchmark.[57] The new benchmark gathers data from 51 private equity and venture capital funds with a range of social objectives. The funds operate across sectors, target both risk-adjusted market rate returns and social impact objectives, are available to institutional rather than individual investors, and were launched from 1998 to 2010. Although some impact investing funds seek concessionary returns, the new Benchmark includes only funds that target risk-adjusted market rate returns consistent with other private investment funds. The funds included pursue one or more of the following social impact objectives: financial inclusion, employment, economic development, sustainable living, agriculture, and education. Although the Benchmark does not include environmental funds, some of the social themes address sustainability issues. Cambridge Associates will update the benchmark on a quarterly basis.

The report analyzing the funds in the benchmark found the returns of funds launched from 1998 to 2004 in line with or better than returns of non-impact investing funds.[58] More recently launched impact investing funds trailed their non-impact investing comparators, but the report suggests that the returns for the impact investing funds were largely unrealized at the time of the analysis. Emerging market impact investing funds raised from 1998 to 2004 outperformed their comparators 15.5% to 7.6%, while later funds lagged behind their non-impact investing peers. Many smaller impact investing

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[56] George Serafeim, Jade Huang, Joshua Linder, Patrick Faul & John Streur, *The Financial and Societal Benefits of ESG Integration: Focus on Materiality* (June 2016), http://www.calvert.com/perspective/research/calvert-serafeim-series-report-materiality.
[57] Amit Bouri et al., *Introducing the Impact Investing Benchmark* (2015), *available at* http://www.thegiin.org/binary-data/Introducing_the_Impact_Investing_Benchmark.pdf.
[58] *Id.* at 8–9.

funds, defined as those raising less than $100 million, outperformed their smaller non-impact investing counterparts, especially the older funds.

#### 5. Deutsche Bank Meta-Study (2012)

The Deutsche Bank Group's Climate Change Investment Research division published a meta-study: *Sustainable Investing/Establishing Long-term Value and Performance* (2012). The study found that companies with high ratings in CSR and ESG outperformed in corporate financial performance. The study examined more than 100 academic studies of responsible investing, 56 research papers, two literature reviews, and four meta-studies. The report categorized the studies based on CSR, ESG (and E, S, and G separately), and SRI, and then looked for a correlation between scores in those three categories and the cost of capital (equity or debt), corporate financial performance (both market based returns and accounting measures), and fund returns for funds based on these factors (most funds were SRI). The report is useful both because of the large number of studies included in the research and because the analysis differentiated between different investment strategies.

For securities, the report found that companies with high ratings in CSR and ESG had a lower cost of capital, both debt and equity, and also outperformed in corporate financial performance. At the fund level, the comparison results were neutral or mixed. No studies reported underperformance.

#### 6. UNEP-FI and Mercer Meta-Study (2007)

A prior meta-study, conducted by the United Nations Environmental Program Financial Initiative (UNEP-FI) and Mercer, examined 20 academic studies and 10 broker studies that examined the link between ESG factors and investment performance.[59] Most studies found the use of ESG factors led to neutral or positive results. The three studies that found negative results all focused on screening as the strategy.

#### 7. Revelli and Viviani - International Meta-Study (2015)

An international study found that consideration of CSR in stock selection neither strengthens nor weakens portfolios.[60] Christophe Revelli of the KEDGE Business School in Marseilles, France, and Jean-Laurent Viviani of the Université de Rennes I examined 85 studies and 190 experiments to test the relationship between SRI and financial performance while also analyzing researcher methodologies with respect to dimensions of SRI. They found that differences between the studies they examined resulted from the differences in the dimensions studied, including markets, financial performance measures, investment horizons, SRI thematic approaches, family investments and journal impact. The authors

[59] UNEP-FI & MERCER, *supra* note 2.
[60] Revelli & Viviani, *supra* note 39.

conclude that CSR does not result in stronger or weaker returns compared with conventional investments.

A problem with the study is that it reaches one conclusion without differentiation for changes in ESG strategies over time. It does not differentiate between screening and ESG integration or consider changes in strategies over the time period of the studies, which spanned the period 1972 – 2012, with most studies from the 1990s on.

### 8. Eccles, Ioannou, and Serafeim - High Sustainability Companies Outperform Low Sustainability Companies (2011)

In a 15-year study,[61] Robert G. Eccles, Ioannis Ioannou, and George Serafeim analyzed the governance and organizational structure and financial performance of 180 U.S. companies. Half of the companies had "voluntary incorporation of social and environmental issues into a company's business model and operations" by 1993 and half had few or no sustainability policies. The companies in the first group were dubbed High Sustainability companies and those in the second group were Low Sustainability companies.

The researchers matched and then compared companies in the two groups so they could "shed light on the organizational and performance implications of integrating social and environmental issues into a company's strategy and business model through the adoption of corporate policies."[62] Among other organizational findings, High Sustainability companies were more likely to create a process to engage stakeholders in identifying risks and opportunities, to be long-term oriented, and to measure and disclose more extra-financial data. The researchers found that High Sustainability companies outperformed Low Sustainability companies in both stock market performance and accounting performance. Further, the market underestimated the future profitability of the High Sustainability companies compared to the other group.

### 9. Study Comparing Social Index and S&P 500 (2011)

An 18-year study compared a U.S. social investment index, the MSCI KLD 400 Social Index, with the S&P 500.[63] The study found that differences between the two indices could be explained by conventional investment factors. That is, the ESG factors did not affect the returns in either a negative or positive way. The author's conclusion is that any risk exposures created by SRI can be addressed through portfolio construction. The authors noted that they found no evidence of market advantage in using ESG factors,

[61] Robert G. Eccles, Ioannis Ioannou, & George Serafeim, *The Impact of Corporate Sustainability on Organizational Processes and Performance* (Mar. 1, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507874.
[62] *Id.* at 3.
[63] Lloyd Kurtz & Dan DiBartolomeo, *The Long-Term Performance of a Social Investment Universe*, 20 J. INVESTING 95 (2011).

perhaps because "the field is getting crowded." They concluded that "values-based investors" can achieve financial results comparable to non-SRI investing, but that alpha-seeking social investors may be disappointed.

### 10. RCM Study - Best-in-Class Strategy (2011)

A study published in 2011 by RCM, a global asset management company, analyzed the best-in-class strategy.[64] The study used data mainly from MCI ESG Research for the period of December 2005 to September 2010. The researchers evaluated ESG factors on a sector-by-sector basis to identify best-in-class companies and worst-in-class companies. The researchers then created portfolios using the data and found that the best-in-class portfolios outperformed the benchmark during the test period, while the worst-in-class portfolios underperformed. The white paper reports: "investing in companies that operate best-in-class ESG strategies did not detract from returns. Even in extreme market conditions, performance was not negatively impacted. Not only that, but outperformance was seen across the range of global sectors and geographies."[65] The study also found that investing in companies identified as best-in-class on sustainability did not lead to greater volatility when compared with the market.

### 11. Corporate Responses to ESG Issues Benefit the Company

A 2013 study by EY (formerly Ernst & Young) and Boston College Center for Corporate Citizenship found that sustainability reporting brought benefits including improved reputation, increased employee and consumer loyalty, reduction in waste, improved relationships with regulatory bodies, cost savings, and improved planning to manage long-term risk and increase long-term profitability.[66]

A 2009 study published in the Harvard Business Review found that corporations that complied fully and as early as possible with environmental regulations benefitted financially even if initial costs were substantial.[67] The study showed that sustainable practices, rather than being a financial burden on the cost of doing business, can lower that cost and increase revenues.

A study published in 2011 showed that companies with strong employment practices outperformed the market over a period of many years.[68]

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[64] *Sustainability: Opportunity or Opportunity Cost? Applying ESG factors to a Portfolio Does Not Negatively Impact Performance and May Enhance it*, RCM (2011), *available at* https://www.allianz.com/media/responsibility/documents/rcmsustainabilitywhitepaper2011.pdf.
[65] *Id*. at 12.
[66] Value of Sustainability Reporting, http://www.ey.com/Publication/vwLUAssets/EY_-_Value_of_sustainability_reporting/$FILE/EY-Value-of-Sustainability-Reporting.pdf.
[67] Ram Nidumolu, CK Prahalad & MR Rangaswami, *Why Sustainability is Now the Key Driver of Innovation*, HARV. BUS. REV. (2009) (studying 30 large corporations over a long time period).
[68] *See* Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity*

Earlier studies demonstrated a positive relationship between the adoption of CSR practices and policies and corporate financial performance.[69] Recent information from Europe shows similar results.[70]

## VI. Investor Interest in Impact Investing and ESG Investing

### A. Financial Analysts Use ESG Factors

In addition to managing and promoting SRI funds to investors interested in social responsibility and sustainability, investment firms increasingly seek extra-financial information disclosed by companies to make better financial decisions. A 2011 study found a high level of market interest in ESG disclosure, based on an analysis of "hits" accessing extra-financial metrics in the Bloomberg database during three bimonthly periods in late 2010 and early 2011.[71] Their report suggests that investors may be interested in transparency concerning ESG performance and policies as a way to understand whether companies are using that extra-financial information. In addition, the authors' hypothesize that the market perceives less risk in transparent companies, because there is less uncertainty about them.[72] The companies are better positioned to deliver on expected performance if they are "using effective ESG management to capture revenue-generating opportunities, achieve cost savings, and minimize the downside of failures, fines, and lawsuits."[73]

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*Prices,*101 J. FIN. ECON. 621 (2011).

[69] *See* Jennifer J. Griffin & John F. Mahon, *The Corporate Social Performance and Corporate Financial Performance Debate: Twenty-Five Years of Incomparable Research*, 36 BUS. & SOC'Y 5 (1997); Ronald M. Roman, Sefa Hayibor & Bradley R. Agle*, The Relationship Between Social and Financial Performance: Repainting A Portrait*, 38 BUS. & SOC'Y 109 (1999); Marc Orlitzky, Frank L. Schmidt & Sara L. Rynes, *Corporate Social And Financial Performance: A Meta-Analysis*, 24 ORGANIZATION STUDIES, 403 (2003); M. L. Wu, *Corporate Social Performance, Corporate Financial Performance, and Firm Size: A Meta Analysis*, 8 J. AM. ACADEMY BUS. 163 (2006).

[70] *See* John Howell, *European Companies Profit from Sustainability*, 3BL MEDIA, LLC, (June 15, 2015), *available at* https://3blmedia.com/News/European-Companies-Profit-Sustainability-Minute#sthash.KNFyirX0.dpuf. "CDP, a research firm that collects environmental data on more than 5,000 companies worldwide, reports that companies with published targets for cutting their CO2 emissions are more profitable, delivering a return on invested capital of 9.9 percent, compared with 9.2 percent for those with no targets. And Euronext's Low Carbon 100 Europe index, which includes those European firms with the lowest CO2 emissions in their respective industries, has risen by 60 percent since the end of 2010. That rise compares with a 45 percent lift in the same time period in the broader STOXX Europe 600 index, from which the Low Carbon 100 Europe list was selected."

[71] Robert G. Eccles, Michael P. Krzus & George Serafeim, *Market Interest in Nonfinancial Information*, (Harv. Bus. School, Working Paper 12-018 at 1, 2011) at 6. The Bloomberg database contains 247 extra-financial metrics, which the study grouped into five categories: disclosure scores, environmental metrics, social metrics, governance metrics, and Carbon Disclosure Project data. Bloomberg calculates the disclosure scores based on how many of the other metrics a company reports. The study answers the question: "What specific types of nonfinancial information are being used by investors?" *Id.* To do so the study compares data from the global and U.S. markets, across different components of ESG, and across asset classes and firm types. *Id.* at 15.

[72] *Id.,* at 7.

[73] *Id.*

Transparency and governance information also appear to be used as a proxy for good management,[74] because "more capable executives are confident in providing more performance information for which they are held accountable."[75] Investors may be relying in part on research that shows the connection between governance and firm performance,[76] and in part on management's ability to address ESG factors to the long-term benefit of the company.[77]

### B. Analysts' Views of Corporate Social Responsibility

Corporate social responsibility (CSR) describes an approach taken by a company to integrate ESG policies and practices throughout the operations of the company. CSR can include policies related to corporate governance, employee relations, supply chain relationships, customer relationships, environmental management, philanthropy, and community involvement.[78] Overall, analysts increasingly rate companies with strong CSR ratings higher than those without strong CSR ratings.[79]

Ioannis Ioannou and George Serafeim studied sell-side analysts' stock recommendations for a large sample of companies from 1993-2007[80] and found a change in the analysts' views of CSR ratings over that period of time.[81] In the early years of the study, companies with relatively high CSR ratings received less favorable recommendations than other companies.[82] The authors attribute this finding to the fact that analysts were influenced by the then prevailing agency theory, which saw CSR policies as serving non-shareholder stakeholders and destroying shareholder wealth.[83] In the later years of the study, analysts' recommendations for companies with high CSR ratings shifted

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[74] UNEP-FI & MERCER, *supra* note 2, at 50–51.
[75] Eccles et al., *supra* note 71, at 10.
[76] *Id*. The article describes the existence of "[a] long and significant stream of literature and research findings on the implications of governance for firm performance and riskiness. *Id*. at 1 (citing Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control*, in G.M. CONSTANTINIDES, M. HARRIS & R. M. STULZ (ED.), HANDBOOK OF THE ECONOMICS OF FINANCE 1 (2003).
[77] Eccles et al., *supra* note 71, at 2 ("transparency around ESG performance and policies is used as a proxy for management quality and the potential for the management to grow profitably the business in the future.").
[78] UNEP-FI & MERCER, *supra* note 2, at 7.
[79] 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) (citing to a number of studies and scholarly articles describing the importance to companies of establishing CSR policies and practices)..
[80] *Id.* at 4.
[81] The study used CSR ratings based on policies and practices adopted by corporations with respect to corporate governance, environmental and social issues. *Id.* at 4, 18.
[82] *Id.* at 4.
[83] The authors describe the analysts as influenced by the then prevailing agency theory which saw CSR policies as serving non-shareholder stakeholders and destroying shareholder wealth. They note the influence of Milton Friedman who wrote, in 1970 that "the social responsibility of the firm is to increase its profits". *Id.* at 7–8 (citing Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, NEW YORK TIMES MAGAZINE 32(13), 122–126 (1970)).

to less pessimistic and eventually to optimistic recommendations.[84] The authors attribute this shift to a change in the perceptions of CSR for both shareholders and analysts.[85] The authors explain that by the end of the period of the study CSR had been re-interpreted "as a legitimate part of corporate strategy, minimizing operational risks and even contributing positively towards long-term financial performance."[86] In an interesting related finding, the authors showed that analysts with more experience or higher status were likely to adjust their assessments of CSR ratings more quickly than other analysts.[87]

### C. U.N. Principles for Responsible Investment

#### 1. Created by the U.N.

The Principles for Responsible Investment (PRI) provide additional evidence of investor interest in ESG investing.[88] Convened by the U.N. Secretary-General, a group of international institutional investors developed the Principles in 2006. The preamble states:

> As institutional investors we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.[89]

#### 2. Signatories

As of May 2018, over 1900 institutions have signed the Principles,[90] agreeing to "incorporate ESG issues into investment analysis and decision-making processes,"[91] to incorporate ESG issues into active ownership practices, to seek appropriate disclosure on ESG issues, and to promote the implementation of the Principles.[92] The Principles encourage investors to consider ESG factors as part of a conventional investment analysis.

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[84] UNEP-FI & MERCER, *supra* note 2, at 4, 26–27.
[85] *Id.* at 3.
[86] *Id.* at 12.
[87] *Id.* at 27.
[88] U.N. PRINCIPLES FOR RESPONSIBLE INVESTING, https://www.unpri.org/signatories/who-has-signed-the-principles.
[89] *The Six Principles*, U.N. PRINCIPLES FOR RESPONSIBLE INVESTING, http://www.unpri.org/about-pri/the-six-principles/.
[90] *Signatories to the Principles for Responsible Investing*, U.N. PRINCIPLES FOR RESPONSIBLE INVESTING, http://www.unpri.org/directory/. There are three signatory categories: asset owners (321), investment managers (1058), and professional service partners (212) for a total on November 10, 2016 of 1,591. *Id.* J.P. Morgan Asset Management, Russell Investments, Breckinridge Capital Advisors, Goldman Sachs Asset Management, Mellon Capital Management Corporation, and Mirova are signatories in the investment manager's category. *Id.*
[91] *The Six Principles*, *supra* note 87. This is the first of six Principles.
[92] *The Six Principles*, *supra* note 87.

### D. Investment Services

Firms that offer traditional investment services to institutional investors and individuals increasingly tout their sustainability products or ESG approaches. Some firms now offer special ESG products, and 50% of firms responding to a Financial Times survey of CEOs in 2016 reported that they used ESG factors "as a default across all funds and products."[93] The survey also reported: "52% of CEOs said client demand had been the major influencing factor on their ESG policy." The financial companies are using ESG integration both to improve results and because their clients demand it.

#### 1. J.P. Morgan

In the "About Us" link on J.P. Morgan's homepage, one of three links is to a page entitled "corporate responsibility.[94] On that page, J.P. Morgan explains, "Balancing non-financial factors, such as environmental and social issues with financial priorities, is fundamental to risk management and the core of corporate responsibility." This statement is listed under the heading "Principles Guiding Our Business." The website also explains the firm's belief that meeting societal needs will boost economic growth in the long term, and states that J.P. Morgan strives to manage its own buildings in an efficient and sustainable manner. The corporate responsibility page also describes J.P. Morgan's commitment to strengthening communities through its products, services and initiatives.

#### 2. Russell Investments

Russell Investments says on its "about Russell" page that it has "five distinct capabilities that we believe are required to run money."[95] The second of these is responsible investment, and Russell explains: "Russell Investments recognizes the importance of environmental, social, and corporate governance issues. They not only affect our clients' investments and financial security. They affect our business and communities in which we live and work. To reinforce our commitment to these issues, we are a signatory of the UN Principles for Responsible Investment (UN PRI)."[96] The website then describes the work of the Russell Sustainability Council.[97]

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[93] Elizabeth Pfeuti, *Fund Managers Start to Heed Investors' ESG Calls*, FINANCIAL NEWS (Aug. 21, 2016).
[94] J.P. MORGAN, *Corporate Sustainability*, https://www.jpmorgan.com/country/US/EN/corporate-responsibility.
[95] RUSSELL INVESTMENTS, *About Russell*, http://www.russell.com/us/about-russell/default.page.
[96] RUSSELL INVESTMENTS, *Responsible Investments*, http://www.russell.com/us/about-russell/corporate-responsibility/responsible-investment.page.
[97] *Id.*

### 3. Breckinridge Capital Advisors

Breckinridge Capital Advisors has incorporated the use of ESG factors into its analysis of fixed income assets.[98] In a video on the Breckinridge website, Nicholas Elfner, Director of Corporate Research, explains that ESG analysis is "fully integrated in the credit research group."[99] Current methodologies to analyze fixed income assets may not assess extra-financial risks affecting companies and municipalities. With its focus on fixed income investments, Breckinridge is particularly concerned with risk mitigation and has found that ESG factors may identify risks that do not surface in the traditional credit process.[100] Elfner explains that the result of ESG factor analysis is a "better, more comprehensive, forward looking assessment of a debt issuer's creditworthiness. Additionally, Breckinridge believes that a company or municipality that works to manage its material ESG risks may be a more stable credit and a better long-term investment."[101]

### 4. Goldman Sachs

Goldman Sachs integrates ESG analysis into its financing, investing, and asset management work, and applies ESG considerations in how it runs itself.[102] The firm established an Environmental Policy Framework in 2005, and its Board continues to review the framework.[103] Under the framework Goldman has "committed to deploy our people, capital and ideas to help find effective market-based solutions to environmental issues."[104] To that end, Goldman finances, co-invests, and serves as a financial advisor for a variety of clean energy transactions.[105] Goldman also incorporates ESG analysis in its own business structure, for example by reducing the carbon footprint of its offices,[106] and uses

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[98] BRECKINRIDGE, *Learn More About Our ESG Approach*, FAST.WISITA (Apr. 19, 2016), http://fast.wistia.net/embed/iframe/2sy4yochuj.
[99] *Id.*
[100] *Id.*
[101] *Id.* Email from Kristin Wetherbee to author (Feb. 12, 2016).
[102] *See* GOLDMAN SACHS, ENVIRONMENTAL, SOCIAL, AND GOVERNANCE IMPACT REPORT, http://www.goldmansachs.com/citizenship/esg-reporting/index.html. Goldman began publishing an Environmental Report in 2006. It became an Environmental, Social and Governance Report in 2010. *Id.*
[103] GOLDMAN SACHS, OUR IMPACT DRIVES GLOBAL PROGRESS: SELECTED HIGHLIGHTS FROM 2012 ESG REPORT, (2012), *available at* http://www.goldmansachs.com/citizenship/esg-reporting/esg-2012-highlight-pdf-report.pdf. Board engagement reflects a high-level commitment to the environmental framework. Goldman also prepares a governance report each year, following the G3 reporting framework.
[104] *Id.*
[105] *Id.* at 2–3.
[106] *Id.* at 4 (describing Goldman's operational impact).

ESG factor analysis in work for asset management clients. The website for Goldman Sachs Asset Management[107] explains:

> [W]e believe responsible and sustainable investing extends beyond the evaluation of quantitative factors and traditional fundamental analysis. Where material, it should include the analysis of an entity's material impact on its stakeholders, the environment and society. We recognize that these environmental, social and governance (ESG) factors can affect investment performance, expose potential investment risks and provide an indication of management excellence and leadership. As a result, it is important for our investment professionals to understand how environmental, social and governance factors influence our investment decisions. To this end, GSAM is working to more formally integrate the analysis of these factors into our investment processes, where appropriate and consistent with our fiduciary duties.[108]

Goldman views its use of ESG in part as "good citizenship" as indicated by the discussion of ESG in the citizenship link on the website, but as the quoted passage explains, Goldman's asset managers view ESG analysis as an important tool to improve results for clients.

#### 5. BNY Mellon

BNY Mellon makes its own corporate social responsibility a central part of its explanation of "who we are." The firm files a CSR report annually,[109] and says that it is expanding its social responsibility "beyond our already strong employee engagement, environmental stewardship and community commitments."[110] BNY Mellon uses the term "social finance" to mean "investment activities that include both financial and significant social and/or environmental impact."[111] BNY Mellon has created a framework that integrates ESG factors into investment decisions and includes environmental finance, impact investing, and development finance. The website notes: "Social finance has increasing value for mainstream investors because it can provide a sustainable set of tools to help manage investment risk, diversify portfolios and support long-term financial

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[107] As an investment firm Goldman Sachs engages in investment banking, securities work, investing and lending, and investment management. GSAM is one of two divisions within investment management; the other is private wealth management. Thus, GSAM is the core of Goldman Sachs' investment management work, not a separate "socially responsible" division. *See* GOLDMAN SACHS, http://www.goldmansachs.com (last visited May 21, 2015).

[108] *Responsible and Sustainable Investing*, GOLDMAN SACHS, http://www.goldmansachs.com/s/esg-impact/governance/responsible-and-sustainable-investing/. Goldman became a signatory of the U.N. Principles for Responsible Investing in 2011. *Id.*

[109] *See* 2013 ANNUAL CSR REPORT, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-responsibility/2013-annual-report.jsp.

[110] *Corporate Social Responsibility*, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-responsibility/index.jsp.

[111] *Social Finance*, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-finance/index.jsp.

performance." The description of social finance recognizes that some investors want to build their investments around their social and environmental values, but also notes that for mainstream investors "we believe there's untapped market potential in social finance."

#### 6. Mirova

One more example is Mirova, a subsidiary created by the international investment firm, Natixis Asset Management.[112] In 2013 Natixis established Mirova as an investment division focused on responsible investment. Then in January 2014 Natixis moved the division into a management company called Mirova, a wholly owned subsidiary. The creation of the subsidiary reflects the desire "to accelerate the development of its responsible investment activities." Mirova seeks to offer "a new approach to responsible investment" and its "philosophy is based on the conviction that integrating sustainable development themes can generate solutions that create value for investors over the long term."

## VII. Reporting Issues – Information Challenges

### A. Sustainability Reporting and Integrated Reporting

Sustainability reporting refers to reporting by a company about its environmental, social, and economic impacts. The Global Reporting Initiative (GRI) defines sustainability reporting as follows:

> A sustainability report is a report published by a company or organization about the economic, environmental and social impacts caused by its everyday activities. A sustainability report also presents the organization's values and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy.[113]

Integrated reporting is the merging of financial and extra-financial information about a company based on an assumption that both financial and extra-financial information are needed to assess a company's true value.[114] While sustainability reporting focuses on the extra-financial data, integrated reporting presents all data relevant to a company in one report.[115] Integrated reporting can assist those who manage a company to

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[112] *Natixis Asset Management announces the creation of Mirova, a management company*, MIROVA (Jan. 6 2014), *available at* http://www.mirova.com/Content/Documents/Presse/va/PR%20Mirova.pdf.
[113] *Sustainability Reporting*, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/sustainability-reporting/Pages/default.aspx.
[114] *See Integrated Reporting: Tips for Organizations*, EY, http://www.ey.com/GL/en/Services/Specialty-Services/Climate-Change-and-Sustainability-Services/EY-integrated-reporting-tips-for-organizations (explaining: "Intangible assets have gone from accounting for just 17% of market value in 1975 to 80% in 2010.").
[115] *See* ROBERT G. ECCLES & MICHAEL P. KRZUS, ONE REPORT: INTEGRATED REPORTING FOR A SUSTAINABLE STRATEGY (2010). *See also* ROBERT G. ECCLES & MICHAEL P. KRZUS, THE INTEGRATED REPORTING MOVEMENT: MEANING, MOMENTUM, MOTIVES, AND MATERIALITY (2014).

link long-term strategies with environmental, social, and financial objectives. Integrated reporting has been defined as follows:

> An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium, and long term.[116]

### B. Development of Sustainability Reporting

In the early 1990s, advisors connected with CERES, the Coalition for Environmentally Responsible Economies, began developing a framework for environmental reporting, and in 1997 CERES created the Global Reporting Initiative (GRI).[117] As work on the initiative continued, the scope expanded to include social, governance and economic reporting. GRI issued the first Sustainability Reporting Framework, with Reporting Guidelines, in 2000. At that time, CERES separated from GRI and GRI became a separate international nonprofit organization. GRI's mission is to "to make sustainability reporting standard practice for all companies and organizations."[118] GRI has continued to update the Reporting Framework and released the GRI Standards in 2016. The GRI Standards are based on the Sustainability Reporting Guidelines, G4, issued by GRI in May 2013.

### C. Development of Integrated Reporting

The International Integrated Reporting Council (IIRC), "a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs,"[119] was created to develop a globally accepted reporting framework that would integrate information about the creation of value over time into one concise report. The initial version of its International Integrated Reporting <IR> Framework was released in December 2013. This framework incorporates six types of capital: financial, manufactured, human, social and relationship, intellectual and natural, and it provides Guiding Principles and Content Elements, but it does not establish measurement and reporting standards.

A company can use the Generally Accepted Accounting Principles (GAAP) for financial information included in an integrated report. For extra-financial information, the

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[116] The International Integrated Reporting Council (IIRC), *The International <IR> Framework*, at 7 (2013), http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf.

[117] *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; *What Is GRI?*, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/about-gri/what-is-GRI/Pages/default.aspx.

[118] *About GRI*, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/about-gri/Pages/default.aspx.

[119] *The IIRC*, http://integratedreporting.org/the-iirc-2/.

Climate Change Reporting Framework[120] developed by the Climate Disclosure Standards Board and the G4 Guidelines provide guidance on disclosures but do not provide reporting standards.

### D. The Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board (SASB) was created in July 2011 and is "dedicated to enhancing the efficiency of the U.S. capital markets by fostering high quality disclosure of material sustainability information that meets investor needs and enhances public trust in companies."[121] From 2012 to 2016 SASB developed Provisional Standards for 79 industries grouped into 11 sectors and requested public comment on the standards.[122] The standards are industry-specific, and create performance metrics and a process for determining materiality of issues.[123]

The SASB standards are designed for voluntary use in making disclosures required by existing U.S. regulation in filings with the Securities and Exchange Commission (SEC), such as Forms 10-K and 20-F. SASB made changes to the Provisional Standards and released the Exposure Draft of the Standards, requesting public comment from Oct 2, 2017 through Jan. 31, 2018. SASB plans to release final Standards in mid-2018.[124]

### E. Reporting by Companies

Although a standardized reporting format that captures extra-financial data has not been available, a 2013 KPMG survey found increasing numbers of companies providing some form of sustainability reporting or integrated reporting.[125] The survey found that 71% of companies worldwide reported on corporate responsibility or sustainability, and 93% of the world's 250 largest companies reported. Of those reporting, 78% of worldwide companies and 82% of the largest 240 companies refer to the GRI reporting guidelines. The companies surveyed were the largest 100 companies in each of 41 countries. The increases in reporting are driven in part by growing numbers of mandatory reporting policies, both government and stock exchange.

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[120] *See CDSB Reporting Framework*, CLIMATE DISCLOSURE STANDARDS BOARD, http://www.cdsb.net/cdsb-reporting-framework (2013).
[121] *Standards Board*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, *available at* https://www.sasb.org/about-the-sasb/the_sasb/.
[122] *Provisional Standards*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, *available at* https://www.sasb.org/download-the-standards/.
[123] *See Revision: Conceptual Framework*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, *available at* http://www.sasb.org/wp-content/uploads/2016/04/SASB-Conceptual-Framework-04.04.2016.pdf.
[124] *See Exposure Drafts*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, *available at* http://www.sasb.org/standards/status-standard/.
[125] *See The KPMG Survey on Corporate Responsibility Reporting 2013*, KPMG (2013), http://www.kpmg.com/global/en/issuesandinsights/articlespublications/corporate-responsibility/pages/corporate-responsibility-reporting-survey-2013.aspx.

Sustainability reports assist investors and other stakeholders in understanding a company's progress and overall strategy [126] and assist companies in developing sustainability strategies that can be incorporated into business operations.[127] In a poll taken by people attending GRI's Global Conference on Sustainability and Reporting a majority of respondents said that principal objectives of a sustainability strategy were "to add value" and "to identify and mitigate risks."[128] Business reasons, including financial benefits, appear to be leading to greater use of sustainable and integrated reporting as a means of improving companies' responses to ESG issues.

### F. Will Reporting Be Required By the SEC?

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.[129] One section of the concept release, titled "Disclosure of Information Relating to Pubic Policy and Sustainability Matters," notes the increasing interest in ESG information for voting and investment decisions.[130] This section reviews comments from those advocating more disclosure requirements and those cautioning against regulations requiring social or environmental disclosure.

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 are concerned about social and environmental factors for financial as well as extra-financial reasons. And the increase in attention to these issues for shareholder action may make them material for that reason.[131]

In June 2016, the SEC's own Investor Advisory Committee submitted comments on the concept release, responding to the request for feedback.[132] With respect to

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[126] As the EY and GRI report concluded: "Once reporting has become standardized and easy to compare, there is little doubt that performance indicators on sustainability issues will become as important for business as financial performance." EY & GRI, *Sustainability Reporting – The Time is Now*, http://www.ey.com/Publication/vwLUAssets/EY-Sustainability-reporting-the-time-is-now/$FILE/EY-Sustainability-reporting-the-time-is-now.pdf.

[127] *The KPMG Survey on Corporate Responsibility Reporting 2013*, *supra* note 106, at 10 ("CR reporting is the means by which a business can understand both its exposure to the risks of these [environmental and social] changes and its potential to profit from the new commercial opportunities.").

[128] EY & GRI, *supra* note 126, at 7.

[129] *See Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K, 17 CFR Parts 210, 229, 230, 232, 239, 240 and 249, Release No. 33-10064; 34-77599; File No. S7-06-16 (April 2016) (herein "SEC concept release") https://www.sec.gov/rules/concept/2016/33-10064.pdf.*

[130] SEC concept release, *supra* note 129, at 204.

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

[132] Letter from SEC Investor Advisory Committee to SEC Division of Corporate Finance (June 15, 2016), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-approved-letter-reg-sk-comment-letter-062016.pdf.

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."[133] The comments 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."[134] 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."[135] The GRI and the SASB, discussed above, are attempting to create that analytical framework.

## VIII. Fiduciary Duties

### A. Duty of Obedience

In trust law the duty of obedience is the duty to carry out the terms of the trust, as established by the settlor.[136] For example, if a settlor directs the trustee to invest in an environmentally sustainable way, the trustee will be bound by that direction, unless the trustee seeks court authorization to modify the terms of the trust.[137] Most trust instruments will not provide mandatory instructions on investment decision making, and for those trusts the duty of obedience affects investment decision making only in the sense that the trustee must manage the assets of the trust in a manner consistent with the settlor's directions with respect to the beneficial interests. For a charitable trust or nonprofit corporation, the duty of obedience is the duty to carry out the charitable purposes of the charity.

### B. Duty of Loyalty – Acting in the Interests of the Beneficiaries

The duty of loyalty is the duty to act in the sole interests (trust law)[138] or the best interests (nonprofit corporate law)[139] of the beneficiaries. A fiduciary cannot put the interests of the fiduciary, someone related to the fiduciary, or anyone else above the interests of the beneficiaries. This duty focuses on risks to the beneficiaries caused by conflicts of interest, but also means that the fiduciary must at all times be mindful of the interests of the beneficiaries and cannot let social issues unrelated to the interests of the beneficiaries influence decisions.

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[133] *Id*.
[134] *Id.*
[135] *Id.*
[136] RESTATEMENT (THIRD) OF TRUSTS § 76 (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).
[137] A trustee might ask a court to modify an investment restriction based on changed circumstances. *See* RESTATEMENT (THIRD) OF TRUSTS § 66 (2003); In re Pulitzer's Estate, 249 N.Y.S. 87 (1931), aff'd mem. Sub nom. Matter of Pulitzer, 260 N.Y.S. 975 (1931) (permitting the trustee to sell stock in two newspaper companies, despite a settlor-imposed restriction, due to financial problems during the Great Depression).
[138] RESTATEMENT (THIRD) OF TRUSTS § 78 (2007).
[139] RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORG. § 2.02 TD No 1 (2016).

### 1. Prudent Investments

If the interests of the beneficiaries with respect to investments are viewed as solely financial—to earn the highest return possible with the least risk—then an investment strategy that knowingly accepts a lower return is a breach of the duty of loyalty. A Comment to UPIA voiced this concern:

> 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.[140]

An investment decision adverse to the interests of the beneficiaries could violate the duty of loyalty, but many forms of impact investing do not necessarily result in below-market returns. For example, a fiduciary engaging in ESG investing does not expect a lower return. Indeed, some analysts use ESG investing to increase returns on a risk-adjusted basis. Thus, ESG investing is not per se a breach of the duty of loyalty. The fiduciary must take appropriate steps in selecting a fund or fund manager and otherwise comply with the duty to be a prudent investor, but under a current understanding of the prudent investor standard, a fiduciary can engage in ESG investing in compliance with the prudent investor standard. As long as the investment decisions are prudent, they will not violate the duty of loyalty. Thus, a decision to engage in ESG investing does not put any interests above the financial interests of the beneficiaries.

### 2. Interests of Beneficiaries of Private Trusts

Some beneficiaries of private trusts may want to use their investment assets to accomplish non-financial as well as financial goals and may be willing to take a reduced financial return in order to do so. In this case, the investment decision might result in two types of benefits, financial and non-financial. A determination of whether such a decision breaches the duty of loyalty requires consideration of the beneficiaries' interests. The difficulty for a trustee of a private trust is that typically the trustee will owe duties to multiple beneficiaries, sometimes including not-yet-ascertained beneficiaries. A decision based on beneficiaries' preferences with respect to investments may not comply with the duty of loyalty, unless the investments meet the prudent investor standard, although some trustees might argue that the long-term, non-financial benefits of impact investing inure to the benefit of all beneficiaries.

Although the interests of beneficiaries with respect to the investment of trust assets have been interpreted to mean financial interests, perhaps interests should be interpreted more broadly. For example, should investments yield blended value and not just financial value? The difficulty for a trustee is determining how to determine

[140] UNIF. PRUDENT INVESTOR ACT § 5 cmt. (1994).

which non-financial interests should be considered, if the consequence will be accepting a lower rate of return.

### 3. Mission-Related Investing by Charities

Some charities chose to use investment assets to promote their charitable missions while also generating financial returns. For a charity, the duty of loyalty is owed to the mission of the charity. The fiduciary must put the interests of the charitable mission above all other interests. A charity with an endowment might decide to invest the endowment in a way that generates income to use directly in carrying out its mission and also invest in companies that align with its mission. Whether an impact investing fund can be considered mission-related depends on a charity's mission and whether the fund's guidelines help carry out that mission. A cancer organization might choose not to invest in tobacco stocks; an environmental organization might choose to invest in a company developing solar energy.

If a charity acquires an asset with a dual purpose, both as an investment and as a means to carry out its mission, then the charity is complying with its duty of loyalty even if the acquisition does not generate as much return as another investment might.[141] The mission part of the investment can compensate for a somewhat lower investment return. Both UPMIFA (for nonprofit corporations) and UPIA (for charitable trusts) support mission-related investing. Both statutes direct a fiduciary to consider the charity's purposes in making investment decisions,[142] and permit a fiduciary to consider an asset's "special relationship or special value" to the purposes of the charity.[143]

A charity might want its endowment to align with its mission but still meet benchmarks for financial return. Mission-related investing does not necessarily result in lower-than-benchmark returns. For example, the Jessie Smith Noyes Foundation ties its investments to a mission-driven portfolio, but monitors the funds and the fund managers against conventional benchmarks.[144] The Foundation's investment policy states that its goals include producing income and capital gains to support operations and grant-making, providing capital directly to enterprises that further the mission, owning equity or debt in companies that further its mission, and avoiding investments in "companies whose environmental or social impacts contribute to the issues that the Foundation's grant-making seeks to address."[145] The review process for managers suggests that any managers who do not succeed financially as well as with respect to the Foundation's mission will be replaced.

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[141] *See* Gary, *supra* note 9.
[142] UNIF. PRUDENT INVESTOR ACT § 2(a) (1994); UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3(a) (2006).
[143] UNIF. PRUDENT INVESTOR ACT § 2(c)(8) (1994); UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3(e)(1)(H) (2006).
[144] *See Jessie Smith Noyes Foundation Investment Policy*, JESSIE SMITH NOYES FOUND., http://www.noyes.org/mission-based-investing/investment-policy.
[145] *Id.*

### 4. IRS Notice 2015-62

In response to growing interest in—and questions about—mission-related investing, the Internal Revenue Service issued Notice 2015-62 in September 2015.[146] The Notice applies to private foundations, a category of charities that typically have only one or a few donors,[147] but the analysis of fiduciary duties applies to any charity. The Notice confirms that an investment made both to further the charity's purposes and to produce financial returns is not a breach of fiduciary duties, even if returns are lower than they might otherwise be.

The Internal Revenue Code (I.R.C.) imposes penalties on private foundation managers who make investments that jeopardize the carrying out of the foundation's exempt purposes.[148] Jeopardizing investments are those entered into by managers who "have failed to exercise ordinary business care and prudence."[149] This rule focuses on the financial performance of the investments. An exception to the rule permits program-related investments (PRIs), defined as investments entered into primarily to accomplish one or more of the charitable purposes of the private foundation.[150] A PRI might produce some financial gain, but any financial return is considered incidental to the primary purpose of carrying out the charity's mission.

Until Notice 2015-62 no I.R.C. provision directly addressed the treatment of mission-related investments that were not *primarily* related to mission. The Notice clarifies that a mission-related investment will not be considered a jeopardizing investment, even if the return on the investment is less than would be expected for an investment unrelated to the charity's purposes. The Notice explains that this result is consistent with state law.[151] Thus, Notice 2015-62 supports the conclusion that a charity's trustees or directors can engage in mission-related investing without breaching their fiduciary duties.

## C. Duty of Care and the Duty to Act as a Prudent Investor

Under current law fiduciaries have a general duty to manage property as a prudent person would, keeping in mind the directions of the settlor (for a trust) and the interests of the beneficiaries of a trust or the purposes of the charity.[152] The fiduciary must act as a prudent investor with respect to any investment assets, and this section explores the history and current meaning of the prudent investor standard. The standard developed in trust law,

[146] Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).
[147] I.R.C. § 509 (2012).
[148] I.R.C. § 4944(c).
[149] Treas. Reg. § 53.4944-1(a)(2)(i).
[150] I.R.C. § 4944(c).
[151] Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).
[152] *See* RESTATEMENT (THIRD) OF TRUSTS § 77 (2007); UNIF. TRUST CODE § 804 (2010) ("Prudent Administration"); UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (2006).

and applies to all fiduciaries who manage property for others, including directors of charitable nonprofit corporations and managers of pension funds.

### 1. History of the Prudent Investor Standard

The famous case of *Harvard College vs. Amory*[153] was the first to articulate the idea of a prudent investor. In that case, the Supreme Judicial Court of Massachusetts declared that a trustee must act with the care a prudent man would use to manage his own assets.[154] Prior to this case, trustees relied on "legal lists." They could invest in anything on the list, but had to avoid anything not on the list.[155] The idea of a "prudent man" was intended to permit more discretion for the trustees. State legislatures and courts adopted the prudent man standard, later termed the prudent person standard, but over time interpretations of the standard increasingly restricted the initial flexibility.[156] The courts focused on the protection of principal and avoidance of risk. Over time the standard came to mean that investing in government or corporate bonds was prudent and investing in land or new enterprises was not.[157]

In the second half of the twentieth century, the standard continued to evolve. An influential study analyzed returns of stocks and bonds from 1926 through 1978 and demonstrated that returns for stocks exceeded those for bonds on an inflation-adjusted basis.[158] Economists developed modern portfolio theory and the theory of efficient markets, and professional investment managers began to develop new strategies for better investment results.[159] The Uniform Prudent Investor Act (UPIA) embraced modern portfolio theory, including the idea that risk analysis should be carried out on the portfolio as a whole rather than on an asset-by-asset basis. UPIA also adopted modern portfolio

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[153] 26 Mass. 446 (1830).
[154] The court's famous statement, which became the foundation of the prudent man rule, was either an alternative holding or dictum. *See* Harvey P. Dale, Victoria B. Bjorklund, Jennifer I. Reynoso, and Jillian P. Diamant, *Evolution Not Revolution: A Legislative History of the New York Prudent Management of Institutional Funds Act,* 17 N.Y.U. J. of Legis. & Pub. Pol'y 377, 385 (2014).
[155] *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 643-45 (1996) (describing the history and development of the prudence standard prior to the Uniform Prudent Investor Act (UPIA); *see, also*, Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis,* Discussion Paper 816, The Harvard John M. Olin Discussion Paper Series: http://www.law.harvard.edu/programs/olin_center/; Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?* 50 J. LAW & ECON. 681, 683-686 (2007).
[156] *See* RESTATEMENT (THIRD) OF TRUSTS § 90 (2007), Reporter's General Note.
[157] *See* RESTATEMENT (SECOND) OF TRUSTS § 227 (1959), cmt. (f). The Restatement explains that although "a man of intelligence" may invest in something if the risk of loss is not out of proportion with the opportunity for gain, a trustee could not do so because preservation of the fund must be a primary consideration. *Id.* at cmt. (e).
[158] *See* Roger G. Ibbotson & Rex A. Sinquefield, STOCKS, BONDS, BILLS, AND INFLATION: HISTORICAL RETURNS (1926-1978) 29-30 (2d ed. 1979).
[159] *See* Jonathan R. Macey, AN INTRODUCTION TO MODERN FINANCIAL THEORY (ACTEC Foundation, 1991); *see also* Langbein, *supra* note 155, at 642 (explaining the effect of these theories on the development of UPIA).

theory's emphasis on diversification of assets in the portfolio.[160] The prudent investor standard, as set forth in UPIA, guides fiduciary practice in all states.[161]

UPIA directs trustees to manage risk across the trust's portfolio, and to consider "the risk and return objectives" of the trust in making decisions.[162] Rather than making the goal risk avoidance, under UPIA a trustee should manage risk, as appropriate for the purposes of the trust. UPIA also emphasizes a prudent investor's duty to diversify investments.[163] UPIA permits delegation of investment decision making authority so long as the trustees "exercise reasonable care, skill, and caution" in establishing the scope and terms of the delegation and in selecting and monitoring financial managers.[164] Finally, UPIA directs trustees to consider the purposes of the trust in making investment decisions.[165]

UPIA applies to trusts, but the prudent investor standard applies more broadly to other fiduciaries.[166] Trust law has long informed legal rules related to charities, and the prudent investor rule will likely apply to any charity, however structured. In addition, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) adopts the prudent investor standard from UPIA for charities organized as nonprofit corporations.[167] Any fiduciary managing funds would look to UPIA for an understanding of the prudent investor standard.

### 2. The Prudent Investor Standard Today

The prudent investor standard continues to evolve, as investment strategies change. The Introductory Note to the Restatement's explanation of the prudent investor rule anticipated the changes to come:

> [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.[168]

The current change affecting what it means to be a prudent investor is the growing awareness that ESG factors can affect the financial bottom line of companies. Ideas about

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[160] *See* UNIF. PRUDENT INVESTOR ACT § 3, cmt.
[161] Forty-five states have statutes based on UPIA or adopting its principles. The other states have comparable statutes that pre-dated the promulgation of UPIA in 1994. *See id.,* Editor's Notes.
[162] *Id.* at § 2(b).
[163] *Id.* at § 3.
[164] *Id.* at § 9. *See, also*, Tibble v. Edison Internat'l, 135 S.Ct. 1823 (2015) (confirming the ongoing duty to monitor the prudence of investments and investment policy).
[165] *Id.* at § 2(a).
[166] *See* UNIF. PRUDENT INVESTOR ACT, Prefatory Note (1994).
[167] UNIF. PRUDENT MGMT. OF INST. FUNDS ACT, Prefatory Note (2006).
[168] RESTATEMENT (THIRD) OF TRUSTS, Pt. 6, Ch. 17, intro note (2007).

how an investor can best use ESG factors in making prudent decisions are developing, and as new strategies develop, they come within the prudent investor standard, which is a standard based on industry norms.

### 3. Fiduciary Questions Regarding the Duty to Act as a Prudent Investor

Trustees have wondered whether they can engage in ESG investing, fearing that it could be a breach of their duty to act as a prudent investor. Investors who use ESG investing often do so in part for the perceived non-financial benefits. If a fiduciary invests assets in a way that accepts a reduced financial return because the fiduciary wants to gain non-financial benefits for the trust, then the fiduciary would not be acting as a prudent investor unless the non-financial benefits relate to the purposes of the trust. The investment would raise a duty of loyalty question, as discussed above.

In the early years of SRI, many people assumed that SRI meant accepting a reduced investment return in exchange for social benefits. Early SRI involved negative screens—removing stocks of companies engaged in behavior the trustee or beneficiaries found objectionable. Because modern portfolio theory emphasized the importance of divestment, the assumption was that removing a group of stocks from a portfolio for a non-financial reason would result in lower returns for the portfolio. Although this assumption persists, studies have shown that ESG investing does not necessitate below-market returns.

A prudent investor looks at what other prudent investors are doing. Studies have shown that ESG investing does not necessarily result in lower returns, and financial analysts now use ESG factors to improve their decision making. The prudence investor standard has evolved to incorporate the use of ESG factors, if they are used as part of an overall financial strategy that uses traditional financial metrics as material information about environmental, social, and governance issues.

### 4. D.O.L. Bulletin 2015-01

A Department of Labor Bulletin issued in the fall of 2015 reflects the growing understanding that ESG investing is not per se a breach of the fiduciary duty to act as a prudent investor.[169]

In 1994 the DOL issued Interpretive Bulletin 94-1 to clarify that investments that were selected for collateral (e.g., social or environmental) benefits as well as financial return were acceptable, so long as the financial returns were comparable to the expected returns of other investments available to the pension plan. IB 94-1 stated that plan assets could not be used to promote public policy interests at the expense of the financial interests of the plan's beneficiaries. Fiduciaries should not accept lower expected returns.

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[169] I.B. 2015-01, published as § 2509.2015-01.

Then in 2008, the DOL issued Interpretive Bulletin 2008-01, which replaced IB 94-1. Although the new bulletin said that it did not alter the basic legal principles of IB 94-1, it stated that consideration of "collateral, non-economic factors" in investment decision-making should be rare and well documented. This statement resulted in confusion about how to treat ESG factors that have current or long-term financial or risk implications.

To address the confusion, the DOL issued Interpretive Bulletin 2015-01, published as § 2509.2015-01. This new bulletin removes IB 2008-1, reinstates IB 94-1 and provides related guidance. The bulletin addresses ETIs (economically targeted investments), which are investments selected for economic benefits as well as financial returns, and ESG investing. IB 2015-01 explains 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."

IB 2015-01 explains that "fiduciaries should appropriately consider factors that potentially influence risk and return" and that "environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment." The DOL 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." Finally, IB 2015-01 clarifies 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."

Although this DOL Bulletin applies to ERISA plans and not directly to other fiduciary situations, the guidance indicates the understanding that ESG investing is not per se a breach of fiduciary duty. ESG factors may affect the economic value of investments and a fiduciary should not ignore ESG factors simply because of historic concerns about SRI.

### D. Duty of Impartiality

The duty of impartiality 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. Many private trusts continue for different generations of beneficiaries, who will become entitled to distributions at different times.

The duty of impartiality requires fiduciaries to treat different generations of beneficiaries impartially.[170] The duty is an extension of the duty of loyalty, requiring the fiduciary to act in the best interests of the beneficiaries, but recognizes that beneficiaries have competing financial interests in the trust· Thus, the duty does not demand that

[170] *See* RESTATEMENT (THIRD) OF TRUSTS § 79 (2007).

fiduciaries treat each beneficiary equally, but, depending on the purpose of the trust, requires the trustee to consider the different needs of all present and future beneficiaries.

The fiduciary's duty of impartiality is of fundamental importance for the investment function,[171] because in investing 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."[172] 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.

## IX. Planning

### A. Drafting Instructions

If a settlor wants to permit, encourage or even require a trustee to engage in ESG investing or impact investing, the settlor can include a provision in the trust with those instructions. The settlor will need to be careful not to be overly prescriptive, to leave the trustee adequate flexibility for future changes. For example, using the term "ESG investing" might be ambiguous and in 20 years might be confusing. Providing that the trustee may consider environmental, social, and governance factors in making investment decisions or in choosing an investment advisor would provide guidance without being too restrictive.

### B. Choosing an Investment Advisor

In choosing an investment advisor, a trustee may want the selection process to include consideration of the environmental and social preferences of the settlor or beneficiaries or may want an advisor familiar with ESG integration as a strategy. If the directors or trustees of a charity decide to align investment of the endowment with mission, they will want to find an investment advisor or advisors who can assist in carrying out that plan.

Values are personal, so the first step is for the settlor, beneficiaries, or charity to think about the values and preferences they would like an investment advisor to consider. If an estate planner is working with a settlor to build preferences into a trust instrument,

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

[172] Jim Hawley & Jon Lukomnik, *The Long and Short of It: Are we asking the right questions?* 19 (Working Paper, 2017, on file with author) (discussing financial benefits of long-term strategies for investing).

the planner will need to understand the settlor's concerns and what the settlor hopes to accomplish through the investment of the trust assets. If the fiduciaries of a charity want to ensure that the charity's endowment is aligned with its mission, the fiduciaries will need to have a clear understanding of the mission and then consider how investment choices can affect the mission.

Here are some questions the trustee may want to ask, depending on the interests being pursued.[173] The questions are formulated around ESG investing as a strategy, but they can be adapted to particular goals and interests.

> What are the views or philosophy of the investment firm in relation to impact investing, ESG integration, and other investment goals?
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> Does the firm have dedicated ESG or impact investing strategies or funds?
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> What internal or external skills/expertise/research does the manager use to identify and assess ESG risks and opportunities relevant to prospective and actual investments?
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> How does the firm organize its ESG investing work - does the firm buy data, use a separate ESG research team, expect managers to develop ESG expertise, or some combination of those or other strategies? Why have they chosen this approach?
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> How do managers think about ESG and how are ESG factors integrated into their investment philosophy?
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> How are managers incentivized to incorporate ESG factors?
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> How does the firm implement its ESG strategy? Can they share a case study when ESG factors helped or hurt returns?
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> How are ESG factors incorporated into investment analysis and decision-making processes?
>
> How does the firm use ESG information to identify investment risks and opportunities or opportunities for engagement? How does this information impact investment decisions? How do they integrate ESG factors into the financial valuation of an investment?

[173] For useful questions and other resources related to interviewing investment firms see Wespath Investment Management, ESG in RFPs and the Asset Manager Selection Process, https://www.responsible-investor.com/images/uploads/reports/Wespath_Anita_Green.pdf; Aligning Expectations Guidance for Asset Owners on Incorporating ESG Factors into Manager Selection, Appointment and Monitoring, http://www.unpri.org/wp-content/uploads/Aligning_Expectations_2013.pdf.

How does the firm approach the analysis of investment risks that may have a low probability but a severe impact?

Depending on the concern being pursued, how does the firm define the issue for purposes of the strategy? For example, if the fiduciary is seeking a firm that will create a portfolio that is "fossil fuel free," what would that mean in constructing the portfolio?

With respect to shareholder engagement, does the manager have voting guidelines that relate to the concerns of the trust or charity? Can the firm help the fiduciary develop guidelines?

## X. Conclusion

The prudent investor standard now encompasses ESG investing, when used as part of an overall strategy that considers traditional financial analytics and material extra-financial information. Impact investing will not be a breach of a trustee's duty to act as a prudent investor, as long as the investment strategy does not contemplate lower financial benefits in order to obtain non-financial benefits.

If a fiduciary engages in impact investing with the goal of blended value, accepting a lower financial return in exchange for non-financial benefits, the fiduciary may violate the duty of loyalty unless an exception applies. First, the settlor of a private trust may have authorized impact investing in the trust instrument. If so, the trustee has a duty to carry out the terms of the trust, including the settlor's directions on investments. Second, a charity can engage in mission-related investing, even at a financial cost to the portfolio. A third option might be the consent of all beneficiaries to modify the terms of the trust to permit the trustee to engage in impact-first impact investing.

Investing for environmental or social impact will continue to be challenging, in part because reporting is not standardized. Better reporting will help, but attributing improved performance to consideration of ESG factors will remain tricky and determining whether the investment strategy has positive environmental and social effects will also be difficult. The benefits of targeted impact investing—investing in a particular project—will be easier to evaluate, because that strategy focuses directly on the impact sought.

Fiduciaries and their advisors should remember that the requirement to choose and monitor investments and investment advisors carefully remains. Fiduciaries can feel confident, however, that impact investing is not, per se, a breach of the fiduciary's duties. Looking ahead, the consideration of ESG factors may be something that all prudent investors should do.