

Integrating ESG – a practical framework for fund managers

Environment, social and governance (ESG) issues are now central to value, risk and investor engagement. As a consequence, fund managers are looking to integrate ESG considerations into their strategy and operations. This entails a shift for many managers who need to consider the ESG risks and opportunities for their businesses and the outcomes they want to achieve. But ESG integration is difficult because ESG is a broad theme and its application needs to be tailored to each specific context. This note sets out some practical steps managers can take towards ESG integration.

Why ESG integration matters

- **Value and risk:** the value of investments may increase if they are shown to have a positive impact on ESG outcomes. Conversely, a negative impact can destroy value through reputational harm. So ESG analysis needs to be integrated into the appraisal, monitoring and exit of investments.
- **Fundraising:** institutional investors are increasingly taking into account a manager's ability to meet ESG standards when making manager selections. These investors not only care about ESG but also have their own regulations to comply with (see [here](#) for our briefing on new rules facing pension scheme trustees on climate change disclosures).
- **Regulation:** ESG regulation has come into force and more is on the way. The EU's sustainable finance disclosure regulation (SFDR) came into effect in March 2021. It will affect EU AIFMs and UK AIFMs that market their funds into the EU. In the coming months, the UK Government is expected to consult on domestic legislation regulating ESG disclosures in the funds industry.

Six Practical Steps to integrate ESG

Overleaf we have set out some headline areas that fund managers should consider as part of the ESG integration process. These are not necessarily in chronological order and are iterative. Some steps will likely need to be revisited as the landscape changes in the coming months (for example due to regulation). But they should give managers a steer on how to apply ESG both when investing (externally) and also internally as a firm.



Six Practical Steps to integrate ESG

- 1. Senior leadership:** ESG integration involves a firm reflecting on and potentially changing its core strategy and operations so as to embed ESG factors. This will not be possible without the backing of senior leadership. So the process must begin with the board / C-suite making a commitment to this change. The day-to-day design and delivery of the project can be managed by an executive. But this executive must (regularly) report to the senior leadership team as sponsor of the project. **Actions: prepare a board paper / strategic positioning paper and a project delivery plan.**
- 2. ESG materiality:** ESG is context-specific: a manufacturing firm may place more focus on health and safety, whereas a professional services firm may place more focus on human capital management. So, you need to determine which are the most material ESG issues for your business. As part of this process stakeholder engagement is key: speak to investors, employees, suppliers, management of investee companies, industry bodies and peers. This will help in framing your ESG approach from the two perspectives of investment manager and as a firm. **Actions: undertake internal research, engage with stakeholders, produce a stakeholder impact map and an ESG materiality matrix.**
- 3. Focus on outcomes:** with the materiality assessment done, you can consider the ESG outcomes your business aims to impact and how you will measure performance against those outcomes. For example, you could select a sub-set of the UN Sustainable Development Goals. **Actions: determine the long-term goals / UN SDGs you intend to impact, consider joining the UN Principles for Responsible Investment; consider how you will measure performance.**
- 4. Processes:** work out what business processes need to shift as a result of the above. It is likely that your investment process will need to change. Does your due diligence process need to change so that there is a focus on material ESG risks and opportunities? Is ESG considered in the business plans of underlying investments and do you need to implement regular ESG reviews for underlying investments? **Actions: update policies (including due diligence policy), update investment strategies (if applicable), update investee entity business plans and engage with management at investee entities.**
- 5. Governance and reporting:** think about whether you have the right structures in place as a firm. Do you have the right boards and committees in place and are the right people appointed to these? You may wish to consider the remuneration of some of your staff so that it is linked to sustainability outcomes? What enhanced reporting do you need to provide to your investors and how does this need to be updated in line with ESG regulation? How are you going to collect data from underlying investments to meet your reporting obligations? **Actions: review governance structures and policies, review remuneration policies, review applicable ESG regulation, update template reports and commit to an annual ESG impact report for stakeholders.**
- 6. Horizon scanning:** ESG is an evolving theme so it is important to keep abreast of current events, market practice and changes in regulation. In terms of regulation, it is worth understanding the key features of the SFDR and how it applies (the SFDR has been tipped as the gold/green standard of ESG regulation so you may wish to adopt some of its standards even if they do not directly apply). Our latest briefing is [here](#). **Actions: improve understanding of emerging regulation and subscribe to OC's ESG updates.**

Osborne Clarke can assist you in implementing these steps and beyond. Please get in touch for more information or to discuss how we can help.

Key contacts



Daniel Faundez

Associate Director UK
United Kingdom

T +44 117 917 3455
daniel.faundez@osborneclarke.com



Anna Perry

Senior Knowledge Lawyer UK
United Kingdom

T +44 117 917 3896
anna.perry@osborneclarke.com