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Responsible Investing

United Nations White Paper Explains How Hedge Fund Investors Can Layer Environmental, Social and Governance Factors into Manager Selection

Dec. 6, 2012

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There has been a surge of recent interest in "responsible investment" in and by hedge funds. However, the meaning of "responsible investment" is still being developed. The term broadly refers to the integration of environmental, social and governance (ESG) investment criteria; and hedge fund managers are increasingly incorporating ESG factors into their investment strategies. See "More Hedge Funds Are Employing Environmental, Social and Governance Investment Criteria," Hedge Fund Law Report, Vol. 4, No. 39 (Nov. 3, 2011). However, there is little consensus on the impact of incorporating ESG criteria into hedge fund investments and strategies, or how to do so most efficiently and effectively.

In 2006, the United Nations (U.N.) Secretary-General launched the Principles for Responsible Investment (PRI), a set of aspirational standards designed to guide investors towards creating a sustainable global financial system that fosters good governance, transparency, integrity and accountability. Hedge funds are important investment vehicles for many signatories to the PRI initiative. To assist its signatories in their hedge fund investments, PRI recently issued a white paper entitled, "Responsible Investment in Hedge Funds: A Discussion Paper." PRI's paper seeks to encourage meaningful debate about responsible investment in hedge funds; identify the ESG risks and opportunities presented by different hedge fund strategies and techniques; and provide guidance to investors on how to integrate ESG issues into their fund investment practices. Fund managers that are able to understand the issues at stake and to participate meaningfully in the dialogue can seize upon opportunities to attract capital from ESG-focused investors.

This article provides (1) an overview of PRI's paper, including its assessment of the advantages and risks of various hedge fund investment techniques and strategies for ESG investors, and (2) a roadmap for responsible investment in and by hedge funds.

Advantages and Risks of Various Hedge Fund Investment Techniques

Different hedge fund investment techniques present various risks and advantages to ESG-focused investors.

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Short Selling

Shorting can generate alpha if a hedge fund manager is able to identify and short overvalued securities. Efficient use of shorting can also allow investors and hedge fund managers to build portfolios that combine long and short positions, thereby hedging against the risk of market fluctuations. Critics call for strict regulation of short selling, observing that the technique can exacerbate market downturns, lead to artificial price fluctuations and harm market confidence. Nevertheless, many analysts and researchers support short selling as a legitimate investment technique that promotes efficient and liquid markets. The PRI paper urges investors to discuss short selling with hedge fund managers to ensure that the investors understand the technique and its potential impact on markets. For more on short sales by hedge fund managers, see "Impact of Regulation SHO on the Short Sale Activity of Hedge Fund Managers and Brokers-Dealers," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011).

Leverage

Leverage can help a fund manager generate alpha and allow fund managers to magnify the portfolio's risk/return characteristics. However, when leverage is excessive or improperly managed, it can have a destabilizing effect on a portfolio or the market. Following the 2008 financial crisis, fairly or not, hedge fund managers were publicly criticized for using excessive leverage and exacerbating the global financial crisis of 2008, and they remain under intense public and regulatory scrutiny.

According to the PRI paper, before investing, investors should understand a fund manager's approach to leverage, including: how leverage will be used in a fund; restrictions on the fund's use of leverage; the potential market impact of the fund's use of leverage; and the procedures to manage leverage and mitigate risk both within the fund and in the broader market. For more on trends in hedge fund leverage, see "Federal Reserve Credit Officer Survey Identifies Trends in Prime Broker Credit Terms, Hedge Fund Leverage and Counterparty Risk," Hedge Fund Law Report, Vol. 5, No. 17 (Apr. 26, 2012).

Derivatives

Derivative trading can generate alpha and facilitate more efficient and liquid trading than transacting directly in the underlying security or asset. However, according to the PRI paper, derivatives can encourage speculative trading and enhance losses. In the most extreme cases, losses can even exceed the amount of capital contributed to a hedge fund; in general, however, investor liability is limited to the investor's capital account balance in the fund. Derivative trading, particularly over-the-counter trading, also magnifies the risk of counterparty default.

The PRI paper recommends that investors in hedge funds ensure that they understand a fund manager's use of derivatives and management of counterparty and other risks. Investors should also understand proposed regulatory changes to the derivatives market and their impact on the industry. See "Practising Law Institute Panel Discusses Sweeping Regulatory Changes for Hedge Fund Managers That Trade Swaps," Hedge Fund Law Report, Vol. 5, No. 45 (Nov. 29, 2012).

High Frequency Trading

Some hedge fund managers engage in high frequency trading to profit from short-term mispricings in the market. Advocates and practitioners argue that this strategy contributes to market liquidity. Critics of the practice, however, assert that high frequency trading creates an

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unfair advantage for short-term versus long-term investors and increases market volatility. (A recent paper by CFTC Chief Economist Andrei Kirilenko and co-authors supports this view.) For a discussion of a recent case involving an enforcement action based on market manipulation through high frequency trading, see "Recent CFTC Settlement Highlights Regulatory Focus on Manipulation of Commodity Futures and High Frequency Trading," Hedge Fund Law Report, Vol. 5, No. 17 (Apr. 26, 2012). The PRI paper encourages hedge fund investors to understand the impact of high frequency trading strategies on a fund itself and the market overall.

Advantages and Risks of Various Hedge Fund Strategies

According to the PRI paper, investors focused on ESG issues should evaluate the capacity of various hedge fund strategies to integrate ESG criteria. Many hedge fund managers have not previously considered formally integrating ESG issues into their investment practices. Therefore, a fund manager's past practices may offer little guidance for responsible investors.

With the aim of assisting ESG-focused investors, PRI examined various hedge fund strategies, discussed below, to evaluate the ESG risks and opportunities each presents. PRI's criteria, which align with the organization's governing principles, include:

- The relevance of ESG data to research before investment decisions are made.
- The concept of active and responsible ownership (most importantly, voting rights and engagement with corporate management).
- Understanding and managing the overall market risks of each particular strategy.
- Examination of issues of particular concern to an investor, such as the need to maintain good relationships with particular stakeholders (e.g., a foreign government).

Fundamental Selection, Equity or Credit Long/Short Strategies

Strategies that focus on fundamental analysis lend themselves best to allowing a fund manager to consider ESG issues in investment decision-making. In contrast, consideration of ESG issues can be more difficult in strategies that involve being long/short on an index, as described below.

PRI's paper urged investors to consider the following when selecting a fund and fund manager:

- In hedge funds that engage in fundamental analysis, insist that ESG risks and opportunities be evaluated by fund managers in their investment decisions, particularly with respect to investments in emerging markets.
- Ensure that fund managers subscribe to international standards for governance, transparency and regulatory improvements.
- Discourage the practice of borrowing shares for the purpose of voting, which may result in an investor voting in different ways on key issues at companies held in various parts of its portfolio. Economic interests and voting rights should be coupled to promote efficient and transparent markets.
- Avoid strategies that involve large bets on a stock's decline or naked shorting (shorting without borrowing the stock that is being sold), as this may raise concerns for individual companies or the market at large.

Relative Value, Arbitrage and Volatility Strategies

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Certain hedge fund strategies – among others, statistical arbitrage, capital structure arbitrage, volatility arbitrage, convertible arbitrage, market making, relative value in structured mortgage-backed securities, basis trades, etc. – call for little or no analysis of fundamental factors and instead rely on computerized quantitative models. These types of investment strategies would appear to offer little or no possibility for consideration of ESG issues. However, fund managers using quantitative analysis have recently been successfully using ESG data in advanced optimization strategies.

ESG-focused investors should ensure that they understand what types of information hedge fund managers use in employing relative value, arbitrage and volatility strategies and demand that fund managers assess whether ESG information can add value. If high frequency trading is used, investors could also ensure that they understand the impact of high frequency trading on the fund itself and on the broader market.

Event-Driven, Corporate Distressed, Bankruptcy and Restructuring Strategies

ESG-focused investors should pay attention to the long-term impact of takeovers that occur through mergers or acquisitions. Distressed investing presents special social and governance concerns for ESG-focused investors, particularly with respect to "operational restructurings" that involve the potential for job losses resulting from a reorganization of a company. "Financial restructurings" that involve the making of investments in companies that are in default, in bankruptcy or in financial distress with the goal of restructuring or turning such companies around may present fewer ESG concerns.

Additionally, investors can ensure that hedge fund managers investing in distressed and event-driven strategies do not apply coercive tactics, which can include acquiring shareholder rights through derivatives positions.

Global Macro, Multi-Strategy and Global Tactical Asset Allocation Strategies

Global strategies can often encompass aspects of various other strategies discussed in this section along with other considerations. For instance, the use of equity/credit indices within a global macro strategy will require the ESG-focused investor to consider all of the fundamental analysis considerations related to equities and long/short credit strategies outlined above. In addition, global macro strategies require an investor to also consider ESG factors specific to a country, currency exchange risks and "security-level risks" related to foreign markets (including custody risks, settlement risks and capital control risks).

Foreign Exchange Strategies

Strategies employing large, directional foreign exchange bets raise concerns for ESG-focused investors because in extreme cases, these trades could destabilize markets and harm an investor's overall portfolio. Stakeholders could include foreign governments that could also oppose these trades. Investors can consider developing stringent due diligence measures to assess whether, if pursued by a range of fund managers, currency-based strategies could destabilize foreign markets.

Fixed Income – Government and Supranational Debt Strategies

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Investors can also discuss with fund managers country-specific issues, including exposure to the debt of countries with oppressive regimes and human rights violations. Investors can discuss restrictions on investments in sovereign bonds with a hedge fund manager, for instance, expressing displeasure with investments in the debt of a country under U.N. sanctions.

Mortgages, Asset Backed Securities, Specialized Credit and Financial Services

Investors can also insist that fund managers who pursue loan servicing and collection strategies comply with fair lending laws and avoid certain types of strategies altogether (such as traded life strategies). Investors can also demand disclosure from fund managers with respect to all parties involved in structuring securities and with respect to positions the issuer holds in the securities.

Commodities

Speculation provides liquidity in commodities markets, but some argue that aggressive speculative trading may have adverse effects on certain countries and negatively affect parts of an investor's portfolio. ESG issues are fundamentally embedded in commodities trading, and investors should ensure that they understand the particular issues associated with different commodity investments, including, for instance, the impact of commodity derivatives on markets.

Private Equity Strategies

Investors need to ensure that they understand the ESG risks and opportunities involved in private equity investments, just as they do for investment in public companies.

Roadmap for Investment in Hedge Funds

The PRI paper also provided ESG-focused investors with recommendations for engaging hedge fund managers with respect to ESG issues.

Communicate ESG Requests Before an Investment and Assess a Hedge Fund Manager's Ability to Comply

Responsible investors should explain to hedge fund managers why responsible investment practices are important for their portfolios. Investors should communicate their specific expectations for responsible investment practices prior to investing in a hedge fund. In contrast to ownership in a public company, where a shareholder has some influence post-investment, an investor in a hedge fund typically has much less ability to influence a fund manager once the investor is invested in the fund.

An investor's success in influencing a fund manager to adopt a responsible investment policy or accommodate specific ESG requests will depend on several factors, including the size of the investment, the size and history of management and whether an investment is made through a separate account versus a commingled fund. Aside from these factors, investors are more likely to have influence when collaborating, which is permitted in many jurisdictions.

Investors should evaluate a manager's ability to incorporate ESG factors when selecting securities and to assess and monitor broader issues such as the effect of hedge fund instruments

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and strategies on the market. Currently, very few hedge funds follow a policy that includes responsible investment commitments. Nevertheless, managers can demonstrate expertise in and dedication to responsible investing by discussing the role ESG factors played in past trades; by making ESG-related disclosures; and by actively incorporating investors' ESG-related requests in future investments.

Implement ESG Requests Through Formal, Legally-Binding Mechanisms

A hedge fund manager's ESG commitments can be evidenced in various ways, including: a side letter; the investment restrictions section of the manager's limited partnership agreement or shareholder agreement; and an ESG/responsible investment policy, including voting or engagement strategies where applicable. Investors should seek the highest available level of legal protection they can achieve with fund managers. The levels of legal protection, from most binding to least binding are: binding contractual commitments, with penalties for breaches; a formal responsible investment policy that is treated like all other policies, with penalties for breaches; and non-contractual commitments.

Ensure Capacity to Adhere to a Responsible Investment Policy and Understand Consequences of Breach

An investor could consider requiring that a manager commit to abide by its published responsible investment policy, as there may be no link between such a policy and the manager's contractual commitments. After investing in a hedge fund, an investor can ensure that a manager is actively monitoring and reporting its compliance with agreed-upon responsible investment standards, for example, through an annual letter to the fund manager affirming compliance. Investors should also assess their position on what penalties should follow a breach of an ESG policy or reporting requirements. For material breaches, investors can evaluate their redemption rights and consider redeeming their investments from the fund.

For a copy of PRI's paper, click here.

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