CFA SOCIETY UNITED KINGDOM

WE GROW TALENT

Cases on Ethics in Sustainable Investments

PORTFOLIO AND FUND MANAGERS

CFA Society United Kingdom

PORTFOLIO AND FUND MANAGER ROLES

ESG and sustainable investment have moved into the centre stage of the investment world. Portfolio Managers must consider the sustainability objectives of each portfolio they run and the degree to which ESG issues influence its construction and performance. These need to be accurately described in their fund literature and investor communications. Portfolio managers also need to ensure that the introduction of sustainability objectives does not inappropriately conflict with each of their funds' other objectives.

1) Sustainability Context:

New sustainability regulations are providing greater definition to many, if not all, sustainability terms. In describing the objectives and performance of their investments, portfolio managers now need to ensure they use these terms in fund literature and client communications in a way that complies with new regulation such as UK's SDR and EU's SFDR. Where a portfolio is run without sustainability objectives this needs to be made clear.

To complicate the task of complying with regulatory disclosures, the requirements are likely to be different in each market and portfolio managers selling their funds into multiple markets need to know the differences.

For dedicated single client portfolios, managers need to ensure that the fund is run in accordance with the client's declared sustainability objectives in the investment policy statement. Where it is run to an ESG benchmark, this benchmark requires careful selection.

Where sustainability factors are being introduced to a portfolio for the first time, fund managers should consider if the funds' other pre-existing objectives have been compromised or enhanced by the changes and ensure this is explained to clients and reflected in fund literature along with any change of benchmark.

Fund managers need to consider the integrity of their ESG data and ratings sources, especially if they come from 3rd party providers. Much ESG data is qualitative, partial, and sometimes under dispute, so independent assurance of data providers should be sought.

Fund managers have always had to consider conflicts of interest in managing their portfolios. Running sustainable investment portfolios introduces additional potential sources of conflicts of interest, such as affiliation or membership with environmental or social lobby groups, which in turn may need appropriate disclosure and management.

There are a growing number of sustainability related corporate actions and portfolio managers should ensure that securities they hold are voted in a way that reflects their client's mandate.

2) Key CFA Institute standards relevant to portfolio & fund manager roles:

CFA INSTITUTE STANDARD	RELEVANT ISSUE
I (C) MISREPRESENTATION	Portfolio managers have been under growing pressure to make their existing funds appear more sustainable or to launch new funds which meet the sustainability targets of their clients. Previously sustainability has not been well defined and in cases it has been possible for portfolio managers to overstate their funds' sustainability credentials. Evolving regulations are providing more definition and now portfolio managers need to exercise care to ensure there is no misrepresentation.
III (A) LOYALTY, PRUDENCE & CARE III (C) SUITABILITY	Portfolio managers need to remain true to the agreed fund mandate and the sustainability and any other objectives of the client. Client representatives and intermediaries may through personal bias seek to either over- or under-play the importance of sustainability in the construction of the portfolio.
VI (A) AVOID OR DISCLOSE CONFLICTS	Adding sustainability as an investment objective may sometimes conflict with or require compromise with traditional factors. Equally a growing number of corporate actions involve sustainability issues, and these issues may conflict with other objectives of the fund. Finally, portfolio managers with strong personal sustainability convictions and outside interests need to ensure that these are disclosed appropriately and do not bias their professional judgement in performing their role.
I(A) KNOWLEDGE OF THE LAW	When funds are marketed in more than one jurisdiction, and they need to comply with the requirements of each jurisdiction. The introduction of sustainability as an objective or strategy for a fund further complicates this as sustainability regulations e.g. around disclosure, fund content, and fund labelling are still evolving in many areas and are not harmonised.

APPLICATION OF THE CFA INSTITUTE STANDARDS (13 cases)

Issue 1: Failure to adequately explain choice of a fund's index

Example

Dell, CFA is a fund manager constructing and marketing ESG funds. She is currently preparing a new fund that will focus on cross-cutting innovative technologies that can address climate change risks and opportunities. When she comes to pick the relevant fund benchmarks for reporting purposes, she decides on a mix of generic tech and environmental indices that she thinks can reflect the nature of the new fund. However, she is unable to provide adequate reasons for her selection in the marketing documentation, given that the benchmark selection is particularly challenging. The complexity and uniqueness of the companies and technologies of the new fund and the limited universe of companies in the green and sustainable sectors makes it difficult to appropriately combine them together under a single approach and methodology.

CFA UK Comment

Dell is probably in violation of CFA Institute's *Standard I(C) Suitability* as she failed to properly disclose the methodology behind the benchmark selection when reporting performance of the new fund. The new fund is targeting unique new opportunities which are difficult to reflect with an appropriate benchmark. Even though Dell considered these challenges in constructing the new fund, she should have disclosed this in the marketing documentation in a transparent way. Dell could refer to the GIPS disclosure guidance for the use of a custom benchmark or combination of multiple benchmarks: disclose the benchmark components, weights, and rebalancing process, if applicable; disclose the calculation methodology; and clearly label the benchmark to indicate that it is a custom benchmark.

Issue 2: Ensuring fund sustainability investments remain suitable

Example

Lilly, CFA is the manager of ABC fund, an ESG-focused fund which currently invests in DEF, a company investing in energy efficient buildings overseas. DEF satisfies the requirements of a local 'best practice' code allowing it to be independently certified as providing positive environmental impact. However, a scientific study from a leading academic in the field finds that one of the innovative building materials that DEF has widely used has side effects which, if true, would negate DEF's positive environmental impact. After researching the matter, an independent assessor withdraws its sustainability certification of DEF. Yet the buildings continue to generate reliable revenues at an attractive growth rate ahead of inflation. Lilly decides that ABC will retain its investment in DEF because the requirements of the local 'best practice' code are not mandatory in the countries where DEF operates or in ABC's own jurisdiction. Lilly also notes the lack of scientific consensus as to the sustainability of the specific building materials widely used by DEF. Lilly rationalises that if DEF's assets were located within ABC's own jurisdiction, then the independent assessor would have retained its positive impact certification.

CFA UK Comment

While the overseas code's requirements are not mandatory under local law, we believe the withdrawal of the certification means that Lilly must give careful consideration to divesting the holding in DEF. If the certificate is required under the terms of the fund mandate, then the DEF

holding must be sold. Any justification to retain the DEF holding either based on the lack of scientific consensus, or the fact ABC's own jurisdiction may have retained the certificate, should be carefully scrutinised to ensure it is not being used as an excuse to reach a desirable conclusion. If Lilly continues to keep the asset in the fund, there should be suitable disclosure, ongoing monitoring of the situation and an explanation as to why Lilly has reached the decision that the asset remains in compliance with their mandate. A failure to do this may result in a breach by Lilly of CFA Institute's Standard *I(A) Knowledge of the Law*.

Issue 3: Misrepresentation of overall fund performance outcomes by omission

Example

Christie, CFA is writing an ESG report for the fund he runs and trying to demonstrate how the fund has had a positive sustainable impact. However, he has only a couple of favourable case studies from his analysts and supplements them with publicly available academic literature supporting the theme of "achieving positive impact by doing the right thing". The favourable case studies focus on examples of environmental impact reduction for a couple of industrial companies that have also been very good financial investments in the reporting period. He gives a high profile to the impact outcomes for the case studies and links this to their strong investment performance. He cuts and pastes some summary conclusions from academic studies linking financial and economic returns to good environmental practice.

CFA UK Comment

We think that Christie would likely be in breach of CFA Institute's Standard *I(C) Misrepresentation* as he misrepresents the source of the fund's strong performance by over-emphasising the case studies and linking the performance of those featured investments directly to ESG impact and omitting discussion of other reasons for it. As this is an ESG report, Christie should acknowledge the small number of case studies with narrow focus on the area of environment and the report should contain balanced comment across the spectrum of issues it embraces. Narrative about E, S and G issues should be included, and standout case studies placed in perspective of the overall ESG analysis. When he is using excerpts from academic work to support the performance benefits of the fund he should firstly reference and acknowledge the sources to avoid plagiarism and secondly be careful to ensure the general finding is substantively true when applied to the fund's investments. Christie should avoid the temptation to simplify and highlight specific areas of success by assuming coincidence of facts is a causal relationship when it may not be.

Issue 4: Greenwashing of fund's environmental credentials

Example

Derwent, CFA is trying to demonstrate that his mediocre fund, which lacks any systematic ESG and sustainability factor analysis in its investment process, is an above average performing ESG fund in its impact. He reasons that the area of metrics and measurement methods is currently flexible and there is no clear consensus in calculating outcomes. He sets out to find the most

positive bit of data to support each of the twenty ESG performance criteria his fund is assessed on. By cherry picking from Scope 1,2 or 3 climate impact facts and using different E, S and G scores from a mix of suppliers Derwent can show above average outcomes across the whole scorecard. He knows that he could have equally shown poor outcomes by selecting data differently.

CFA UK Comment

Rather than acknowledging the complexity of his assessment and his fund's mediocre performance, Derwent has avoided applying a consistent, objective, and unbiased methodology and knowingly sought to misrepresent performance. Derwent's breach of CFA institutes *Standard I(C) Misrepresentation* (and SDR regulation) is demonstrated by Derwent's deliberate actions to cherry pick positive and exclude negative data to show his fund is making a positive impact.

Issue 5: Misrepresenting the potential future performance of a new ESG fund

Example

Tarrant, CFA is developing an ESG-integrated version of an existing European equities fund and building on the success of the existing fund. He gathers historic data firstly showing the traditional fund's historic benchmark outperformance and secondly that in recent years ESG screened European indices have outperformed traditional European indices. He publishes a report using this as evidence that investors can expect a stronger performance from the new ESG integrated fund compared to both the existing fund and traditional European equities indices.

CFA UK Comment

We think that Tarrant's approach fails to comply with the requirements of CFA Institute's *Standard I(C) Misrepresentation* and does not comply with GIPS. It misrepresents likely future performance, on two counts:

- First, the integration of ESG as a stock selection tool changes the investment process. This change, and its potential consequences, need to be mentioned in his report. The new investment process will materially differ from that of the historic product and lead to different investment decisions. It is therefore a misrepresentation to use the track record of the old fund as an indicator of the new fund's performance.
- Second, due to the screening process, the ESG indices he is using have a high active deviation from the traditional benchmarks and it should not be assumed that historic outperformance of the ESG indices will consistently prevail in the future given the significantly different sector weightings and stock selections.

Issue 6: Placing client's interests first

Example

Davis, CFA manages the pension fund for Jeffries Limited ("Jeffries") which following a members' vote adopted a Sustainable Investment mandate with a 'best-in-class' approach. The historic scheme held a substantial position in Jeffries shares. However, Jeffries screens as a bottom quartile investment in the best-of-class sustainable approach mandated so the change would call for significant divestment of the Jeffries shareholding. The founder of Jeffries, who is also the Chair of the pension fund trustee board, urges Davis not to sell the holding in Jeffries shares. Davis, fearing that the founder would seek to use his significant influence to change the pension fund manager, delays divesting while he considers his options.

CFA UK Comment

CFA Institute's *Standard III (A) Loyalty, Prudence & Care* stipulates that Davis must identify that his client is the pension scheme members who voted for the new mandate. His mandate is contracted with the board of trustees, not just the Chair of the trustee board, and he needs to work in the interest of all the trustees. If the founder were also a CFA charter holder, we think that he also would likely be in breach of CFA Institute's Standard III(A) Loyalty, Prudence & Care as well as CFA Institute's *Standard I(D) Misconduct* as he is breaking his fiduciary duties as a trustee.

Issue 7: Investment where 'E' and 'S' scores are in conflict

Example

Jane, CFA works at a large passive equity fund manager. One of the funds she helps manage tracks an in-house index based on the universe of S&P500 companies after screening out those companies which fail to either (i) achieve an ESG score of at least '7' from one provider of ESG ratings which their firm subscribes to or (ii) appear on a 'watch list' from a second ESG agency. Jane is responsible for preparing the compilation of the index and focuses on one particular company which manufactures and installs solar panels. Despite the obvious environmental benefits of its core activities, Jane notes the first agency only gives it a score of '6', marking it down heavily for Social factors due to industrial relations issues and poor health and safety related workforce practices in some of overseas component manufacturers in its supply chain. The second agency does not have the company on its watch list, and it gives detailed commentary about the 'Social' issues, highlights how the company is working to resolve the problems with its employees and explains why this merits the company not being on its watch list. Jane wonders whether the first agency is wrong and concludes that the company should be kept in the index.

CFA UK Comment

In our view, Jane has likely violated CFA Institute's Standard V(A) Diligence & Reasonable Basis. While ESG ratings can contain an element of subjectivity, the fund's rules around index inclusion are clear and Jane does not have a reasonable basis to override the first ESG agency's score of '6', even if the second agency's reasons are valid and in short time the '6' is likely to be upgraded due to management remediation of the industrial relations and health and safety concerns at the company.

Issue 8: Performance reporting following a change in fund strategy

Example

Otter, CFA, works for Crayfish Asset Management as a fund manager on a mainstream fund with an excellent track record of performance versus its benchmark. This mainstream investment fund has always permitted fossil fuel investments. However, with a notable change in client demand and expectations the firm is considering transitioning the fund to a sustainable fund by removing the fossil-fuel investments from the next year-end. Otter, CFA, instructs the marketing department to update the historic performance charts of the fund to demonstrate how the ex-fossil fuel NAV of the fund would have performed historically against the fund's new fossil-free benchmark. None of the labelling on the presentation is changed as they feel this performance track record is now representative of the fund being marketed.

CFA UK Comment

We think that Otter, CFA is in breach of CFA Institute's *Standard III(D) Performance Reporting and GIPS*. As presented, the performance track record does not represent the actual achieved performance of the fund historically, but it is presented as such; nor is the date of the change specified in the disclosures. If the fund manager wishes to illustrate how the ex-fossil fuel NAV would have performed historically against a relevant fossil-free benchmark, this should be presented as the results of a simulation with comments and disclaimers to highlight that this does not represent the performance of a real fund, or indeed the fund being marketed. The fund's actual performance over the entire period (before and after the change) can be chain linked, as also the relevant benchmarks.

Issue 9: Superficial sustainability assessment of investments

Example

Jahred Miyet, CFA is a senior portfolio analyst at Sustainable Advisors & Funds Management, an asset management firm focused on providing sustainable and impact investments for both professional and retail clients. Jahred has recently designed a new fund, domiciled in the UK, to focus on investments in shares of some of the largest renewable energy companies in emerging markets. He intends to assign this fund a "Sustainable Focus" label under the UK's Sustainability Disclosure Requirements (SDR), as he expects a minimum of 70% of assets to be invested in renewable energy company shares. He develops a process for screening and choosing the selected universe of renewable energy companies, including financial, technological, macroeconomic, and governance factors. The selection process does not include an assessment of how such companies are mitigating environmental and social risks, as Jahred believes that given that such companies are "pure renewable energy players", and that the fund will be compliant with a "Sustainable Focus" label.

CFA UK Comment

While investing in renewable energy companies is often considered sustainable by many investors, this is only the case if supported by a proper assessment of environmental and social risks and their mitigation. Even though Jahred performed some screening, he omitted a detailed review of environmental and social risks and is therefore likely in breach of CFA Institute *Standard V(A) Diligence and Reasonable Basis*. There is also no indication of how the investments will be reviewed on an ongoing basis during the lifetime of the fund. From a regulatory perspective, UK's SDR (and major current sustainable finance taxonomies around the world) expect a robust and evidence-based analysis of the sustainability characteristics and risks of investments held within the required minimum allocation to such investments, and therefore the fund risks being rejected for approval by the regulator. In addition, the labelling and positioning of the fund could be misleading for investors, given Jahred's approach of relying on "pure renewable energy players", with only a high-level assessment and disclosure, and is likely to be in breach of *Standard V(B) on Communication with Clients and Prospective Clients*.

Issue 10: External involvement conflict of interest with work

Example

Commers, CFA is an equity manager responsible for a portfolio of listed energy investments. In her spare time outside the office, as already agreed and cleared internally in her firm, she is part of a NGO Campaign for preserving the biodiversity environment in her region, which has been severely damaged lately during an extraordinary heatwave season. One of her holdings, West Energy Ltd., has put on its AGM agenda to approve the discharge of hot water into the rivers above current limits to preserve energy production capacity and avoid blackouts for the region. The company has already received the 'green light' from local authorities under emergency powers, but still needs shareholder approval to execute it. The local NGOs have started a public campaign against West Energy Ltd. as the discharge of high levels of hot water into the rivers is likely to trigger a significant biodiversity loss as water temperatures in local rivers reach abnormal levels. Commers has been appointed to vote at the AGM of West Energy Ltd. and she has been instructed by her company to support the decision to avoid reporting further potential stock losses.

CFA UK Comment

Even though Commer's outside involvement with an NGO was signed off by her company's internal compliance department, with the current situation and specifics surrounding the coming AGM voting on the discharge issue, we think she has a conflict given her NGO work. Therefore, we think that Commers should disclose this conflict in more detail to meet her responsibilities under CFA Institute's *Standard VI(A) Disclosure of Conflicts* and potentially recuse herself from this vote.

Issue 11: Failure to manage portfolio investments in line with the fund mandate

Example

Wong, CFA manages a fund focusing on impact investing. A few months ago, Wong invested in the shares of Atlas Waste, a foreign waste management company. Since it was bought, Atlas Waste has been a high performing asset in the fund and at the time of the initial investment it was in compliance with all relevant environmental regulations. These regulations have since been recently updated; however, they do not immediately apply to businesses that are already operational and the investment in Atlas Waste could therefore be considered 'grandfathered' for a few years.

CFA UK Comment

Atlas Waste is a high performing asset generating strong returns; however, it is no longer in full compliance with new environmental regulations. In this case, it is not yet non-compliant, because of the 'grandfathering' provisions in the regulations. Given the impact orientation of the fund, however, this is something that should be disclosed. Furthermore, there is an argument for removing it from the portfolio, depending on the precise description of the mandate and Wong will need to ensure that Atlas Waste is a suitable investment for the fund and document this. If the investment in Atlas Waste is retained but not compliant with the fund mandate, we believe Wong will be in breach of CFA Institute's *Standard III(C) Suitability.*

Issue 12: Cross-departmental Conflict of Interest

Example

Hau, CFA works for the asset management arm of Green World Bank ("GWB"), an investment conglomerate focused on the financing of the green transition. Hau works in the asset management arm and runs a successful US$5bn green bond fund. GWB's corporate finance department is helping to place Global Cement's green bond to finance a 2m-tonne demonstration plant in a carbon capture project aiming to produce zero carbon cement. Hau is asked by the head of corporate finance to help underwrite the issue shortly before it goes live. Hau has insufficient time to independently review the deal, but he trusts his colleagues and agrees to the underwriting. The corporate finance arm provides Hau with their ESG and impact assessments for the Global Cement bond issue which he archives as his due diligence. GWB's green bond fund has an independent board which Hau reports to quarterly on both the fund's sustainability impact and financial performance. As a result of the underwriting commitment the fund is left with a substantial position and the Global Cement bond is among his top 5 holdings. For the board papers he includes the ESG and impact assessments for Global Cement and the bond issue previously sent over by the corporate bank but does not attribute them to GWB's corporate finance arm. He also does not disclose the fee GWB earned from Global Cement for the corporate finance mandate - only the underwriting fee his green bond fund received. The context of this disclosure is to show that the underwriting fee off-sets the current loss on the Global Cement bond holding in the secondary after market.

CFA UK Comment

We believe there is an internal conflict of interest as GWB's banking arm is acting for Global Cement and receives a fee for doing so. Hau should be routinely disclosing in his quarterly reporting to the fund's independent board all those bond issues syndicated by GWB's corporate bank in which his green bond fund takes a position. Hau has therefore probably violated CFA Institute's Standard VI(A) Disclosure of Conflict for failing to do so. Hau is possibly also breaching CFA Institute's *Standard III(A) Prudence and Care* and CFA Institute's *Standard V(A) Diligence & Reasonable Basis* as he has accepted the corporate bank's assessment of Global Cement's bond's 'green' credentials rather than carrying out his own independent analysis.

Issue 13: Loyalty to the client

Example

Landau, CFA is a discretionary portfolio manager at ABC Asset Management. A client has asked to invest in a sustainability focused portfolio and so he selects a fund themed on climate change and environmental protection. ABC provide an annual sustainability report for clients that covers its range of model sustainable development portfolios. Landau is aware that this client's portfolio contains shares in a European battery manufacturing company which has been reported in the media as having sourced materials from mines in a frontier market country using child labour. His firm is still in the process of investigating the matter, however, and talking to the company before taking any divestment action. The sustainability report on the fund is annual and although the firm does not plan to make any comment publicly either until the annual report is due or when a final divestment decision is taken, Landau decides to call his client to appraise him of the issue. His loyalty to his client leads him to ask the client whether he remains happy with his current portfolio or wishes to switch out to another sustainable development fund not invested in the shares of the European battery maker.

CFA UK Comment

Landau is probably acting in accordance with CFA Institute's Standard III(A) Loyalty, Prudence & Care in informing his client of an issue that he reasonably assumes is a potential concern for his client, based on the client's declared focus on sustainable development goals. Standard III(A) Loyalty, Prudence & Care calls for the placing of client loyalty and care in meeting the client's wishes above any duty to other stakeholders. Landau should, however, ask his client for confidentiality and discretion around the discussion, even though the reports of the use of child labour are well documented in the press. Landau should also seek to ensure that he has the same conversation with all his other clients in the same position. All ABC clients with the same investment mandates should be treated fairly and be made aware of the issue.