



INVESTMENT FUNDS

A Lifeline for ESG in Investment Funds?

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The battle over environmental and social governance principles continues round after round with the latest battle having been won by the proponents of ESG. Last month, a federal appeals court dismissed a case that sought to block SEC regulations requiring investment funds to categorize and disclose their votes on ESG matters. Is ESG recovering from the blows it has taken over the past 12 months?

The primary fiduciary obligation of an investment fund manager is to act in the best interests of investors at all times. The manager must be committed to prioritising the financial well-being of the investors above all else and that translates into an obligation to take all decisions with a view to generating profits for investors. When a manager is managing other people's money, the focus must be on the empirical metric of value generation, rather than principles and values the manager holds dear. The only exception to this rule is when the manager has a contract with the investor that allows the manager to take into account specific principles. This is the case, for example, in "impact funds".

Within the realm of pension funds, in particular, the intersection of fiduciary duties and ESG rules presents a complex landscape as ESG seeks to look beyond the maximisation of profits at other factors such as environmental sustainability, social responsibility, social engineering and corporate governance.

The challenge for managers arises principally due to the perceived incompatibility between financial returns and ESG objectives. Proponents of ESG integration contend that incorporating these factors into investment decisions enhances long-term financial performance by mitigating risks associated with environmental and social issues. There is, however, no conclusive evidence of these claims and most of the studies supporting ESG talk to its *potential* to drive value rather than evidencing actual, universal value creation. This places investment

managers in a difficult position. If they cannot prove that the implementation of ESG in their decision-making enhances profits paid to investors, they may be in breach of their fiduciary obligations.

In the United States, a 2020 regulation sought to address this issue by requiring certain retirement plan advisers to only consider "pecuniary factors" or those that have a material effect on risk and return. Effectively, this prohibited pension fund managers (managing around \$12 trillion on behalf of 150 million Americans) from justifying investment decisions with reference to ESG factors. It did not mean that they could not take into account ESG factors, but decisions could not hinge on these factors. The 2020 regulations set off a ping-pong between proponents of ESG and those opposed to ESG.

When President Biden came to power, his administration amended the 2020 regulations to allow ESG considerations. Critics of Biden's approach claim that Democrats want Wall Street to use worker's hard-earned money not to grow savings, but to fund a far left political agenda and the Biden amendments were promptly challenged in court. Whilst the court expressed an aversion to the rise of ESG in investment decision-making, it upheld the regulations in large part based on a principle of US law known as the "Chevron Deference". That outcome was appealed and the appeal has been buoyed by the US Supreme Court last month overturning the Chevron Deference. In the interim, however, Congress passed legislation prohibiting fund managers from basing investment decisions on ESG thereby effectively overruling the court. Biden was not done though and, for the first time in his presidency, exercise a veto blocking that legislation.

The battle then shifted to the US Fifth Circuit court where four States sought to invalidate a Securities and Exchange Commission ruling requiring funds to disclose their votes on ESG matters. In practice, this rule will require funds to take ESG factors into consideration in decision-making. The court upheld the SEC regulations, but it noted that this was not on principled grounds, but due to a lack of evidence of harm. The court found that it had insufficient evidence that the new regulatory burdens would result in an increase in costs to investors. If the States can assemble stronger evidence of injury, they may refile the case as they apparently intend to do. Proving an increase of costs does not seem to be particularly onerous.

The specifics of these cases aside, pension fund managers must always balance their fiduciary duties with the growing demands to consider other factors. A fund manager who takes an investment decision based on factors other than profit maximisation is potentially in breach of her fiduciary obligations and could be exposed to a claim from investors. The purpose of a pension fund is to provide for the retirement of its members. A retirement fund manager normally does not have an impact mandate. In the absence of a convincing connection between factors taken into account in decision-making and profit maximisation, managers are therefore exposed to claims.

ESG principles are far more entrenched in the European Union than they are in the US. The absence of ESG legislation in US has already resulted in complaints from European investment fund managers that the shackles of ESG regulatory compliance makes European fund managers uncompetitive. Developments in the US will therefore have a ripple effect into other jurisdictions and whilst ESG appears to have steadied itself from a series of blows in the US, the attacks will continue over the next few months.

At a recent conference of the world's top fund lawyers, I asked what the impact of the battle over the 'E' in ESG would be on the 'S'. In other words, if environmental considerations are already being downplayed, will social factors survive? Universally, the answer was that ESG is now nearly exclusively about environmental factors. Social considerations in investment decisions (other than in an environmental context) are now the exclusive domain of funds where managers have a specific mandate to promote human rights, job creation, affirmative action etc.

The South African context is, of course, slightly different. Compliance with specific legislation requiring social factors to be taken into account of course impacts the fiduciary analysis. Noting developments in the US, however, where the pendulum continues to swing from one side to the other, legislation may not be clear for some time and pension fund managers will not only need to ensure that they have actual obligations to implement ESG, but that these obligations are unambiguous and settled. Alternatively, they will need to ensure that they have a mandate to take into account factors other than profit maximisation.

The lack of standardised ESG metrics, varying stakeholder preferences and the evolving regulatory landscape make decision-making ever more complex for fund managers. Scepticism appears to be growing regarding the efficacy of ESG strategies in delivering superior returns and this complicates the integration of these principles into fiduciary duties. Pension fund managers, in particular, should be wary of being swept up by the latest trend and straying too far from profit maximisation motives.



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