THE REGULATORY FUNDAMENTALS GROUP LLC

A Discussion of ESG and Divestment Practices

March 2017

Introduction

At the request of RFG members, over the past few months RFG has conducted a series of telephone interviews with six organizations to better understand how they approach divestment and "ESG" issues when undertaking investment activities. ESG, or Environmental, Social and Governance factors, are a set of criteria used to screen investments by socially conscious investors and/or investors that believe that such criteria are useful in evaluating potential performance. In some cases, additional information was gathered from publicly-available information on institutions' websites.

It is important to understand two caveats about the scope of this effort.

First, RFG is aware of a shift by some institutions towards a more active focus on how to make investment decisions that foster a social "good" or that have higher ESG ratings than other investments they might make. Although RFG will monitor such developments prospectively, divestment issues—not ongoing investment process—was the primary focus of this particular effort.[1] However, in the course of preparing this report, four institutions, and/or their managers indicated that they use ESG criteria on some level. Three of those use ESG criteria "informally" or on a "qualitative basis" as one set of criteria. One is a signatory to the UN Principles for Responsible Investment (www.unpri.org) and is seeking to increase awareness of the issues among managers and to promote ESG investing. One institution that was not asked specifically about the use of ESG criteria indicated that all investment decisions are considered in light of principles related to their mission.

Second, this report is intended to identify the approaches organizations have adopted when dealing with ESG and divestment issues, not to identify a better or preferred approach. Each organization will need to consider for itself what the best approach to these issues might be given its unique circumstances. With respect to the specific approaches used on divestment, RFG found that half of those interviewed considered calls for divestment on an ad hoc basis and the other half adopted a more defined process, such as the use of standing committees. Two institutions with defined structures each employed two committees to consider relevant issues (one with representatives from the campus community and the other a committee of the governing body). Another institution interviewed was actively engaged in the process of evaluating structures and criteria as it sought to determine its preferred approach.

A high-level summary of the results of these efforts, in a question by question format, can be found below. Appendix A sets forth some suggestions of specific practices that might be followed when setting up a divestiture committee. Appendix B contains initial thoughts as to the charter for an Advisory Committee on Divestment and Shareholder Engagement.

[1] A more active focus on doing social "good" could raise different fiduciary issues (for example, uniform state laws allow for consideration of an asset's "special relationship or special value, if any to the charitable purposes of the institution"), alter the need for staff to evaluate social issues and require that the impact of such considerations be considered when analyzing investment returns. These issues are not addressed in this report.

Responses to Interview Questions

1. **Do you have a divestiture committee and, if so, who is on it? What was the rationale for including each person (i.e., subject matter expertise, represents a constituency, etc.)**

   Organizations interviewed were evenly divided between those who considered calls for divestment on an ad hoc basis and those who employed a defined process (such as the use of standing committees).

   Generally, the schools with ad hoc approaches created working groups to consider issues as they arose. One such ad hoc group was chaired by the CFO of the university and included faculty and students. Of note, one of the institutions with the strongest commitment to social issues does not have specific committees or groups to address the issue. Instead it has a board policy on Socially Responsible Investing (SRI, also known as sustainable, socially conscious, "green" or ethical investing) that seeks to consider during the investment process both financial return and social good. From this policy, a specific investment list is developed by investment staff. The topics are discussed daily by the investment staff.

   One interviewed institution was actively engaged in the process of evaluating structures and criteria for an ongoing approach that it expects will contain both guidelines and a more defined process. A committee tasked with such issues will likely consist of faculty, staff, students, and probably some alumni.

   Two of the institutions with defined structures have two committees each (one with representatives from the campus community and the other a committee of the governing body). One of these institutions maintains an advisory committee (comprised of an equal number of representatives from faculty, students, and alumni) that presents its recommendations to a committee of the governing body. The committees meet regularly but not in a regular fashion, generally five to ten times a year.

   The other university that maintains two committees has an advisory panel with representatives of students, faculty, staff and alumni and a committee of the governing body. Additionally, this organization hired a new staff person (at the director level) who reports to the President's office, and serves as a point of contact for the community and as a liaison to the university leadership. The Trustee committee meets 4–5 times per year. The advisory panel meets on an ad hoc basis.

2. **Are other committees or groups engaged in the process?**

   Several schools noted that these issues can be initiated by students or faculty on a flexible basis. Although, in the past, momentum was lost when students graduated; they now appear to be somewhat better organized. Groups involved in the process are made up students, faculty, staff, and alumni.

Considerable variation existed with respect to the way an issue was raised for consideration. One institution allowed a single person to submit a request for review. Another allowed groups outside the institution to raise issues. Others employed a more restrictive approach.

The role of the investment office also varied. At some organizations, the investment office is primarily responsible for implementing investment decisions, but does not actively weigh in on this sort of policy matter. Other investment offices actively contribute to the process. One school has interested students work with the investment office to jointly present a recommendation to the investment committee.

Other groups included the offices of the president and the general counsel (which may review the divestment policy for issues).

Alumni at two schools were reported to have expressed interest in ESG issues. Other organizations did not see interest from alumni on this topic.

One organization focused on the analysis of proxy issues. It relied upon background material provided by Sustainable Investments Institute (Si2, at www.siinstitute.org), a not-for-profit organization that provides institutional investors with analyses of issues of social concern and corporate responsibility raised through the proxy process.

One organization noted that it works with MSCI, (www.msci.com, investment consultants) to identify the list of restricted companies once a divestment decision is made.

3. Are there any specific policies or "rules of the road" that the committees operate under?

Only one school reported that it has a specific statement of criteria for divestment and investing responsibility. Another school is guided by a board policy which is based on religious principles. One school has made public statements that there is a presumption against divestment but its divestment record is comparable to its peers. In a similar vein, one school says that it will not divest for the purpose of making a business, social, or political statement. Another school is actively considering these issues.

4. How are potential areas of divestment selected?

Most organizations said they respond to community and student pressures on an ad hoc basis. One indicated it is actively guided by internal principles. "It helps not to be pressured by well-intentioned activists who take on issues of the day: our issues are already clear to us."

5. How does one implement a decision to divest?

Five schools noted how complex implementation can be. One said that the most important lesson is that there is a significant gap between a broad statement of principle and development of procedures which can be implemented.

For example, what does a decision to divest from tobacco mean? There are a lot of companies that touch various parts of the tobacco industry. Does divestment include those that are involved in the manufacture of packaging? What about a company that participates in distribution? Other questions arise when a decision is made to divest from a country. What does it mean to divest from the Sudan? Does this apply only to Sudan-chartered companies or does it apply to a company that sells even one product to Sudan, or has even one subsidiary in Sudan? In short, the details matter in terms of what to implement.

Two of the schools reported using MSCI (www.msci.com) to identify the list of restricted companies. One of the schools asserted that purchased research should be confirmed and that good data and metrics are not always available.

One looks directly at the company and does a great deal of diligence about its controls and its affiliates. An advisory panel has latitude to decide how it wants to conduct that examination.

A related issue is how to measure the impact of investment decisions. One responder measures the impact of each divestment decision, using MSCI to develop appropriate benchmarks including or excluding restricted securities. "You may start with an industry but it has to be defined clearly such that the third party, MSCI, can take it and develop a list of companies which must be restricted."

In short, responding organizations noted that certain resolutions can be difficult to implement because they lack nuances or have been developed without an appreciation for their full impact on the endowment.

6. How do you interact with investment managers for funds/ for SMAs?

We discussed this question with four institutions. All took some steps to involve managers.

One institution "recommended" that its external investment managers avoid investments in the 100 publicly-traded companies for which coal extraction is the primary business. SMA managers are subject to resolutions on divestment and proxy voting guidelines. There is an understanding that the portfolio may need to be adjusted if a divestment action impacts the portfolio.

Another institution reports that it does due diligence on private equity managers, so that it understands the sectors the managers would be going into. This institution avoids areas that would cause social harm (outside of oil and gas). Another institution takes a similar approach—it avoids certain types of funds completely based on the likelihood they would be associated with something that is inconsistent with its institutional values.

A third institution annually surveys managers asking questions such as: Do you take ESG issues into your investment process? It looks for responses that show serious consideration of the issue. This organization reports that, "If you have those who follow the "G," then the "E" and the "S" are going to follow." In the end, all organizations employ a very qualitative assessment about what managers are doing, especially as they operate in different strategies and asset classes.

The students at one institution asked that ESG issues be imposed on its discretionary investment managers. The investment office, however, feels strongly "If we give up that discretion, then you are impacting our portfolio: it's one thing to divest from securities held in SMAs, but you are really limiting your ability to construct a portfolio if you apply this to commingled funds."

7. What divestment areas have you considered and which of these have you actually divested from?

One institution noted that it avoids anything not consistent with its institutional principles. The other answers are summarized in the chart below.

South Africa	**Sudan**	**Tobacco**	**Fossil Fuels**	**Gun Manufacturers**	**Companies doing business in Israel**
2: Some divestment	3: Some divestment	2: Divestment	2: No divestment	2: Considered	3: Topic raised
2: Divestment (but one had lifted the restriction)	2: Divestment	1: Some divestment	2: Did divest from coal or thermal coal		1: Topic raised but not considered
		1: Considered	1: Topic Raised		

8. What issues (for and against divestiture) did you consider when making these decisions?

Four of the institutions considered the potential for financial loss when making divestment decisions. Two of those schools have publicly adopted the position that the primary purpose of the endowment is to maximize return, not to make political statements.

One employs six defined criteria to indicate when divestment *may* be undertaken. These criteria are: social injury, shareholder rights have been exhausted or would be futile, desired change would diminish the social injury, the benefit to society from the company's action or inaction does not outweigh the social injury, the company has failed to alter its behavior, and divestment will not weaken the university's ability to carry out its mission (e.g., by causing division in the university community).

Another institution also considers effectiveness of divestment in achieving changes.

Two institutions indicate that community consensus is an important factor.

One considers financial loss irrelevant if an investment is contrary to its principles.

9. How long does the process of considering an issue take?

Most of the institutions indicated that the process took years, but two mentioned six months as the shorter end of the range. One institution noted that the question was not relevant to it as it has a continual process.

10. Is there a look back to see the impact over time?

Only two schools affirmatively reported a look back at the impact of divestment decisions on the endowment. One school reported that tobacco divestment costs 10 bp annualized. It has also analyzed the cost of divestment from thermal coal, Sudan, tobacco, and South Africa. This school measures the impact through comparisons of market indices with and without the restricted assets. The other used "back testing," not to change its policies, but to understand what the tradeoffs might be. The approach compared returns with and without screened companies.

Two institutions affirmatively reported no look back.

11. How do you use ESG considerations, if you use them, in the investment process?

In terms of ESG integration into the investment process, four schools indicated that they, and/or their managers, use ESG criteria on some level. Three of those schools use ESG criteria "informally" or on a "qualitative basis" as one set of criteria. One of the institutions using ESG criteria is a signatory to the UN Principles for Responsible Investment and is seeking to increase awareness of the issues among managers and to promote ESG investing. Two schools were not asked specifically about the use of ESG criteria, although one of those schools indicated that all investment decisions are considered in light of its principles.

We thought it worth including some of the specific comments we received in this response:

> **Institution**: This institution considers the issues and is seeking to increase awareness of these issues among managers. "It's both a challenge and opportunity here: we continue to review with internal investors and external managers that we hire, to increase their awareness and

promote the idea that successful long-term investing needs to take ESG risks into account." This institution is a signatory to the UN Principles for Responsible Investment, which is part of their strategy of shareholder engagement. They actively seek to implement the 6 principles of the UN PRI and one is incorporation of ESG into the investment process.

This institution reviews a manager's ESG program and policy as part of its operational due diligence program.

Institution: This institution uses general guidance to support the policies of the university as supported by the trustees, but there is no explicit ESG playbook that must be followed. Nonetheless, ESG issues are considered—as they are part of every investor's tool box. Also, its proxy voting guidelines address ESG issues. "Any good investor would consider ESG issues to the profitability of the investment as part of making the investment decision."

Institution: This school generally does not face these types of investment restrictions; however, it does not invest in morally abhorrent companies. The investment office has some informal ESG guidelines. The school does due diligence on private equity managers, so that it understands the type of sectors they would be going into. It avoids areas that could be perceived as causing social harm (outside of oil and gas).

Institution: This school is looking at what their managers are doing in this area. They expect to make the case that their managers are already aware of ESG and are trying to practice it. The analysis being undertaken is qualitative and not focused on particular issues (social, water, conservation, environmental). They do not intend to enter into impact investing or mission-related investing. "ESG is on the list but not near the top of the list for our processes." The school hired student "research assistants" to research all the white papers and all the available investment opportunities within ESG. They have screened over 230 funds, met with a lot of managers, and had conversations with consultants at Cambridge. A total investment of 10 million dollars was placed in an environmental opportunities fund. An additional 25 million commitment is available for alternate energy investments.

Institution: This school is careful to make no investments that run contrary to principles but did not provide information on ESG and the investment process. The board creates a document on the principles, which is reviewed almost daily, and based on this input a list of restricted companies is prepared by investment staff. If a company they are invested in takes on activities that run counter to the principles they pull the investment immediately.

12. Do you have any lessons learned or best practices on divestment that should be shared with others?

The following suggestions were offered:

- The most important lesson is that there is a significant gap between a broad statement of principle and development of procedures which can be implemented. For example, if you are divesting from tobacco companies, does packaging or distribution count?
- Community involvement is a forceful way to be clear that the school is taking the views of the community seriously with structure, process, and resources.
- For divestment, there should be a screening process with structures and committees: institutions need to indicate that good ideas are not enough. There needs to be a large public outcry, a reason and justification, with facts and data. Still, coming to a decision can be difficult.
- In developing procedures and structures, it is best to take it slowly and incrementally. Once a committee is created it will not go away. These issues have long-term consequences from a governance and investment point of view.

13. Is your institution active as a shareholder? In what ways? What persons or committees are driving that process?

In terms of shareholder activism, two of the institutions indicated that proxy voting guidelines are set by their governing bodies. In fact, previously, one institution created a committee specifically for the purpose of addressing proxies (but the committee may now be defunct). One school is "exploring" shareholder advocacy but currently assigns responsibility to managers to vote proxies. The other two schools were not asked about this topic and information was not available on their websites.

The two institutions with governing bodies that address proxies reported as follows:

Institution: An advisory committee analyses issues, and then the committee of the governing body determines how the school votes on social responsibility proxies each year and issues an annual report that summarizes the recommendations and rationale.

Institution: The board of trustees sets proxy voting guidelines that mandate yes on proxy resolutions asking companies to adopt sustainability principles, reduce greenhouse gas emissions and increase the energy efficiency of their operations. There are many proxy voting guidelines on ESG issues. Also, there may be times when companies are sent letters urging them to adjust practices on social impact issues.

A third institution is exploring shareholder advocacy and had a member of staff attend the Forum for Sustainable and Responsible Investment. They are devoting staff resources to follow industry developments. The impact on the portfolio is one of many criteria that is being looked at. When managers are assigned the responsibility to vote all proxies, this generally can be reviewed on an ad hoc basis.

14. Is there anything else we should be asking?

We received two responses to this.

One responded that impact investing (investing because of a social good rather than because it is financially beneficial) is interesting because (a) ten different people think of it in ten different ways and (b) fiduciary issues become more difficult. This respondent asserted that impact investing is better for personal money rather than institutional money. Additionally, the respondent raised the issue that all charitable endowments are designed to foster the social mission of the endowed organization; in light of this should the charity be giving money away to foster another social good?

Another respondent recalled that in 2016, after the United Nations issued a statement to the effect that the U.S. should give African American reparations for slavery, student activists picketed investment offices. A "reparations movement" formed, asserting that for large pools of capital (such as endowments), institutions should provide .01% to work on correcting the inequalities of the past.

Appendix A

Possible Practices for Divestment Consideration

This appendix reflects some specific practices and considerations that were shared with RFG with respect to divestiture considerations.

Guiding Principles

Consider in advance the types of social considerations that might motivate the organization to invest or not to invest in a particular opportunity. Some examples are set out below.

a. The endowment is held in trust to advance the mission of the charitable organization (in the case of a university, education).
b. The primary goal of the investment policy is to maximize return on the endowment.
c. Summarize appropriate state law requirements.
d. However, due consideration may be given to issues of social injury or the fundamental principles of the organization (which may be listed).
e. There is a presumption against divestment unrelated to investment performance.
f. The endowment is not to be used for the purpose of making political or social statements.
g. Consideration of financial loss is relevant [or is not relevant] to divestment decisions.

Criteria for Considering a Change

If a member of the community has a concern, what threshold criteria need to be met for this to receive a formal consideration by the organization or its governing body? Some examples are set out below.

a. Request for review by [one or more] individual[s] who [is/are] a member of the community (faculty, staff, students, alumni, donors), with information as to:
    i. Evaluation of the social injury (e.g., confirmation of direct causation; does it raise moral or humanitarian issues).
    ii. Statement as to reasons to believe that a community consensus about this issue exists.
    iii. Discussion of why other remedies (such as exercise of shareholder rights) would serve no purpose.
    iv. Information that supports a reasonable expectation that divestment will have an impact at alleviating the injury.

   Upon receipt of the above [by who?] the next step will be [as described below] which will include a review of the impact of the decision on the community.

b. If an advisory committee exists, consider adding the need for a recommendation of the advisory committee, with evaluation of the criteria set forth above [and possibly at this point include additional criteria set forth below?]

Process of Consideration

Clearly any process used to consider issues needs to be tailored to the institution but some potential steps are described below.

<u>Advisory Committee</u>: Create an advisory committee with representatives from the stakeholder community including students, faculty, alumni, [and representatives of the investment office which prepares a financial impact analysis], which is authorized to meet regularly and on an as needed basis to consider issues of divestment [and exercise of shareholder rights] on issues of social responsibility. This committee presents its recommendations and reasoning, based on a review of the Statement of Divestment Criteria (discussed below), to [describe a committee of the governing body]. The advisory committee may elect to bring in experts to provide additional information on an issue. An issue, once decided, generally will not be reconsidered for a period of time [to be specified].

<u>Committee of the Governing Body</u>: Create a committee of the governing body to receive and evaluate reports from the advisory committee and consider divestment requests. [This committee will also consider the exercise of shareholder rights and proxy voting guidelines/This committee may set proxy voting guidelines on issues of social responsibility.] An issue, once decided, generally will not be reconsidered for a period of time [to be specified].

<u>Governing Body</u>: The governing body considers the divestment request report from its committee and the advisory committee [and sets proxy voting guidelines on issues of social responsibility]. [It may decide to take "no action" if one or more of the criteria indicates that consideration is premature or would cause division in the community.] An issue, once decided, generally will not be reconsidered for a period of time [to be specified].

<u>Statement of Divestment Criteria</u>: Draft a Statement of Divestment Criteria which will be evaluated for divestment requests. This Statement might include the Guiding Principles and the following possible criteria:

a. Evaluation of the social injury:
    i. Confirmation of direct causation;
    ii. Does it raise moral or humanitarian issues; is it morally reprehensible?
    iii. Is the harm so grave that it would be inconsistent with the goals and principles of the institution to invest in the company or industry?
b. There is community consensus on divestment (which may be evidenced by [required] endorsements from student, faculty and alumni organizations).
c. Exhaustion of other remedies, such as exercise of shareholder rights, or a determination that such exercise would serve no purpose.
d. An expectation that divestment will have an impact at alleviating the injury.

e. A determination that the benefits to society stemming from the actions or inactions of the company or industry do not outweigh the injury caused by the company or industry.
f. An evaluation that divestment will not have negative impacts on the community (such as by causing divisions within the community).
g. A financial impact analysis of a decision to divest.
h. If a divestment decision is made, a review of the implementation criteria/concerns noted below.
i. [other criteria to be determined.]

[Proxy Voting Guidelines: As noted above, proxy voting guidelines on issues of social responsibility are considered by the community advisory committee which makes recommendations. The committee of the governing body or the governing body then sets the guidelines.]

Implementation of Decisions to Divest

This is a complex area that requires more analysis than was undertaken for purposes of this study.

Decisions to divest should be carefully delineated by the governing body, with input from investment office staff and the advisory committee so that implementation guidance is clear. For example, if an industry is to be restricted, are subsidiaries of affected companies included? Are companies doing business with that industry such as by supplying packaging or distribution included? Will consultants such as MSCI be used to identify targeted companies?

The governing body should also determine whether financial impact analysis will continue on an annual basis to ascertain the impact to the endowment of the divestment decision and whether the perceived benefits are being realized. This may lead to a review of the decision after a set period of time.

Appendix B

Institution

Advisory Committee on Divestment and Shareholder Engagement

Responsibilities and Guidelines

The governing body [the Board, the Trustees] of the Institution is vested with responsibility for the governance of the Institution and hereby establishes the Advisory Committee on Divestment and Shareholder Engagement (ACDSE).

ACDSE Responsibilities.

1. The ACDSE will advise the governing body, [or the committee of the governing body] on the social, economic and ethical issues relating to the following:
    a. [Shareholder engagement (proxy voting, shareholder resolutions, etc.)]
    b. Divestment proposals [which it deems to meet the criteria enumerated in the Statement of Divestment Criteria]
    c. Any other issues related to socially responsible investing.
2. The ACDSE will also be responsible for the evaluation of previously reviewed actions by the governing body, if requested.

Membership.

1. The ACDSE will be comprised of [insert number] voting members as follows:

    X Student Members
    X Faculty Members
    X Alumni or Donor Members
    [X members external to the Institution]

    Members will be recommended by [ ] and approved by the governing body. These members will be appointed for staggered [ ] year terms, renewable by the governing body.

2. [The ACDSE will also have [2] non-voting members as follows]:

    1 representative from the investment office staff

    1 representative from the office of the President of the Institution

    There is no term limit for these members.

Voting.

The vote of [ ] voting members is necessary for a recommendation to move an issue to the governing body [the committee of the governing body]. Votes may be taken by telephone and email.

Recommendations to the Governing Body.

If the ACDSE votes to recommend an issue to the governing body, it shall prepare a report with a discussion of all opinions of ACDSE members and, concerning divestment proposals, an evaluation of each of the criteria of the Statement of Divestment Criteria.

Meetings.

1. The ACDSE shall hold at least [ ] regularly scheduled meetings during the academic year. Additional meetings may be called by the Chair.
2. Additionally, the ACDSE shall hold at least [ ] annual meeting open to all members of the Institution's community. The primary purpose of this meeting will be to receive questions and comments from the community.

ACDSE Report and Website.

1. All matters taken up by the ACDSE shall be listed on the committee's website, including whether or not they were recommended to the governing body.
2. An annual report on the activities of the ACDSE shall be presented to the governing body and be posted on the website.
3. Support for the ACDSE website and the annual report will be provided by the Office of [ ].