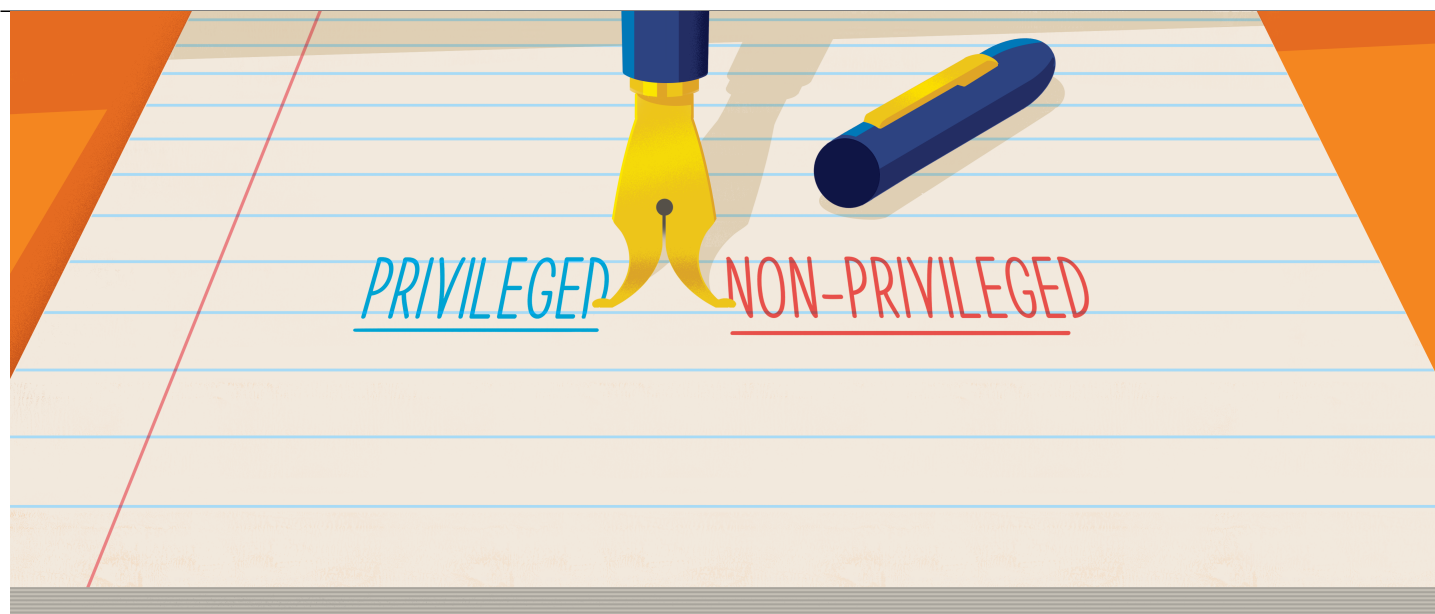




## **ESG's Renewed Focus on Civic Responsibility**

**Compliance and Ethics**

**Environmental**



If environmental, social, and governance (ESG) were a plane, the pilot would be announcing a course correction. Following the events of 2020 and January 2021, many institutional investors are concerned about the civic and political activities of their financial advisors and the companies in which they invest.

Coupled with this is their sudden recognition of the risk to their reputations in associating with investment firms or individuals who advocate extremist positions, support disinformation news sources, or are associated with or are themselves the subject of moral criticism. Now, as the corporate community has made admirable advances in other areas of ESG, institutions are focusing on civic stewardship. This may be the year that civic responsibility takes center stage in ESG discussions.

The challenge for in-house counsel will be to help their institutions anticipate what will be an unprecedented demand from constituents for a stronger demonstration of their commitment to civic responsibility.

## Civic pressure

Many companies have announced moratoriums on corporate PACs, and some have withdrawn support for politicians or cable TV hosts who are perceived as having propelled [the events of January 6](#) at the US Capitol. Others, especially social media companies and cable TV companies, are being challenged to control hate speech and disinformation programming. And others have been forced to distance themselves or remove founders or other senior managers for their personal connections to accused criminals. Investors wonder how these recent events will affect their investments or if they will draw rebuke from their constituents and stakeholders.

Institutions are looking at how the events at the Capitol will affect them in both the public and private markets. In the public markets, investors are asking to what extent they can spur good civic practices of companies through moral suasion or, failing that, the proxy process. In addition, expect investors

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to push for reforms to aid efforts to attain these outcomes.

For example, on Jan. 28, 2021, the [Interfaith Center on Corporate Responsibility \(ICCR\)](#), a coalition of investors representing over US\$2 trillion in assets under management that engages with large US corporations on ESG issues, released a statement calling on the CEOs of the Business Roundtable to initiate a six-month moratorium on political spending in order to assess the risks, and to consider a permanent ban on all political advertising, including direct investments, support of PACs, and use of dark money.

In private markets, where investors' rights are different, many are asking counsel how they can extricate themselves from investment firms that are associated with bad conduct. They are finding out that breaking up is hard to do.

## Public markets

An investor in a public company has two choices for addressing bad corporate citizenship: Sell or hold. To some extent, investors who decide to stay can influence the activities of a public company. However, since the very largest shareholders (such as company founders who retain large voting interests and the mega investment firms like BlackRock, Vanguard, and State Street) usually are not activists, the impact of direct investor advocacy is muted. This leaves the proxy process.

## Proxy voting

Proxy voting is the process by which shareholders vote on matters that come before the owners of a corporation, such as electing members of the board of directors and shareholder resolutions. In the US Securities and Exchange Commission rules closely govern the entire process, from how shareholders can get their proposals on the ballot to the information that must be included on the proxy cards. Because they can receive tens or even hundreds of thousands of proxy ballots each year, many institutional investors hire third-party proxy advisors to help research the proposals and process the ballots.

However, the proxy process is lengthy and inefficient. Public companies often can find legal grounds to exclude proxy proposals on subjects they consider controversial or inconvenient, such as those seeking cessation of political contributions or selection of cable TV or internet advertising platforms. Moreover, in order to survive, a proxy solicitation on governance matters usually must be styled as a request rather than a directive. Many critics of the proxy process argue that leading proxy advisory firms are either not proactive enough in pushing for change or too quick to take sides against management. To some extent, both criticisms are valid, but in whole the [proxy process is not built to effect widespread corporate reform](#).

Therefore, given the current situation, institutional investors will likely focus on systematic engagement on civic responsibility. A good precedent for this is the [Climate Action 100+ initiative](#), where institutional investors have engaged with greenhouse gas emitters and other companies around the world to drive the clean energy transition.

Expect to see new efforts following a similar model to build consensus among US public companies

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to support civic responsibility. This may include cessation of corporate PACs and dark money funding of political campaigns and public referenda to promote public disclosure of political contributions. Or companies could face greater accountability in their choice of where they spend their advertising dollars. And despite the limits of the proxy process, activist investors are likely to use it to seek accountability from public companies for their political activities.

## Private markets

Unlike stockholders in public companies, institutions investing in private equity, venture capital, and hedge funds typically have limited ability to exit the investment by selling their shares. Most private equity and VC funds have term lives of 10 and 15 years, including extensions, and the fund sponsors can block investors from selling their stakes. Hedge funds usually offer investors some periodic liquidity, but many will not release them early following an adverse reputational event or even the arrest of a key manager for fraud.

For example, investors in the Galleon hedge fund were [released](#) after the arrest of the founder, Raj Rajaratnam, for insider trading because the founder permitted it, but investors in funds sponsored by Apollo Global Management were not permitted to redeem after its founder, Leon Black, was linked to Jeffrey Epstein.

Investors can't easily fire the fund manager either. Many contracts give investors no ability to remove the manager except for "cause," which not only usually requires a showing of egregious conduct but for the entry of a final, non-appealable judgment of bad action before investors can show the manager the door. Moreover, federal securities laws give investors no private right of action to enforce good conduct by private managers, and the last several years have shown a marked erosion of any minimum [contractual standard of conduct](#) by private firms.

This means that, once they make their commitment to the fund, institutional investors are pretty much stuck with private managers who support questionable causes or engage in questionable personal conduct. This results in a reputational headache and indeed, in the last few months, some institutions are striving to get out of these investments, sometimes at great cost.

## Solutions?

Without many remedies, the question for institutional investors is whether they can bring about systematic changes to improve civic behavior and limit risk. The road to improvement is the same for investors in all markets: For financial and investment firms to bring a greater sense of purpose to their businesses, and specifically, better transparency in the deployment of corporate funds in political discourse, either by changes in self-governance or regulatory force.

Even though some categories of institutional investors (such as 501(c)(3) nonprofits) cannot lobby, expect to see industry groups representing investors, such as the Institutional Limited Partners Association (ILPA), to pressure Congress and the SEC to enact stricter rules governing personal conduct by investment firms and corporate managements. For example, there may be renewed interest in efforts to require a uniform fiduciary standard of behavior by private investment firms without direct or indirect modification by contract. It is also likely that there will be widespread support for efforts to encourage investment firms and companies to consider ESG factors in their investment and operating decisions.

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Can recent events and public concerns influence institutional investment activity? They can, and they will. The largest institutional investors — not only BlackRock, Vanguard, and State Street but other institutional investment firms — are proxies for the public. Their millions of clients have not been heard on what they expect of these firms in policing the investments they make on their behalf. This will likely change.

Time will tell, of course, whether this oncoming tide will be a tsunami propelling corporate managers toward a new paradigm in discharging their obligations to their investors, or a dissipating ripple.

*The views expressed in this article are those of the authors only and not necessarily of their respective organizations.*

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