# ESG and Offshore Fund Governance

Climate activist, Greta Thunberg, has on various occasions lashed out at global leaders for "empty" and "beautiful" words that she considers do not translate to meaningful action on climate change. Most recently at COP-26, Ms Thunberg sought to paraphrase the pronouncements of certain politicians as "blah blah blah", and spoke of the failure of governments to implement climate change strategy[1].

Whether or not you agree with Ms Thunberg's political views on government actions regarding emission reductions, there can be little disagreement in respect of the pace of growth in private sector interest and investment in ESG funds. The data is irrefutable: US sustainable funds saw $15.7 billion in net inflows during the third quarter of 2021, according to Morning Star with assets in these funds totaling more than $330 billion as of September[2]. According to Bloomberg, Global ESG assets are on track to exceed $53 trillion by 2025, representing more than a third of the $140.5 trillion in projected total assets under management[3]. Further, more than half of the environmental, social and governance-linked funds in the market outperformed the S&P 500 in the first several months of 2021[4].

Although the reasons for the growth and performance of ESG products are the subject of vigorous debate, the data is conclusive in relation to the surge of interest in funds being raised with an environmental or social purpose.

This begs a question: How do statements of intention around the environmental purpose and social objectives of a fund translate into action? When an offering document states that the purpose of a fund is to advance environmental and social goals, how can investors be certain that the fund will, in fact, deliver on its promise?

## Governance is Key

This is where the "G" in ESG becomes critical. Without strong governance mechanisms and safeguards being the cornerstone against which the various building blocks of a fund's operations lean, everything else can collapse (including the "E" and "S" objectives). Without a robust system of governance, there can be little comfort that an offering document is anything more than just a private sector example of what Ms Thunberg refers to as "beautiful words".

Fund domicile is a critical issue when it comes to assuring robust governance of a fund vehicle. The jurisdiction in which the fund is formed and registered must enshrine a system of corporate governance that ensures professionalism, as well as accountability and transparency. However, to operate efficiently, in relation to ESG investments (or for that matter, the alternative investment industry generally), the jurisdiction should simultaneously allow its management the flexibility to innovate, and run their businesses as nimbly and profitably as possible. The Cayman Islands has developed a tried and trusted environment that delivers on these dual demands.

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1 https://www.bbc.com/news/uk-scotland-glasgow-west-59165781
2 https://www.cnbc.com/2021/11/06/the-evolution-of-esg-investing-heres-whats-next.html
3 https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
4 https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/most-esg-funds-outperformed-s-p-500-in-early-2021-as-studies-debate-why-64811634

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## Duties and Diligence

At the core of effective governance is competence, accountability and a duty of care. Particularly in the context of ESG, it would be unacceptable for a fund to be managed by a "rubber-stamp director". Fortunately, in the private funds space in Cayman, those days are well and truly behind us.

For anyone who doubted Cayman's credentials in this relation, attention should be drawn to the watershed moment of the Weavering case. Although the first instance judgement of which was handed down over a decade ago, the impact of which is still being felt to this day.

Briefly, the case was brought by the liquidators of Weavering Macro Fixed Income Fund Limited (In Liquidation) ("**Fund**") for breach of directors' duties as a result of the defendants' failure, among other things, to review documentation revealing breaches of the Fund's investment guidelines. Jones J, in explaining the fiduciary duties of directors in a Cayman Islands fund, held that the Directors failed to exercise the requisite independent judgment and reasonable care and skill in conducting the affairs of the Fund and that they had failed to act in the best interests of the Fund as required by law.

The Weavering case brought into sharp focus that, in the case of a fund, directors have, both collectively and individually, a continuing duty of care to acquire and maintain a sufficient knowledge and understanding of the fund's business to enable them to properly discharge their duties as directors. In the context of funds, including ESG funds, this would include a duty to read and understand the offering materials as well as reports of the fund as part of the requirement to act with due care skill and diligence. Coupled with the obligation to act bona fide the best interests of the fund, directors should probably also regard themselves as responsible for ensuring that the actions and operations of the fund are consistent with the objectives and strategies set out in the offering materials (including as those documents related to ESG).

Weavering was the catalyst that resulted in the Cayman Islands Monetary Authority ("**CIMA**") issuing its Statement of Guidance for Regulated Mutual Funds: Corporate Governance which provides a non-exhaustive set of requirements for governing bodies of regulated funds. The statement of guidance deals with a number of issues that are aimed at entrenching good governance in the context of funds, summarizes relevant fiduciary duties, and sets out rules around frequency of meetings, and the disclosure of information to investors.

In ensuring some level of accountability, the statement of guidance also provides that fund operators retain ultimate responsibility for functions delegated to service providers, whilst requiring that all service provider roles and responsibilities are clearly defined, and are performed in accordance with the fund's constitutional and offering documents.

The result is that although the use of independent directors is now common place on fund governing bodies, independent directors appointed to Cayman Islands funds tend to be highly engaged and professional, bringing a range of skill sets and experiences: from auditors to lawyers, former fund administrators, to former regulators.

## Oversight

The governance framework in the Cayman Islands is complemented by various measures that provide for a level of oversight of funds and their governing bodies.

It has long been the case that mutual funds are required to have an approved auditor appointed to prepare financial statements, and audit the funds. This requirement, with the introduction of the Private Funds Act in 2020, now applies to private equity and venture capital funds as well.

Oversight is also provided for, in the context of mutual funds, by requiring that all fund directors are registered or licensed under the Directors Registration and Licensing Act ("**DRLA**"). As well as requiring registration, the DRLA places limits on the number of boards that persons other than professional directors can serve on, as well as creating grounds for refusal of registration or licensing – effectively implementing a level of quality control over fund governance.

The DRLA is reinforced by CIMA's Regulatory Procedure for Assessing Fitness and Propriety of directors of regulated entities ("**CIMA Regulatory Procedure**"). The CIMA Regulatory Procedure

requires that regulated entities (such as mutual funds and private funds) implement a corporate governance framework that addresses a number of items including to ensure that the objectives and strategies of the governing body are implemented. The CIMA Regulatory Procedure also requires that boards ensure the effective, productive and ethical oversight of their funds, and set out and implement procedures and controls to ensuring the funds attain their objectives.

In an ESG context, this should be construed as meaning that the directors of ESG funds must ensure that the fund behaves in accordance with its ESG intent. Again, the regime requires that oversight, direction and management of funds is conducted in a fit and proper manner. However, even though CIMA has various powers to ensure a high level of compliance (including to replace management or to deregister the fund in certain circumstances) the approach is comparatively non-intrusive. The expectation being that the sophisticated investors towards which Cayman fund products are directed, will take some role in ensuring that management complies with its obligations, with regulator interference seen as a last resort.

## Transparency

One other important element of a robust governance is ensuring transparency. Opaque management is inconsistent with investor trust, and incompatible with ESG. Furthermore, there cannot be proper accountability without a certain level of transparency around decision-making.

However, to be commercially acceptable, it is important that the approach to transparency is commercially viable. It is simple for legislation to require that an entity openly disclose all if its financials, make confidential documents publicly available, and comply with lengthy checklists compelling reporting on a variety of items. However, this would dramatically increase compliance costs, risk strangling innovation, and arguably, ultimately have a negative impact on the growth of the industry.

The approach in the Cayman Islands seems to have found the right balance. In relation to mutual funds, it has long been the case that the fund prepares and files the offering document. The offering document describes the interests being offering as in all material respects, and also contains such information as is necessary to enable a prospective investor in the mutual fund to make an informed decision as to whether or not to invest. Satisfaction of this requirement effectively imports compliance with certain of the ESG-specific onshore rules around disclosure that are starting to develop.

This requirement is now supplemented by rules from CIMA on the content of offering documents and marketing materials (for mutual funds and private funds, respectively). These rules require, among other things, a description of the fund's investment objectives, investment policy and any limitations thereon, risk disclosure, as well as a description of the potential conflicts of interest between the fund, its operators and its service providers.

Service provider fees levels (or details of the manner in which they are calculated) must also be disclosed as well as details of where certain material documents, including financial reports, can be inspected.

Similar rules regarding asset values require certain standards be maintained around asset valuation, as well as disclosure of valuation policies, any deficiencies therein, as well as disclosure of conflicts of interest.

The credentials of the jurisdiction, when it comes to transparency, are further enhanced when one considers its implementation of global regulatory regimes such as FATCA and the OECD Common Reporting Standard, or the introduction of rules around beneficial ownership introduced in response to requirements of the European Union. Implementation and enforcement of these rules clearly demonstrate the Cayman Islands commitment to global best practice in relation to governance and transparency. However, the fact that Cayman is regularly among the first jurisdictions to introduce rules for such regimes is indicative of an agility in rule making that should be capable of sustainably keeping pace with both market and global developments.

## Greenwashing

The presence of a framework for governance is clearly necessary for any jurisdiction or fund to score well against ESG metrics. Unfortunately, there is a perception that the ESG investment funds space still appears to be vulnerable to the possibility of issues such as greenwashing regardless of such measures.

The mischief associated with greenwashing was a key point of focus of the Board of the International Organization of Securities Commissions ("**IOSCO**") in its November 2021 report titled "Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management". In that report IOSCO recommended, among other things, that securities regulators should consider clarifying and even expanding regulatory requirements and guidance to improve product disclosure around sustainability-related products.

The report stated that implementing specific rules or guidance including: (i) a system of product authorization; (ii) parameters around naming sustainability-related products, as well as labelling and classification rules; (iii) rules in respect of investment objective, strategy, risk and website disclosure; and (iv) ongoing monitoring requirements in relation to sustainability-related performance and periodic reporting, "will help prevent greenwashing at a product level". Other recommendations in the report included encouraging industry participants to develop common sustainable finance-related terms and definitions in relation to ESG approaches so as to ensure consistency across the industry.

The recommendations are sensible. However, it may be argued that the combination of directors duties, existing regulatory requirements around disclosure, and common law prohibitions against misrepresentation and misleading conduct should be capable of dealing with greenwashing at least in so far as it relates to investment products aimed at professional investors. As such, there may be no need for additional regulatory intervention. It would follow that specific rules for ESG in a jurisdiction such as the Cayman Islands, the investment funds of which are not generally targeted at retail investors, are not required.

However, as noted above the Cayman Islands has a history of adopting global best practices early when it comes to regulation of the investment management space. As such, it is possible that ESG-specific rules may be developed. Indeed, a policy advisor in the Cayman Islands Ministry of Financial Services has been cited by the Cayman Compass (on 9 December 2021) as stating that the Ministry is in the early stages of policy development around incorporating ESG factors into Cayman's financial services sector. Whether such policy will yield a prescriptive code of rules or a less intrusive form of guidance in line with Cayman's typical regulatory approach remains to be seen. However, in the meantime, reliance on the robust governance rules present in Cayman should provide a high level of comfort to those interested in the space.

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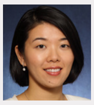

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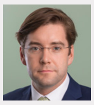

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