THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.

PRI’s MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

PRI DISCLAIMER

The information contained in this report is meant for the purposes of information only and is not intended to be investment, legal, tax or other advice, nor is it intended to be relied upon in making an investment or other decision. This report is provided with the understanding that the authors and publishers are not providing advice on legal, economic, investment or other professional issues and services. PRI Association is not responsible for the content of websites and information resources that may be referenced in the report. The access provided to these sites or the provision of such information resources does not constitute an endorsement by PRI Association of the information contained therein. Unless expressly stated otherwise, the opinions, recommendations, findings, interpretations and conclusions expressed in this report are those of the various contributors to the report and do not necessarily represent the views of PRI Association or the signatories to the Principles for Responsible Investment. The inclusion of company examples does not in any way constitute an endorsement of these organisations by PRI Association or the signatories to the Principles for Responsible Investment. While we have endeavoured to ensure that the information contained in this report has been obtained from reliable and up-to-date sources, the changing nature of statistics, laws, rules and regulations may result in delays, omissions or inaccuracies in information contained in this report. PRI Association is not responsible for any errors or omissions, or for any decision made or action taken based on information contained in this report or for any loss or damage arising from or caused by such decision or action. All information in this report is provided “as-is”, with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, expressed or implied.
ACKNOWLEDGEMENTS

The PRI thanks the following individuals and their organisations for contributing to this guide, as well as the Hedge Funds Advisory Committee for their ongoing support.

- Albertus Rigter, LGT Capital Partners
- Andre Breedt, Capital Fund Management (CFM)
- Andreas Vetsch, LGT Capital Partners
- Ann-Sofie Odenberg, Brummer & Partners
- Ben Watson, Aberdeen Asset Managers Limited
- Bruce Thatcher, York Capital Management Europe (UK) Advisors LLP
- Chloe Wong, Fair Oaks Capital
- Chris Palazzolo, AQR
- Damian Morris, Chancery Advisors
- Daniel Harris, Chancery Advisors
- Debbie McCoy, BlackRock
- Doc Horn, Pictet Asset Management
- Elliot Trexler, Global Return Asset Management LLC
- Emma Lawson, Aurum Research Limited
- Erik Eidolf, Nordkiinn Asset Management
- Filbert Cua, Aetos Alternatives Management
- G. Stephen Kennedy, Albourne Partners Limited
- Guy Saintfiet, Prisma Capital Partners LP
- Helenmarie Rodgers, Prisma Capital Partners LP
- Jarkko Matilainen, NorthPeak Governance LP
- Jeff Dunn, AQR Capital Management
- Jennifer Lau, Aberdeen Asset Managers Limited
- John Lakin, Avenue Capital
- Joshua Strauss, Appleseed Capital
- Julie Lindbo, Avenue Capital
- Juliette Menga, Alternative Investment Group
- Keith O’Callaghan, FQS
- Kevin Lyons, Aberdeen Asset Managers Limited
- Korey Mui, BlackRock
- Lukasz Pomorski, AQR
- Malcolm Leigh, Record Currency Management
- Mark Farrington, Macro Currency Group
- Nataliya Taleva, Pictet Asset Management
- Nathaniel J. Polachek, Commodity Asset Management
- Philipp Keller, Quantica Capital AG
- Pierre de Saab, Dominicé & Co - Asset Management
- Robert Schwartz, Tyndaris LLP
- Sam Sussman, Alternative Investment Group
- Sascha Hirsch, Trust Peak
- Shoaib Khan, Florida State Board of Administration
- Stefano Ciliberti, CFM
- Stephen Coltman, Aberdeen Asset Managers Limited
- Verity Chegar, BlackRock
- Vicky Hudson, Aberdeen Asset Managers Limited
- Vincent Weber, Prime Capital
- Ward Corbett, Catalyst Partners
- William Bryant, Albourne Partners Limited
CONTENTS

EXECUTIVE SUMMARY 5

FOREWORD 7

BACKGROUND 8

RESPONSIBLE INVESTMENT APPROACHES FOR HEDGE FUNDS 13

MODULE I 14

MODULE II 15

MODULE III 18

MODULE IV 22

APPENDIX: RESOURCES AND CODES 23
This guide provides a suggested framework for fund managers and asset owners to incorporate ESG factors into hedge fund strategies. The heterogeneous nature of hedge funds as an asset class means there are important differences from long-only funds in terms of how they might incorporate, develop and implement a responsible investment (RI) policy. Due to the sheer breadth and range of trading instruments and market strategies spanning equities, fixed income, commodities and FX, some hedge funds are likely to be better placed to integrate an RI policy than others.

The paper identifies client demand, materiality and regulation as key drivers to the increasing interest in RI in hedge funds. With respect to client demand, although ESG funds have been growing in the long-only market for some years, institutional investors are becoming increasingly interested how hedge fund managers are applying ESG factors in their portfolios. With regards to how regulatory environments may differ between funds and strategies and an analysis of materiality, the PRI has created various materials to support asset owners and hedge fund managers in broadening their understanding - including the Responsible Investment Regulation Map and a register of academic research.

The central pillar of this guide focuses on how a responsible investment framework might be incorporated, developed and implemented by hedge fund managers to respond to these drivers. It is divided into four modules or steps: I) Policy; II) Governance; III) Investment Process; IV) Monitoring & Reporting.

**MODULE I: POLICY**

The report outlines that a responsible investment policy be formulated both at the investment manager level and the fund or portfolio level. The firm level policy should then apply to the firm-wide assets under management and provide clear details on how ESG considerations are integrated into the investment strategy. This might be incorporated into formal agreements such as the Investment Management Agreement. For hedge funds, the implementation of an RI policy might also have implications for external agreements including Trading and Prime Brokerage Agreements and Administration Agreements.

**EXECUTIVE SUMMARY**

**MODULE II: GOVERNANCE**

Governance is identified as a core component to an RI framework. At a fund level, governance structures should include a written RI policy, processes, practices and reporting. The fund board should monitor and supervise the execution of this activity. To facilitate this oversight, the board should have sufficient topic expertise and knowledge.

At the firm level, the report highlights that a manager may want to consider a separate committee to help supervise all aspects of the RI process. This is advised to ensure successful implementation of the policy and that the manager’s activities remain in compliance.

At the fund or firm level, relevant RI-related KPIs could be introduced to achieve a close alignment of interests between the manager, the fund board and the end investors. These KPIs could apply to individual portfolio managers and become part of their compensation package.

**MODULE III: INVESTMENT PROCESS**

This section outlines some key RI issues surrounding specific asset classes or financial instruments including equities, fixed income, commodities and security indices as relevant to hedge fund managers’ investment process. It is not a conclusive list and links to other PRI publications.

While there are investment processes and ownership practices, such as proxy voting, that overlap between long-only and hedge fund strategies, there are also important differences such as short-selling activities. Short selling can be used to express investment views on companies or issuers that may not be adequately managing ESG factors, and the PRI and International Corporate Governance Network have developed practices and guidance relating to this activity. Nevertheless, some of PRI’s asset owner signatories are concerned about the impact short selling has on shareholders’ rights, exercising stewardship and its potential impact on share prices1.

1 FT Opinion FTfm January 2nd 2020 ‘Japan’s GPIF is right — short selling is downright irresponsible’ & GPIF December 19th 2019 ‘Suspension of Stock Lending Activities’
MODULE IV: MONITORING AND REPORTING

The final section focuses on PRI’s Principle 6. This requires all signatories to report on their activities and progress towards implementing the Principles. This report focuses on monitoring and reporting on:

- How ESG issues are integrated within investment practices;
- Disclosure of active ownership activities (proxy voting and policy or corporate engagement); and
- Public reporting on impact of active ownership activities and investment practices.

This reporting should be timely, consistent, recurring and incorporate real world impacts to allow asset owners and beneficiaries to compare, track and engage with managers. Reporting expectations might be laid out in the Investment Management Agreement.

Though we do not cover every strategy in this guide, we outline some of the new practices across the industry and outline a structured approach to integrating or thinking about ESG in the investment process. It should be read in the context of other work the PRI has completed in this area, including our due diligence questionnaire for asset owners investing in hedge funds.
Alongside the growth of passively managed assets and an explosion in interest in responsible investment, the development of hedge funds has been a key theme within the asset management industry. Capital allocation to hedge fund strategies by institutional investors has grown rapidly over the last ten years and is continuing to accelerate. In the context of responsible investment, the growth of this asset class presents both opportunities and challenges for global asset owners.

Some hedge fund strategies have always incorporated ESG factors. For example, governance has always been core to activist hedge funds which often take a more proactive and public stance than long-only managers on poorly governed businesses. A natural extension of this approach might be engagement on issues such as climate change.

Certain hedge fund strategies also provide new investment opportunities. Hedge funds face the same systemic challenges around climate-related risk, human capital and resource shortages as equity investors. However, the flexibility provided by certain hedge fund strategies can enable asset owners to benefit in new and innovative ways with access to a broader range of asset classes or financial instruments. The hedge fund industry is also at the forefront of data sourcing using new sources of alternative unstructured data sets derived from artificial intelligence in a bid to generate new insights before competitors. This applies across all data sourcing, using ESG-specific data as well as data in more standard areas.

Yet responsible investment also poses challenges for an industry which sits more in the shadows than its long-only peers and operates in a different regulatory environment. In the eyes of politicians, asset owners and regulators, perceptions around the hedge fund industry are rapidly changing, with increasing focus on transparency, risk and pressure on the industry to ensure high internal and external governance standards. All corners of the hedge fund industry must respond to these changes or expect their legitimacy to be challenged.

The time has come for the hedge fund industry to think about responsible investment beyond new products, increasing AUM or identifying new investment opportunities and risks. Market participants must now widen their perspective to consider their role and responsibility as stewards of assets. Leading long-only managers have already taken up the mantle through collaboration in initiatives to promote best practice, such as Climate Action 100+ and the Net-Zero Asset Owner Alliance. Disappointingly, however, large hedge funds are noticeably absent from these collaborative programmes.

The environment for investors across all asset classes is changing. Drivers are not going away and market participants who ignore them are likely to face a backlash from clients, regulators and politicians. Today, business as usual is no longer acceptable.

We hope that this guide provides a little help in developing responsible investment in the hedge fund industry and encourages the industry to step up to the plate on stewardship.
BACKGROUND

This section provides an overview of responsible investment and its application to the hedge fund industry. It also outlines three key drivers (regulation, materiality and client demand) and the relevance to hedge fund managers and those allocating to these strategies. From an asset owner perspective this section also provides an overview of PRI’s RI due diligence questionnaire. This has been developed for asset owners allocating capital to hedge fund managers.

WHAT IS RESPONSIBLE INVESTMENT?

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership. There are many approaches to responsible investment but these are typically a combination of two areas.

Figure 1: Approaches to PRI Principle 1 (incorporation) and Principle 2 (active ownership)

CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (known as: ESG incorporation)

ESG issues can be incorporated into investment practices using a combination of three approaches: integration, screening and thematic.

INTEGRATION

Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.

SCREENING

Applying filters to lists of potential investments to rule securities in or out of contention for investment, based on an investor’s preferences, values or ethics.

THEMATIC

Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.

IMPROVING INVESTEES’ ESG PERFORMANCE (known as: active ownership or stewardship)

Hedge funds can encourage companies/securities to improve their ESG risk management or develop more sustainable business practices. Active ownership might be performed pre and post investment.

ENGAGEMENT

Discussing ESG issues with companies/securities to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors. Some hedge funds adapt activist strategies where the clear objective is to influence management strategy.

PROXY VOTING

Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.

Figure 1: Approaches to PRI Principle 1 (incorporation) and Principle 2 (active ownership)

Hedge funds represent a heterogenous group of managers with a wide range of investment strategies, different governance structures and an ability to invest in a range of assets and financial instruments. Aspects of the approach to ESG incorporation (Principle 1), active ownership (Principle 2) and communication or reporting (Principle 6) differ from long-only security and private equity investors.

This report can be used as a point of reference for hedge fund managers to review and develop their own approach to responsible investment according to their investment strategy. Due to the sheer breadth and range of trading instruments and market strategies spanning equities, fixed income, commodities and FX, some hedge funds are likely to be better placed to integrate an RI policy than others.

2 Claring the air Responsible investment, May 2019
KEY DRIVERS

Key drivers for hedge funds to considering responsible investment fall into three groups.

**Figure 2: Key drivers**

- **Client demand:** Growing demands from beneficiaries and clients for greater transparency about how their money is invested
- **Materiality:** Increasing recognition that ESG factors can affect risk and return
- **Regulation:** More guidance from regulators that considering ESG factors is part of an investor’s fiduciary duty

**Figure 3: Number of signatories with internally managed hedge fund strategies (2019)**

The interest in RI among signatories allocating to hedge fund strategies is encouraging asset owners to increasingly question hedge fund managers about their approach to RI. To facilitate this process, the PRI has published a Due Diligence Questionnaire for Hedge Funds for asset owners. This is the first industry-standard tool for investors to assess hedge fund managers on their responsible investment policies and practices.

**Figure 4: Number of signatories allocating to externally managed hedge fund strategies (2019)**

The DDQ for hedge funds helps asset owners identify those hedge funds that have the personnel, knowledge, and structure to incorporate environmental, social and governance (ESG) factors in the investment decision-making process and was developed alongside industry bodies.

---

3 Don Steinbrugge (9/1/2020); Hedge Fund Week. [Top hedge fund industry trends for 2020](https://www.hedgefundweek.com/2020/09/1/top-hedge-fund-industry-trends-for-2020).
Figure 5: Purpose of the hedge funds DDQ

<table>
<thead>
<tr>
<th>GUIDANCE</th>
<th>A standard for use by investors considering responsible investment as part of their due diligence process for a hedge fund investment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>DIALOGUE</td>
<td>Facilitate a two-way dialogue between investors and investment managers on responsible investment.</td>
</tr>
<tr>
<td>DATA</td>
<td>Standardised questions reduce reporting burden and facilitate comparison between peers, cross-checking of information and data consistency.</td>
</tr>
<tr>
<td>ACCESS</td>
<td>The same questionnaire is available across different industry platforms – the PRI, the Alternative Investment Management Association (AIMA) and Standards Board for Alternative Investments (SBAI), eVestment and DiligenceVault.</td>
</tr>
</tbody>
</table>

Figure 6: Hedge fund DDQ development process

**DATA COLLECTION**
HF DDQs, ESG DDQs, RI policies, RI reports, RI ratings, philosophy and considerations were collected.

**DATA ANALYSIS**
184 questions were analysed reducing the number to 137. From those, 55% were qualitative, and 45% quantitative.

**SELECTION AND EVALUATION**
14 questions were selected and aggregated into 4 sections, based on input from the working group.

**TESTING**
Alignment to industry standards (SBAI and AIMA), and tested among investment managers.

**PUBLICATION AND DISTRIBUTION**
Published and distributed by the PRI, AIMA and the SBAI.

**MATERIALITY**
In Figure 7, we review some of the growing body of academic and industry evidence supporting the premise that identifying and incorporating ESG factors into an investment process may contribute to relative outperformance in certain asset classes. The PRI has also collated a register of academic research which covers a range of topics including reviewing the materiality of ESG factors in asset selection.

Like many other investment approaches, certain hedge fund strategies have primarily focused on governance issues in ESG. For instance, activism and engagement with senior management of companies have been important drivers of returns in event driven and activist hedge funds as well as equity long short funds.
Correlations between ESG and returns

There is a long history of industry and academic research into this topic. In 2003, Paul Gompers' work on the correlation between shareholder rights and profitability, sales growth & M&A was a seminal piece that lead the way. More recently, this type of work has been extended across a range of asset classes that are relevant to hedge fund managers.

Correlation not causation

Most academic and industry work focuses on identifying correlations between ESG factors or rankings and returns or corporate financial performance. Few try to establish or explain causation between better ESG performance and improved corporate financial performance, absolute or relative portfolio or benchmark returns. Sometimes these are aggregated measures of governance, environmental and social performance, sometimes they reflect only a single aspect. They can help investors make more informed decisions but do not capture the implications of factors or trends on corporate or issuer balance sheets, profit and loss accounts or cash flows. Some organisations have tried to explain correlations by outlining three transmission mechanisms: cash flow channel, idiosyncratic risk channel and valuation channel.

Correlations – changes over geography, time & sector

Various research papers identify correlations between ESG scores and financial metrics such as quality, price to book, profitability, volatility, returns and market cap. These relationships often vary in strength depending on the time period and region. One notable and repeatable correlation seems to be between ESG rankings and emerging market equity returns. Many reports split environmental, social and governance rankings – again showing different correlations with most (but not all) surveys identifying governance as the metric with the strongest and most consistent correlation with returns – across a range of asset classes.

The strength of correlations also varied over time, with some commentators highlighting that the correlation strengthened during periods of raised market volatility or market disruption.

Alongside geography and time, correlations between corporate financial performance and ESG rankings also varied between industrial sectors, with a closer correlation in sectors with a greater reliance on heavily regulated activities or those which required a ‘social’ licence to operate. For example, within sectors such as resources, consumer and utilities there is seemingly a stronger statistical relationship between ESG and corporate financial performance.

Correlations – absolute versus rate of change

Another feature of academic research was the delta positive or negative change or rate of change in ESG scores (rather than just the absolute or relative value), which provided an interesting signal in terms of asset returns.
REGULATION

Guidance and policy intervention relating to stewardship, disclosure and RI has increased significantly since the 2008 global financial crisis. Changes have been driven by a range of factors including a realisation among national and international regulators that the financial sector can play an important role in meeting global challenges such as climate change, modern slavery and tax avoidance.

As the client base for hedge funds is qualified or accredited investors, the regulator oversight is different from mutual funds, pension funds, and other investment vehicles. However, ‘soft’ law, codes of best practice, fiduciary duty and changing regulation affecting clients are still highly relevant.

BENEFITS

The implications of increasing interest in RI are similar for all investment managers but for hedge funds there are three particularly relevant benefits:

- As hedge funds can invest in a broad range of assets, these strategies can benefit from ESG themes such as climate change, resource scarcity, energy transition and SDGs in innovative and different ways;
- Renewed focus on different aspects of governance and compliance may contribute to strengthening governance structure and reducing principal-agent issues;
- RI policy development and implementation can contribute to improved industry disclosure, transparency and accountability.

The PRI regulatory map provides signatories with an overview of current and developing regulation. It groups regulation into: ESG regulation targeting asset owners, stewardship codes and corporate disclosure guidelines. The map lists the year, responsible authority and voluntary / mandatory nature.
This section looks at all stages of the investment process and draws on other PRI and industry guidance to provide suggested approaches. It is divided into four modules:

- Module I: RI policy development and implementation;
- Module II: Governance of a RI policy at the firm and fund level;
- Module III: Investment process and active ownership;
- Module IV: Monitoring and reporting.

It outlines approaches that might be undertaken at various stages of the investment process but due to the breadth of hedge fund strategies it is not a definitive list. The section follows the structure of the current PRI Reporting and Assessment framework.

**RESPONSIBLE INVESTMENT APPROACH – FOR INVESTMENT MANAGERS**

The four modules focus on areas that are specific to hedge fund investment managers. It outlines where these investment managers might want to incorporate RI into the investment process, asset selection, active ownership and monitoring and reporting. Due to the breadth of hedge fund strategies it does not address all strategies.

---

**Figure 9: An RI approach for investment managers in the hedge fund industry**

- **MODULE I**
  - Responsible investment policy

- **MODULE II**
  - Governance

- **MODULE III**
  - Investment process
    - Assess materiality of ESG factors
    - Identify ESG factors
    - Identify investment universe
    - Build a portfolio
    - Mandate alignment

- **MODULE IV**
  - Monitoring and reporting

---

**ACTIVE OWNERSHIP**

YES

NO

Guidelines on pre-trade and post-trade breaches
Broadly, these outline two approaches to adopting an RI policy:

- **Development at investment manager or firm level**, where a policy might cover a range of issues or approaches that are understood by and applicable across the entire client base, AUM, portfolio and organisation (asset owner or investment manager).

- **Development at fund or portfolio level** (pooled fund or a segregated managed account). Each fund type is likely to have a different approach to developing, reporting and monitoring RI policies to asset owner requirements.

We acknowledge that policy development may be different across different funds and/or strategies. Nonetheless, these different approaches reflect the hedge fund governance structures that are outlined in the next section.

**POLICY IMPLEMENTATION**

The implementation of this policy might involve a series of steps that have implications for internal processes and policies and external relationships.

Internal RI training can raise awareness of a policy and ensure information and tools are available to meet stated policy commitments. This might be particularly important for investment decision makers, compliance and risk teams. The introduction of clear RI procedures relating to, for example, pre- and post-trade issues, will reduce the possibility of breaches of process or fund criteria.

External agreements including Trading and Prime Brokerage Agreements (especially where the firm or fund has introduced an exclusion list) and the Administration Agreement (to extend the agreement to include monitoring the portfolio for non-compliant positions) may also need reviewing. These counterparty service-level agreements may need adapting to formalise any change in requirements, outline processes where policies are changed or processes when ‘non-compliant’ positions are held.

**POLICY DISCLOSURE AND COMMUNICATION**

At an investment manager level, a hedge fund manager will need to ensure that its RI policy is adequately disclosed to its current and prospective investors. This might include incorporating policy details in public documentation, offer documents or side letters. Disclosure of the RI policy might also be incorporated into the Investment Management Agreement in sufficient detail to enable the asset owner to provide informed consent. At a fund level, where screens are used, documentation should include approaches on what constitutes a breach and how that would be remedied.
Hedge funds often have governance structures or frameworks covering both investment managers’ governance and fund governance. Governance of an RI policy might need to cover both.

**DUAL SET UP – INVESTMENT MANAGER OR FIRM AND FUND LEVELS**

Larger hedge fund managers often have their own internal governance arrangements ranging from boards of directors to investment committees and incorporating business functions like Chief Operating Officers and Chief Compliance Officers. These internal governance roles are key in delivering commitments to investors. Smaller hedge fund managers may outsource the compliance function - this relationship may need reviewing to incorporate or develop a new policy.

<table>
<thead>
<tr>
<th>GOVERNANCE TOPIC</th>
<th>GOVERNANCE STRUCTURE AND ISSUES</th>
<th>RI STRUCTURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of Care</td>
<td>Fiduciary duty</td>
<td>Fiduciary duty with RI</td>
</tr>
</tbody>
</table>
| Governing body and other supervisory bodies | Board of Directors  
Committees  
Separated business functions      | RI competence of governing bodies  
Separate RI committee             |
| Compliance                             | Governing body  
Separate compliance function  
Risk management & reporting       | Reviewing the regulatory agenda, e.g. the EU Commission proposals on Sustainable Finance  
Monitoring and supervising the RI commitment made to investors |
| Interests                              | Alignment of interests  
Conflict of interests                | RI-based KPIs and PM variable compensation                                    |
| Resources and internal codes           | Internal manuals & codes  
Separated and clearly defined duties  
Education and training             | RI policy & training                                                           |
The fund structure typically offers a second level of governance and in many jurisdictions the fund structure has a separate board of directors or similar governing body which supervises the interest of fund investors. At both levels, RI should not be an overlay, but rather core to how an investor understands governance.

Figure 12: Fund governance

<table>
<thead>
<tr>
<th>GOVERNANCE TOPIC</th>
<th>GOVERNANCE STRUCTURE AND ISSUES</th>
<th>RI STRUCTURE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of Care</td>
<td>• Fiduciary duty</td>
<td>• Fiduciary duty with RI</td>
</tr>
<tr>
<td>Governing body and other supervisory bodies</td>
<td>• Board of Directors</td>
<td>• RI board competence and training</td>
</tr>
<tr>
<td>Compliance</td>
<td>• Overall compliance oversight and monitoring</td>
<td>• Supervising RI activity by manager vs. policy and regulatory requirements</td>
</tr>
<tr>
<td></td>
<td>• Supervising manager’s investment activity vs investment guidelines</td>
<td></td>
</tr>
<tr>
<td>Interests</td>
<td>• Board independence</td>
<td>• Monitoring and supervising RI process by manager to evaluate alignment and conflicts</td>
</tr>
<tr>
<td></td>
<td>• Fee paid by investors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Conflict process</td>
<td></td>
</tr>
<tr>
<td>Resources and internal codes</td>
<td>• Supervising and monitoring the state of the processes, codes, potential changes and compliance</td>
<td>• RI Policy &amp; Training</td>
</tr>
</tbody>
</table>

FIDUCIARY DUTY

The PRI defines fiduciary duty as a set of responsibilities imposed upon a person or an organisation which exercise some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. Though hedge funds have different regulatory controls to many other financial investors, the concept of fiduciary duty is still highly relevant.

Figure 13: Fiduciary duty. Source: Fiduciary in the 21st Century

Fiduciary duties (or equivalent obligations) exist to ensure that those who manage other people’s money act in the interests of beneficiaries, rather than serve their own interests.

The most important of these duties are:

**Loyalty:** Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.

**Prudence:** Fiduciaries should act with due care, skill and diligence, investing as an ‘ordinary prudent person’ would do.

The legal interpretation of fiduciary obligations differs depending on regulatory controls and guidance. Over the past decade, there has been relatively little change in the law relating to fiduciary obligations. However, there has been a significant increase in ESG disclosure requirements for asset owners and investment managers and in the use of soft law instruments such as stewardship codes. These stewardship codes encourage investors to engage with listed securities or issuers in which they are invested or promote better practice across other asset classes. There have also been developments in the understanding of the relationship between ESG factors, security returns and corporate financial performance and the broader responsibilities of investment managers. Consequently, the interpretation of fiduciary duty has broadened. This necessarily changes the standards of conduct required of fiduciaries to satisfy their duties under the law.

For hedge funds these fiduciary duties are of particular relevance where the investment strategy is complex and the beneficiary has limited ability to monitor or oversee the actions of the entity acting in their interests.

PRI resources:

- [Fiduciary duty in the 21st century](#)
- [Responsible investment regulation map](#)
GOVERNING BODY, INTERNAL COMPLIANCE AND ESTABLISHING DIVERSITY

RI is still often seen as a “soft” commitment the manager has made to investors through an RI policy. To strengthen the implementation of this policy, at a firm or fund level, a manager needs to make its own internal governance arrangements to monitor and supervise the activity undertaken to comply with a policy. Governing and other supervisory bodies are often formed to oversee aspects of a specific fund or firm governance arrangements might include a separate RI advisory or oversight committee to help supervise and oversee all aspects of the RI process.

Board structure is also under scrutiny. For example, board diversity has become a high-profile topic across the corporate and fund management industry with the emergence of standards or commitments such as the 30% Club (see table below). Adoption of commitments such as the 30% Club have become increasingly widespread as part of an RI policy.

ALIGNING INTERESTS

A well-governed hedge fund has fee structures and other mechanisms to align the interests of the investment manager with investors. Hedge fund managers should introduce a public conflict of interest policy to provide transparency around potential conflicts of interest. This might cover specific processes and controls around the appointment and monitoring of service providers.

Ensuring the managers' clients' and fund boards' interests are aligned, the investment manager may also want to consider introducing relevant quantitative or qualitative RI-related KPIs for its portfolio managers and making these KPIs part of the variable or fixed compensation programme.

**Figure 14: 30% Club – aims and commitment**

The 30% Club aims to develop a diverse pool of talent for all businesses through senior management commitment to better gender balance at all levels of their organisations. The 30% Club identified five factors that create a replicable formula for success in promoting diversity through an organisation:

- a measurable goal with a defined timetable;
- supportive public policy that acknowledges a change to the status quo is required;
- change driven by senior management;
- openness to collaborate;
- a concerted and consistent series of actions and programmes.

Diversity should be emphasised at the investment team level as well as board level. According to some industry associations, hedge fund managers are beginning to recognise the role that diversity can play in making better decisions and delivering better investment outcomes. No matter the size or resources, there are steps that every hedge fund can take to improve its diversity and inclusion.

---

4 ILPA, AIMA, SBAI
The CFA Institute and PRI have developed an ESG integration framework for equity investing. The framework outlines three separate levels of integration of ESG issues into an investment process:

- Investment research;
- Security valuation; and
- Portfolio construction

This framework was designed for equity investors but it provides a useful reference point for hedge fund professionals as they develop ESG-integrated investment processes across a range of asset classes.

Different types of investment strategies (Event Driven, Credit, Systematic, Activism etc.) will have different approaches where elements of this framework will be more relevant. As hedge funds have a broad remit to invest in a range of asset classes, the relevance will depend on the asset class, financial instruments, portfolio mandate and time horizon.

As an example, a fundamental difference between certain hedge fund strategies and long-only equity investment strategies is that hedge funds have the option to take long and short positions in equities (and other asset classes). This provides the opportunity to consider material ESG factors separately for long and short positions. These positions might reflect different corporate approaches to material ESG factors and be identified using frameworks such as the SASB materiality matrix (SASB).

The SASB materiality matrix provides an insight at issuer or security level, but the portfolio-level materiality of an issue might be determined by a broader range of factors such as:

1. Portfolio turnover
2. Investment strategy
3. Time horizon
4. Position size (relative and absolute)

**IDENTIFY ESG FACTORS**

This section covers ESG integration within a selection of asset classes - outlining some key issues surrounding specific asset classes or financial instruments - and is by no means a conclusive list. This section does not look to repeat guidelines or work outlined in other PRI publications, but to provide select specific examples. Investment managers may want to review the appropriate approach as outlined by other PRI work:

**Investor tools**

- Listed Equity
- Fixed income
  - Credit ratings
  - Private debt
- Passive investment
- Private equity
- Hedge funds

- Infrastructure
- Real estate
- Farmland
- Forestry
- Thematic and impact investing
- Stewardship
FIXED INCOME

The integration of ESG factors into fixed income varies depending on the asset classes and financial instruments. This section outlines some issues relating to distressed corporate bonds and sovereign debt.

Distressed corporate bonds

Some investment strategies may take positions in distressed corporate bonds. These may have lower levels of liquidity or be special situations where positions are held for longer periods with higher levels of control. These types of businesses may have lower ESG scores and the investment manager may have a stronger position to influence management strategy to improve ESG performance through engagement with management teams. This approach may also be taken by event driven equity managers with a similar rationale.

Sovereign debt

The PRI has published a guide on the integration of ESG into sovereign debt market. This outlines different ESG factors that are relevant to these markets.

- Governance has traditionally been regarded as the most material ESG factor for sovereign debt and has been extensively incorporated into credit rating models and valuations. Investors can seek measures of a country’s political stability, government and regulatory effectiveness, institutional strength, levels of corruption and the rule of law.

- Social factors can also be material in sovereign credit analysis due to the importance of human capital as a key determinant of economic growth. Measures of demographic change, education, living standards, income inequality and social cohesion can inform sovereign bond valuations.

- Environmental factors have typically been less analysed by sovereign debt investors, though this is changing as the physical and economic impacts of climate change and resource constraints become more evident. Investors are increasingly considering measures of natural resource availability, climate related and energy transition risk.

Hedge fund strategies that incorporate sovereign credit may want to review how these factors influence valuations and investment views.

COMMODITIES

Commodities is another asset class where guidelines are developing. The PRI has undertaken work in this area, developing guidelines and programmes around soft commodities such as palm oil and timber. This approach might lead hedge fund and commodity investors to promote developing standards and practices such as those being considered by the London Metals Exchange for LME-listed brands or the OECD guidelines on certain minerals.

Figure 15: Responsible sourcing and the London Metals Exchange

The LME has launched a consultation on the proposed introduction of responsible sourcing standards across all LME-listed brands. These rules would implement standards which are consistent with, or build upon, the OECD Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas, using the following framework:

The most suitable approach to integrating ESG factors into the selection and ownership of commodities will clearly involve a rigorous focus on the supply chain and the promotion of better practice in the production, extraction and processing of all types of commodities.
**DEFINE INVESTMENT UNIVERSE**

Defining an investment universe is a function of the portfolio mandate. It might involve processes such as a screening to reflect beneficiary values, integration of ESG into investment decision making or a thematic approach to building a portfolio. In all processes, incorporation of ESG factors should co-exist and complement existing processes.

Figure 17: Define an investment universe

**SECURITY INDICES**

Financial instruments investing in security indices are utilised in some hedge fund strategies. Though liquidity remains an issue, the growing numbers of ESG indices provide hedge funds with an opportunity to invest in instruments that attempt to capture ESG trends or criteria. These benchmarks may also be suitable to measure relative performance.

Figure 16: Structure of ESG indices

**BUILD A PORTFOLIO AND ASSET ALLOCATION**

There are a broad range of approaches to incorporate ESG factors into portfolio construction. For example, some ESG mandates have an unconstrained universe and introduce quantitative tilts towards securities or issuers with certain ESG scores or upward trends. Others may require restrictions on positions (long and short) of securities or issuers involved in certain activities such as weapons manufacturing.

Asset allocation decisions play a fundamental role in determining long-term portfolio returns. Multi-asset hedge funds might want to incorporate long-term issues, such as climate change, demographics and resource depletion, into asset allocations decisions. The PRI has recently completed a discussion paper on strategic asset allocation (SAA). The paper argues that SAA should be an obvious place to start reviewing and integrating ESG themes and issues into asset allocation decisions. It outlines three steps in integrating ESG into the SAA process.

Figure 18: Embedding ESG into asset allocation decision

---

**SETTING OBJECTIVES**

Define risk/return objectives and consider a third dimension objective to maximise ‘real world impact’

**SAA TARGETS AND RANGES**

Consider impact of ESG risks and opportunities on expected risk, return and correlation assumptions, undertake scenario analysis

**OPPORTUNITY SET**

Capture ESG opportunities and mitigate risks through asset, region, sector and sub asset class allocation
ACTIVE OWNERSHIP (OR STEWARDSHIP)

Active ownership can be broadly defined as the use of investors’ collective influence over investees, policymakers and other stakeholders to deliver real-world outcomes that ensure the long-term sustainability of investment markets and the broader economy. PRI signatories agree to Principle 2, which states “We will be active owners and incorporate ESG issues into our ownership policies and practices”.

For equity and fixed income investors this approach can include engaging with securities or policy makers to promote better practice either through informal or formal processes. Formal engagement activities might include proxy voting, shareholder resolutions, divestment and policy engagement. These approaches might complement informal management engagement.

**Figure 19: Active ownership approaches for HF managers**

**ENGAGEMENT**
- Discussing ESG issues with companies/securities in order to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors, or with an outsourced specialist service provider. This might involve target setting.

**ACTIVIST**
- Mandates have specific objectives to target securities with low ESG ranking or performance to catalyse an improvement in ESG and corporate financial performance and subsequent shareholder or creditor returns.

**SHORTING**
- Short selling can be one way to express a view that an entity is not adequately incorporating ESG factors.

**DIVESTMENT**
- A potential escalation strategy where engagement either through private or public actions, has not succeeded.

Many of these processes are shared between long only and hedge fund managers. However, hedge fund managers may encounter some specific issues when implementing Principle 2. For example, systematic managers who construct diverse portfolios may not have the resources to be able to engage directly with company management due to rapid portfolio turnover or short holding periods.

DIVESTMENT

When formal or informal engagement towards a set objective is failing, hedge fund managers may consider a range of escalation strategies including public statements, filing resolutions, voting against re-election of responsible directors and, ultimately, divestment. Divestment is considered by an increasing number of asset owners as a possible mechanism to escalate an engagement process. As an alternative to divestment, hedge fund managers may also take short positions on issuers or securities where engagement has not been successful.

STOCK LENDING

For asset owners, stock lending raises challenges. Stock lending is a process that enables hedge funds to construct hedging, arbitrage, or short selling positions. It is the temporary transfer of shares by an investor to a borrower in exchange for a fee, with agreement by the borrower to return equivalent shares to the lender at an agreed time. When shares are lent, voting rights are passed to the borrower and the underlying owner may recall the shares to undertake proxy voting.

In December 2019, Japan’s Government Pension Investment Fund (GPIF) suspended the practice of stock lending. The rationale for suspending the practice was that stock lending results in a temporary transfer of ownership rights to the borrower. GPIF held the view that stock lending creates an inconsistency with their asset managers’ abilities to fulfil their stewardship responsibilities over the underlying investments. Other investment managers have adopted a range of approaches which are outlined in PRI’s Practical Guide to Active Ownership in Listed Equity.

The ICGN Securities Lending Code of Best Practice is an additional source of guidance for investors interested in initiating a share lending programme that does not impede responsible voting activities. Hedge funds should ensure that stock is returned in a timely manner when required for voting.

SHORTING

For hedge funds, short selling is a trading strategy employed when they believe that a financial instrument is overpriced. It generally means borrowing a financial instrument (e.g. equity, commodity futures contract) and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the party from which it was borrowed. There are a range of questions around the relationship between ESG and short selling. Short selling is one way for a hedge fund manager to express the view that an entity is not adequately incorporating ESG factors.
MODULE IV – MONITORING AND REPORTING

The PRI's Principle 6 calls for signatories, including hedge funds, to ‘each report on our activities and progress towards implementing the Principles.’

This could include topics such as:

- How ESG issues are integrated within investment practices;
- Disclosure of active ownership activities (proxy voting and policy or corporate engagement); and
- Public reporting on the impact of active ownership activities and investment practices.

Reporting may be particularly useful to asset owners when it follows these principles:

- **Timely and recurring** – reporting might follow a similar schedule to performance or mandatory reporting;
- **Consistent and comparable** – enabling asset owners to track change and improvement and compare against hedge funds following similar investment strategies;
- **Incorporates real world impact** – so that asset owners can measure the impact of an ESG policy on real world outcomes (See PRI Active Ownership 2.0).

Hedge fund managers might want to adapt their specific approach to ESG reporting to reflect:

- **Long/short exposures** – for example an approach might be to report net long exposure to enable measurement or comparison of a portfolio against ESG metrics.
- **Relative to benchmark** – due to differences in benchmark selection, certain hedge fund strategies may find it difficult to select an appropriate benchmark to compare ESG performance e.g. on their carbon footprint. These funds might rely on improvement year on year rather than a comparison with a specific benchmark.
- **Risk monitoring** – for ex-post analysis, suitable tools might enable risk monitoring to measure net exposure to securities with specific ESG characteristics.
- **Impact measurement** – some institutional clients may require managers to report on the impact of their portfolio. This might be through case studies or quantitative approaches such as carbon footprinting and the EU Taxonomy.
For hedge funds, few legal and regulatory guidelines exist to guide RI policy and practice. Managers need to consider other relevant codes and recommendations as well as best industry practices.

List of ESG-related guidelines appropriate for hedge funds:

<table>
<thead>
<tr>
<th>ORGANISATION</th>
<th>TITLE</th>
<th>KEY POINTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standards Board for Alternative Investments</td>
<td>SBAI The Alternative Investment Standards</td>
<td>Managers achieve conformity with the Standards on a “comply-or-explain” basis and make their disclosure statements available to existing and prospective investors upon request.</td>
</tr>
<tr>
<td>Alignment of Interests Association</td>
<td>AOI Hedge Fund Investing Principles</td>
<td>Best practices in relation to aligning the interests of managers and investors. The concepts outlined in this document are intended to serve as a basis for continued discussion between investors and their hedge fund managers.</td>
</tr>
<tr>
<td>International Organization of Securities Commission</td>
<td>IOSCO Principles For The Valuation Of Hedge Fund Portfolios</td>
<td>Principles for valuing the investment portfolios of hedge funds and the challenges that arise when valuing illiquid or complex financial instruments.</td>
</tr>
</tbody>
</table>

**UN conventions and initiatives**
- UN Global Compact
- The Universal Declaration of Human Rights
- ILO Declaration on Fundamental Principles and Rights at Work
- The Rio Conventions
- The UN Convention Against Corruption

**Other intergovernmental organisations**
- OECD Guidelines for Multinational Enterprises
- OECD Anti-Bribery Convention
- OECD Principles of Corporate Governance
The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org