ASSET MANAGEMENT & CUSTODY ACTIVITIES

Research Brief

SASB’s Industry Research Brief provides evidence for the material sustainability issues in the industry. The brief opens with a summary of the industry, including relevant legislative and regulatory trends and sustainability risks and opportunities. Following this, evidence for each material sustainability issue (in the categories of Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance) is presented. SASB’s Industry Brief can be used to understand the research and data underlying SASB Sustainability Accounting Standards. For accounting metrics and disclosure guidance, please see SASB’s Sustainability Accounting Standards. For information about the legal basis for SASB and SASB’s standards development process, please see the Conceptual Framework.

SASB identifies the minimum set of sustainability issues likely to be material for companies within a given industry. However, the final determination of materiality is the onus of the company.

Related Documents

- Financials Sustainability Accounting Standards
- Industry Working Group Participants
- SASB Conceptual Framework
- Example of Integrated Disclosure in Form 10-K

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sustainability factors has been demonstrated to affect traditional valuation by impacting revenue, assets, liabilities, and cost of capital. To ensure that shareholders are able to evaluate these factors, asset management and custody activities companies should report on the material sustainability risks and opportunities that may affect value in the near and long term. Enhanced reporting will provide stakeholders with a more holistic (and comparable) view of performance that includes both positive and negative externalities, and the non-financial forms of capital that asset management and custody activities companies rely on to create long-term value. Firms that work to improve performance on these issues will position themselves well for the future.

The sustainability issues that will drive competitiveness within the asset management and custody activities industry include:

- Providing transparent information and fair advice to customers
- Ensuring employee incentives and compensation are aligned with both short- and long-term value
- Promoting employee inclusion
- Integrating environmental, social, and governance risk factors in investment management and advisory
- Ensuring legal and regulatory compliance
- Managing systemic risk

The extent to which these sustainability factors impact value will become increasingly clear as policymakers continue to emphasize accountability, enhanced transparency, regulatory compliance, and risk management.
INDUSTRY SUMMARY

The asset management and custody activities industry is comprised of companies that manage investment portfolios on a commission or fee basis for institutional, retail, and high net worth investors. Investment management activities include equities, fixed income, mixed asset, and hedge fund investments. In addition, firms in this industry provide wealth management, private banking, financial planning, and investment advisory and brokerage services. Specific companies are engaged in venture capital and private equity investments.¹

The asset management and custody activities industry serves clients with a range of risk and return requirements, and is characterized by a variety of investment strategies, from active management to index and exchange-traded funds. Revenue is derived from management and performance fees. The industry is highly dependent on skilled employees, despite a recent shift towards automation and algorithmic trading. Consequently, compensation accounts for a majority of industry costs.

Value in the industry is driven by the volume of assets under management (AUM) and investment performance (which also influences the value of the underlying assets). For companies engaged in alternative investments such as hedge funds, private equity, and venture capital, value drivers also include the cost of capital and access to funding sources (particularly relevant for leveraged transactions), and the level of activity in mergers and acquisitions and initial public offerings (especially applicable to returns of financial sponsors). These factors are influenced in turn by investor uncertainty, stock market performance, prevailing interest rates, and the level of economic activity. Recessionary conditions and poor stock market performance following the financial crisis are affecting returns in this industry, for traditional asset managers as well as hedge funds.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) presents far-reaching implications for the financial sector, including the asset management and custody activities industry. Greater regulation of this industry is likely to lead to higher compliance costs and restrictions on certain activities, and will likely affect returns. The industry is facing pressures from investors and regulators to reduce or even forgo asset-based fee models. At the same time, regulations such as the Volcker rule may result in increased AUM for this industry, as banks will be required to limit or close their internal asset management activities.¹

The industry is also impacted by a shift in institutional investing from traditional assets to alternative assets. Further, many clients are now favoring investments in a few select funds rather than funds of funds, which had been common in the recent past. In addition, the difference between traditional and alternative asset management firms is becoming less obvious. Market concentration is expected to

¹ A list of five companies representative of this industry and its activities appears in Appendix I.
increase as institutional investors are attracted to larger existing firms that offer economies of scale and a larger number and variety of funds. At the same time, the industry is becoming increasingly globalized in terms of both investment opportunities and clients, with greater levels of wealth in emerging economies. Expanded wealth coupled with an increase in population suggests an increase in demand for asset management and custody activities, including for retirement and pension funds.

**LEGISLATIVE & REGULATORY TRENDS IN THE ASSET MANAGEMENT & CUSTODY ACTIVITIES INDUSTRY**

Although the regulatory environment that governs the asset management and custody activities industry continues to evolve, regulatory trends have the potential to impact shareholder value and sustainability performance. The following section provides a brief summary of key legislative efforts that are already impacting, or are likely to impact, value in the industry and that further amplify the importance of sustainability issues.

Asset managers in the U.S. are bound by fiduciary duty. While this fiduciary duty is a basic tenet of agency relationship, fiduciary duties of asset managers emanate from a multitude of Federal and state regulatory frameworks, including the Investment Advisor and Investment Company Acts of 1940, and the Employee Retirement Income Security Act (ERISA). ERISA stipulates that fiduciary liability applies not only to trustees but also to anyone exercising discretion over investment plan assets. Fiduciary duty broadly includes the duty of loyalty, whereby fiduciaries have to act in good faith in the interests of beneficiaries, avoid conflicts of interest, and avoid acting for the benefit of themselves or a third party. It also includes a duty of prudence to act with due care, skill, and diligence. These duties have traditionally been interpreted as efforts to maximize investment returns without considering environmental, social, or governance (ESG) issues. However, as discussed below these issues are increasingly becoming material to investment performance itself, and asset owners such as retirement funds and insurance companies are themselves committing to “responsible” investment. This is leading to an evolution of the interpretation of fiduciary duty in practice and law to include ESG considerations. A focus on long-term value and consideration of systemic risks as well as low-probability, high-impact events is expected to become increasingly common in asset management.

Recent financial market regulation is also impacting the asset management and custody activities industry. The Dodd-Frank Act was signed into law in 2010, with the aim of addressing the market failures that led to the financial crisis of 2008 and ensuring market stability. Federal agencies are yet to implement some of the rules proposed by the Dodd-Frank reforms, and final rules already in place have transition periods for implementation. The Dodd-Frank Act requires all hedge fund and

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1 Data as of June 30 2013. Based on annual summary of branch office deposits for all FDIC-insured institutions, including U.S. branches of foreign banks.
private equity advisors with AUM greater than $150 million to register with the Securities and Exchange Commission (SEC), bringing unlisted entities in this industry under the purview of the SEC for the first time. As of October 2012, the SEC reported that a total of 4,061 private fund advisors had registered, 1,504 of which had not registered prior to the Dodd-Frank Act mandate. In addition, such companies are required to have a chief compliance officer to develop a compliance program and are now subject to periodic review by the SEC.

Some non-industry-specific rules implemented or proposed under the Dodd-Frank reforms that will influence industry activity include regulations governing Over-the-Counter (OTC) derivatives and swaps markets, including those related to clearing and reporting requirements (hedge funds may be regulated further if they are classified as a “major swap participant”). Furthermore, the Volcker rule limits banks’ proprietary trading activities and their investments in private equity funds, venture capital funds, or hedge funds, potentially increasing AUM for the asset management industry. These rules focus on transparency, risk management, and limiting spill-over effects from the failure of increasingly interconnected financial institutions.

The asset management and custody activities industry is also subject to the new regulations to address tax evasion by U.S. citizens hiding assets overseas under the Foreign Account Tax Compliance Act (FATCA). Under the final FATCA regulations, issued by the Internal Revenue Service (IRS) in January 2013, financial institutions are required to identify U.S. persons with investments in non-U.S. financial accounts or entities. Companies in the industry, other than those with U.S. funds only and no offshore vehicles, will have to register with the IRS as a foreign financial institution (FFI); institutions that do not register or do so incorrectly can trigger a 30 percent withholding tax on any payment or dividend considered “withholdable.” The IRS issued guidance to FFIs entering into FFI agreements in October 2013; this will have both reputational and operational consequences for asset managers.

Non-financial sector legislation may also impact this industry. For example, carbon markets or other environmental regulations planned or already implemented in some U.S. states such as California and in other countries create both risks and opportunities for the asset management and custody activities industry, as it can affect the value of the underlying investments.
SUSTAINABILITY-RELATED RISKS & OPPORTUNITIES

Recent trends in the regulatory environment suggest a demand for greater accountability of asset management firms towards customers and regulatory agencies. Specifically, firms trading in complex derivatives products, those that are highly leveraged, and those with significant AUM have attracted the most regulatory scrutiny. This legislation has the potential to align the interests of society with those of long-term investors. As new policies mandate more responsible management of sustainability issues, firms that are able to navigate new regulations while addressing all forms of capital - not just financial - will be better positioned to protect shareholder value in the future.

The following section provides a brief description of how the asset management and custody activities industry depends on each form of capital and the specific sustainability issues that will drive performance, including evidence and value impact. The issues are divided into five categories: Environment, Social Capital, Human Capital, Business Model and Innovation, and Leadership and Governance. A table indicating the nature of the value impact and evidence of interest from stakeholders appears in Appendix IIA. Appendix IIB expands on the channels of financial impacts of each sustainability issue and the recommended disclosure framework appears in Appendix III.

ENVIRONMENT

The environmental dimension of sustainability includes corporate impact on the environment, either through the use of non-renewable natural resources as input to the factors of production (e.g., water, minerals, ecosystems, and biodiversity) or through environmental externalities or other harmful releases in the environment, such as air and water pollution, waste disposal, and greenhouse gas emissions.

The asset management and custody activities industry’s primary reliance on environmental capital is in the form of energy consumed to operate offices and data centers. Although energy use contributes to negative externalities, this issue was determined not to be material for this industry. The industry’s primary opportunity in the area of environment is to integrate environmental factors into its investment management and advisory activities. This issue is addressed in the Business Model and Innovation section below.
SOCIAL CAPITAL

Social capital relates to the perceived role of business in society, or the expectation of business contribution to society in return for its license to operate. It addresses the management of relationships with key outside stakeholders, such as customers, local communities, the public, and the government. It includes issues related to access to products and services, affordability, responsible business practices in marketing, and customer privacy.

Commercial banks rely on a social license to operate, which is at risk when companies create negative externalities and erode confidence and trust on the part of clients, investors, and regulators. Since the financial crisis in 2008, commercial banks have been criticized for their reliance on government funds and for unethical behavior. As a result, the industry has been subject to a regulatory overhaul through the Dodd-Frank Act. Although the sustainability risks and opportunities related to the regulatory environment are addressed in the Leadership and Governance section below, the financial crisis and subsequent loss of confidence indicate a significant need for the industry to rebuild social capital. Specifically, commercial banks must ensure financial inclusion and maintain the privacy and security of customer information. Enhanced disclosure in these areas will allow shareholders to assess performance and determine which commercial banks are better positioned to create long-term value.

Transparent Information & Fair Advice for Customers

Asset managers have legal obligations and fiduciary duties related to record keeping, operating and marketing, disclosure requirements, and prohibitions on fraudulent activities. Regulations surrounding this industry are intended to align the interests of companies and their clients and to limit conflicts of interest.

This alignment, coupled with the fact that most asset managers earn fees based on the amount of AUM, provides a significant incentive for companies to provide clients with strategies that match their risk-return profiles. Despite required disclosures, companies still face significant challenges in ensuring that clients understand the nature of risks taken in investment strategies. Beyond clear communication and a proper exercise of fiduciary duty, asset managers are also under pressure from larger clients to reduce their dependence on asset-based fees and create fee structures that reward risk-adjusted performance.

Enhanced disclosure on how firms, including those engaged in venture capital or private equity investments, are managing risks associated with transparency and fair advice will provide shareholders with an understanding of long-term value preservation.
Evidence

In August, 2013, a New York state judge found JPMorgan Chase liable to an investor for breach of contract after the company invested in risky subprime mortgage securities that led to more than $100 million in losses. The suit centered on the idea that the individual provided the bank with a mandate for highly liquid, conservative cash management, which it did not adhere to. The company was ordered to pay $42.5 million for the breach of contract plus five percent interest beginning in May 2008.8

BlackRock reports that “when clients retain BlackRock to manage assets or provide products or services on their behalf, they typically specify guidelines or contractual requirements that the Company is required to observe in the provision of its services. A failure to comply with these guidelines or contractual requirements could result in damage to BlackRock’s reputation or in its clients seeking to recover losses, withdrawing their AUM or terminating their contracts, any of which could cause the Company’s revenues and earnings to decline.”9

Value Impact

The lack of transparent information and a failure to treat investors fairly and in compliance with the Investment Policy Statement is likely to result in intensified regulatory oversight and increase general and administrative expenses. In addition, litigation could arise, which could lead to substantial one-time costs and contingent liabilities. Poor performance in this area can also damage a company’s reputation, devalue intangible assets, and result in difficulty retaining clients. This could lead to reduced revenue through lost management fees, and in the long term lost market share. Developing regulations coupled with investor demand for greater transparency indicate this issue is likely to become increasingly material for the asset management and custody activities industry.

HUMAN CAPITAL

Human capital addresses the management of a company’s human resources (employees and individual contractors) as a key asset to delivering long-term value. It includes factors that affect the productivity of employees, such as employee engagement, diversity, and incentives and compensation, as well as the attraction and retention of employees in highly competitive or constrained markets for specific talent, skills, or education. It also addresses the management of labor relations in industries that rely on economies of scale and compete on the price of products and services or in industries with legacy pension liabilities associated with vast workforces. Lastly, it includes the management of the health and safety of employees and the ability to create a safety culture for companies that operate in dangerous working environments.
Asset management firms are heavily dependent on human capital, requiring highly skilled employees to make strategic investment decisions, create new products and services, manage risks effectively, and provide tailored and effective investment advice to customers. Further, the industry depends on employees to help firms differentiate themselves based on the level of services provided and investment performance, and to build reputation and attract more AUM from existing as well as new customers. As a result, it is also essential that companies maintain a diverse workforce. Asset management and custody activities companies must therefore ensure that employees are incentivized to act in the best interest of clients through remuneration or potential sanctions, and that diversity is maintained.

**Employee Incentives & Risk Taking**

Employee compensation in the asset management and custody activities industry can incentivize short-term or long-term performance. Structures that focus on short-term performance or allow managers to share in investors’ upside gains can encourage risk taking and lead to a concentration of investments in certain asset classes or securities. Both practices can present significant adverse implications for long-term client and corporate value.

Consequently, improved disclosure on employee compensation, focusing on the use of performance metrics and variable remuneration, will provide shareholders with a clear understanding of how companies in this industry are protecting corporate value.

**Evidence**

A recent paper summarizing various academic research highlights three types of asymmetries in employee compensation in financial services that lead to excessive risk taking. These include asymmetries in the amount of gains and losses, and an imbalance between the term, magnitude, and probability of gains and losses, such as pay and bonus arrangements that reward employees for short-term results even when results are subsequently reversed, encouraging them to take tail risks. The paper also discusses misaligned incentives as a result of standard equity-based compensation to executives, which drives them to think about short-term share prices rather than long-term value of the firm.

The paper also indicates that institutional investors experienced smaller percentage losses in their client base in years when they achieved below-average returns than the percentage gains in years of above-average returns. This suggests that individuals are encouraged to take excessive risk because of more significant upsides than downsides.

For hedge funds, fees are typically based on a two percent management fee and 20 percent performance fee. Consequently, hedge fund managers benefit from upsides in investment but do not face significant penalties if there are losses in AUM. This incentivizes hedge fund managers to take risks and add significant leverage.
Value Impact

A failure to manage incentives and risk taking in investment decisions is likely to generate lower than average risk-adjusted returns in the long term. This could lead to AUM redemptions and lower management and incentive fees.

Increased investor concern relating to risk taking could create reputational damage and impact revenue, earnings, market share, and value of intangible assets.

Employee Inclusion

Asset management and custody activities companies face a high degree of competition for skilled employees. Companies can generate significant value by ensuring employee diversity. Enhanced disclosure on this issue will allow shareholders to assess how companies are managing the risks and opportunities associated with employee inclusion.

Evidence

Research suggests that greater diversity among managers and company leaders, in terms of social categories (e.g., age, race, and gender), education, experience, and values, is likely to contribute to improved shareholder value for the industry. A recent survey on women in alternative investments found that 18 percent of the firms surveyed had female chief investment officers, and 16 percent had female chief executives. The survey showed that female hedge fund managers had a strong track record of returns, producing a return of around nine percent through the third quarter of 2012; by contrast, the HFRX Global Hedge Fund Index, released by Hedge Fund Research, registered about three percent net returns.12

Further, companies with the most female board directors outperform those with the least on return on invested capital (ROIC) by 26 percent, and companies with sustained high representation of female board directors outperformed those with sustained low representation by 60 percent on ROIC, and by 46 percent on ROE.13

A recent study by Barclays Wealth found that “variations in how women and men think, behave, and take action in their investment decisions and inheritance planning have far reaching implications. As the rate of women’s wealth rises exponentially across the world, it is becoming increasing vital that financial institutions and wealth managers address and understand these differences.”14

Value Impact

In a saturated investment sector with a variety of investment products, the ability to innovate by generating novel investment ideas is crucial for the success of an asset management company. The ability to deliver superior risk-adjusted returns to investors is likely to ensure inflow of AUM and generate higher management and incentive fees. Enhanced employee diversity could contribute to these goals and correlate positively with the company’s efficiency metrics, such as ROIC and ROE.
BUSINESS MODEL & INNOVATION

This dimension of sustainability is concerned with the impact of environmental and social factors on innovation and business models. It addresses the integration of environmental and social factors in the value creation process of companies, including resource efficiency and other innovation in the production process, as well as product innovation and looking at efficiency and responsibility in the design, use-phase, and disposal of products. It includes management of environmental and social impacts on tangible and financial assets—either a company’s own or those it manages as the fiduciary for others.

The asset management and custody activities industry is highly competitive and relies on rapid innovation and growth to meet evolving customer needs. The primary opportunities for innovation as they relate to sustainability are associated with the increasing need to incorporate environmental, social, and governance factors into investment management and advisory services. Enhanced disclosure on how these factors are integrated will allow shareholders to assess which companies are better positioned to address the associated risks and opportunities.

Integration of Environmental, Social, and Governance Risk Factors in Investment Management & Advisory

Asset management and custody activities companies maintain a fiduciary responsibility to their clients. These companies must therefore consider and integrate analysis of all material issues into investment decisions, including environmental, social, and governance factors.

According to a theory of Universal Ownership, large asset owners are directly impacted by environmental and social externalities, given their long-term liabilities and need for diversification of assets. For example, a large asset owner is likely to invest in both companies that emit large quantities of greenhouse gas emissions and companies that are directly impacted by climate change. Therefore, while it is generally a source of reduced risk in portfolio investment, diversification is also a source of increased ESG risks, and must be recognized as such by asset managers.

This is especially true for equity investments in companies with sizeable hydrocarbon reserves, such as oil & gas and coal companies. Proven hydrocarbon reserves can be accounted for in financial statements and added to the company’s valuation of long-term prospect and growth, and can represent a substantial portion of some companies’ market value. Yet, certain scenarios of regulatory response to climate
change, leading to increased cost of extraction or reduced demand for those products, are not currently factored in the present value of these reserves and yet could result in a substantial reduction in the market value of companies holding these reserves. In turn, this gap in valuation can represent a material risk for asset managers, as many own substantial equity investments in oil & gas and coal companies.

Asset management and custody activities firms also have the opportunity to engage actively with companies that they invest in or own. Proxy voting, shareholder proposals, and other engagement strategies allow these companies to leverage their positions to encourage companies to improve long-term value through enhanced management including around sustainability issues such as energy efficiency and human capital that can affect the value of companies. A strategic approach to active ownership and engagement can increase the value of underlying assets, thereby increasing value for both clients and shareholders.

As the management and use of non-financial forms of capital increasingly contribute to market value, asset management and custody activities companies that fail to address these risks and opportunities could face diminished returns for clients and ultimately reduced value for shareholders.

Evidence

The increase in the number of companies integrating ESG into investment decisions is illustrated by the development of the United Nations-backed Principles for Responsible Investment (UN PRI). UN PRI is an initiative of the world’s largest asset owners (retirement funds and insurance companies) and their asset managers to recognize the importance of ESG factors and market stability in generating both short- and long-term sustainable investment returns. Signatories to the UN PRI acknowledge the demand from investors for incorporating ESG factors into asset allocation and portfolio management, and commit to actively integrate these issues into investment analysis and decision-making processes, develop tools and metrics to evaluate ESG issues, and encourage standardized ESG disclosure from investees. Between 2009 and 2010, the number of signatories to the UN PRI increased by more than 30 percent. Currently 1,000 asset owners and investment managers with over $30 trillion in AUM (15 percent of the world’s investable assets) have become signatories. This represents a significant increase from $4 trillion at the launch of the PRI in 2006.

In addition to this growth in interest, numerous studies have articulated the value of incorporating ESG factors into investment decisions. According to a Deutsche Bank meta-study on sustainable investing, “100% of the academic studies agree that companies with high ratings for CSR and ESG factors have a lower cost of capital in terms of debt (loans and bonds) and equity.” Furthermore, the report indicates that “89% of the studies we examined show that companies with high ratings for ESG factors exhibit market-based outperformance, while 85% of the studies show these types of companies exhibit accounting-based outperformance.”
A study by Mercer on the impacts of climate change on investment portfolios concludes that “[uncertainty around] climate policy could contribute as much as 10 percent to overall portfolio risk.”19 Another UNEP report highlights the materiality of environmental risks for sovereign credit. According to the report, “a 10 percent fall in the productivity of natural resources, such as grazing land or forests, could force current trade imbalances” to increase by an equivalent of four percent of GDP due to higher dependence on imports.20

Active ownership for those engaged in private equity has also been demonstrated to enhance shareholder value. KKR established a Green Portfolio program that sends a specialist team, KKR Capstone, to work with investee companies on environmental initiatives. As a result of the program, the 16 Green Portfolio companies are said to have experienced $160 million of financial improvements in 2008-09.21

A 2009 study of private equity firms indicates that investors with active ownership are able to significantly outperform their peers.22 In an extensive study of U.S. companies from 1999-2009, active ownership engagement is shown to result in a higher return, an average of 1.8 percent, compared to a scenario of no engagement. Further, in scenarios when engagement is successful, asset owners realized a higher return of 4.4 percent above a strategy of no engagement.23

**Value Impact**

A failure to integrate ESG factors and active ownership in investment management is likely to affect the amount of incentive fees due to the underperformance of portfolios. Poor returns can lead to partial or full redemption of funds by clients, reducing earnings from management fees and adversely impacting revenue and market share.

The integration of ESG factors in investment decisions is particularly relevant for emerging market investments, which are an increasing source of diversification for portfolio managers. Emerging markets portfolios are prone to country-specific ESG risks, including political and social pressure, corruption and bribery, and environmental regulations, which can further increase cost of capital and affect the present value of cash flows. These risks are likely to increase volatility of investment portfolios, weakening risk-adjusted returns of asset management firms.

Companies that succeed in integrating ESG factors in investment management and advisory are likely to deliver greater risk-adjusted returns to their clients. Further, these companies will be better positioned to capture new markets by expanding their services to environmentally and socially conscious investors. Strong performance in this area can also enhance reputation and increase the value of intangible assets.
LEADERSHIP & GOVERNANCE

As applied to sustainability, governance involves the management of issues that are inherent to the business model or common practice in the industry and that are in potential conflict with the interest of broader stakeholder groups (government, community, customers, and employees) and therefore create a potential liability, or worse, a limitation or removal of license to operate. This includes regulatory compliance, lobbying, and political contributions. It includes risk management, safety management, supply chain and resource management, conflict of interest, anti-competitive behavior, and corruption and bribery. It also includes risk of business complicity with human rights violations.

Traditional asset management firms manage large sums of money on behalf of institutional clients including pension funds and insurance companies. Hedge funds sometimes employ complex investment algorithms and, with private equity funds, often rely on high levels of financial leverage. These characteristics enhance the importance of governance performance for the industry. Further, regulatory oversight of financial institutions following the financial crisis of 2008 has continued to expose several governance issues in the industry. Consequently, information on regulatory compliance, systemic risk management, and active ownership are essential for shareholders to understand management quality and a company’s ability to protect value.

Management of the Legal & Regulatory Environment

The regulatory environment surrounding the asset management and custody activities industry continues to evolve both nationally and internationally. Companies are required to adhere to a complex and sometimes inconsistent set of rules relating to both performance and disclosure on issues including insider trading, clearing requirements in over-the-counter derivatives markets, and tax evasion. Asset management and custody activities companies are also subject to strict legal requirements as fiduciaries or custodians for their clients. Further, the FATCA regulations present a significant operational and regulatory risk for this industry.

Firms that are able to manage these regulatory concerns and ensure compliance will be better positioned to protect shareholder value and limit future liabilities.

Evidence

Recent legal and regulatory actions against financial institutions demonstrate the risks associated with a failure in governance. For example, in 2012, the SEC initiated 58 insider trading actions against 131 individuals and entities. From 2009-2012, the total illicit profits or losses avoided were estimated to be $600 million.24

In 2013, SAC Capital Advisors pled guilty to insider trading charges and agreed to pay
a record $1.2 billion fine, and to wind down its business of managing money for outside investors.25

Diamondback Capital Management agreed to pay more than $9 million to settle an SEC lawsuit alleging insider trading by a portfolio manager and an analyst working at the firm. According to prosecutors, other employees at the firm did not know about these insider trading actions.26 The hedge fund announced in December 2012 that it would close and wind down its funds after redemption requests of 26 percent of AUM.27

**Value Impact**

The inability to comply with relevant regulations can present material implications for a single company and the overall industry. Poor performance could lead to reduced market share through the depletion of AUM and difficulty attracting new investors. Reputational risk is also likely to lower the value of intangible assets. In addition, contingent liabilities and more stringent regulatory requirements are likely to weaken companies’ operational efficiency through increased general and administrative expenses. Combined, these factors can lead to credit rating downgrades, higher cost of capital, and diminished shareholder value.

**Systemic Risk Management**

Asset managers have the potential to pose, amplify, or transmit a threat to the financial system. Companies in this industry can subsequently be designated by regulators as systemically important financial institutions. Although the regulatory implications of this designation are yet to be finalized, firms will be subject to stricter prudential regulatory standards and oversight by the Federal Reserve Board.

Asset managers will likely face limitations relating to risk-based capital, leverage, liquidity, and credit exposure. In addition, firms will be required to maintain a plan for rapid and orderly dissolution in the event of financial distress. To demonstrate how these risks are being managed, asset managers should enhance disclosure on key aspects of systemic risk management.

**Evidence**

Since the financial crisis, two asset management and custody activities firms, State Street and Bank of New York Mellon, have been designated as systemically important financial institutions. Although the ramifications of this distinction remain unclear, the potential for loss associated with systemic risk have been well articulated.

State Street reports that: “If higher than normal demands for liquidity from our clients were to return to post-Lehman-bankruptcy levels or increase, managing the liquidity requirements of our collective investment pools could become more difficult. If such liquidity problems were to recur, our relationships with our clients may be adversely affected, and, we could, in certain circumstances, be required to consolidate the investment pools into our consolidated statement of condition; levels of redemption activity could increase; and our
Value Impact

The ability to adopt new requirements for systemically important financial institutions are likely to give asset management and custody activities companies a competitive advantage. Specifically, increased quality, transparency, and consistency of the capital base, liquidity, leverage limits, credit risk exposure, concentration, short-term debt limits, and enhanced public disclosures are likely to improve a company’s risk profile and lower the cost of capital.

A failure to adopt new requirements is likely to result in intensified regulatory oversight and litigation, thereby increasing recurring general and administrative expenses, and imposing contingent liabilities. Further, this could diminish the value of intangible assets through damaged reputation, and lead to AUM redemption, lost market share, and decreased revenue.

The regulatory environment surrounding the industry continues to evolve. Consequently, companies are faced with considerable uncertainty with respect to new requirements. However, these regulations are likely to have a material impact on a company’s performance and profitability in the near term.
how these actions impact shareholder value, and whether the cost of these activities is outweighed by corporate gains. Additionally, the issue raises questions of the efficacy of lobbying for or against a regulation that protects near-term profits, but is misaligned with longer-term strategic investments and initiatives.

Although investor interest in the issue appears to be increasing, it is not clear whether shareholder resolutions requiring such disclosure will receive widespread support. Additionally, after indicating it as a priority issue for 2013, the SEC dropped the issue of political spending from its 2014 agenda.30
APPENDIX I: Five Representative Companies | Asset Management & Custody Activities

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<thead>
<tr>
<th>COMPANY NAME (TICKER SYMBOL)</th>
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<tbody>
<tr>
<td>BlackRock (BLK)</td>
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<tr>
<td>Franklin Resources (BEN)</td>
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<tr>
<td>Invesco (IVZ)</td>
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<tr>
<td>T. Rowe Price Group (TROW)</td>
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<td>Apollo Global Management (APO)</td>
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This list includes five companies representative of the Asset Management & Custody Industry and its activities. Only companies that are US listed and where at least 20 percent of revenue is generated by activities in this industry according to the latest information available on Bloomberg Professional Service were included.
APPENDIX IIA: Evidence for Material Sustainability Issues

<table>
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<tr>
<th>MATERIAL SUSTAINABILITY ISSUES</th>
<th>EVIDENCE OF INTEREST</th>
<th>EVIDENCE OF FINANCIAL IMPACT</th>
<th>FORWARD-LOOKING IMPACT</th>
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<tr>
<td></td>
<td>HM (1-100)</td>
<td>IWGs %</td>
<td>EI</td>
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<td>BUSINESS MODEL &amp; INNOVATION</td>
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<td>57</td>
<td>93</td>
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HM: Heat Map, a score out of 100 indicating the relative importance of the issue among SASB’s initial list of 43 generic sustainability issues. The score is based on the frequency of relevant keywords in documents (i.e., 10-Ks, shareholder resolutions, legal news, news articles, and corporate sustainability reports) that are available on the Bloomberg terminal for the industry’s publicly listed companies.

IWGs: SASB Industry Working Groups

%: The percentage of IWG participants that found the issue to be material. (-) denotes that the issue was added after the IWG was convened.

Priority: Average ranking of the issue in terms of importance. One denotes the most material issue. (N/A) denotes that the issue was added after the IWG was convened.

EI: Evidence of Interest, a subjective assessment based on quantitative and qualitative findings.

EFI: Evidence of Financial Impact, a subjective assessment based on quantitative and qualitative findings.

FLI: Forward Looking Impact, a subjective assessment on the presence of a material forward-looking impact.

IV Note to Integration of Environmental, Social & Governance Factors in Investment Management and Advisory – Considerations of “Active Ownership & Shareholder Engagement,” an issue initially proposed during the IWG phase of standards development, have since been incorporated into the issue of “Integration of Environmental, Social, & Governance Factors in Investment Management and Advisory”. Initial scores for Evidence of Interest on “Active Ownership & Shareholder Engagement” were as follows: HM: 50, IWG: 84%, Priority: 6.
### EVIDENCE OF FINANCIAL IMPACT

<table>
<thead>
<tr>
<th></th>
<th>Revenue</th>
<th>Operating Expenses</th>
<th>Non-operating Expenses</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Cost of Capital</th>
<th>Industry Divestment Risk</th>
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<td>Social Capital</td>
<td></td>
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<tr>
<td>Employee Incentives &amp; Risk Taking</td>
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<td>Employee Inclusion</td>
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<tr>
<td>Business Model &amp; Innovation</td>
<td>Integration of Environmental, Social, and Governance Risk Factors in Investment Management &amp; Advisory</td>
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<tr>
<td>Leadership &amp; Governance</td>
<td>Management of the Legal &amp; Regulatory Environment</td>
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</tbody>
</table>

#### APPENDIX IIB: Evidence of Financial Impact for Material Sustainability Issues

- **High Impact**
- **Medium Impact**
- **Low Impact**

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# APPENDIX III: Sustainability Accounting Metrics | Asset Management & Custody Activities

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
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</thead>
<tbody>
<tr>
<td>Employee Incentives &amp; Risk Taking</td>
<td>Discussion of variable compensation policies and practices</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0103-01</td>
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<tr>
<td></td>
<td>Percentage of total compensation that is variable for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0103-02</td>
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<tr>
<td></td>
<td>Percentage of variable compensation that is equity for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0103-03</td>
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<tr>
<td></td>
<td>Percentage of employee compensation which includes ex-post adjustments for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
<td>FN0103-04</td>
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<tr>
<td>Employee Inclusion</td>
<td>Percentage of gender and racial/ethnic group representation for: (1) executives and (2) all others</td>
<td>Quantitative</td>
<td>Percentage (%)</td>
<td>FN0103-05</td>
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<tr>
<td>Transparent Information &amp; Fair Advice for Customers</td>
<td>Amount of fines and settlements associated with failure to provide adequate, clear, and transparent information about products and services(^7)</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0103-06</td>
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<tr>
<td></td>
<td>Description of procedure or programs to provide adequate, clear, and transparent information about products and services, including risks, suitability, and conflicts of interest</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0103-07</td>
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<tr>
<td>Management of the Legal &amp; Regulatory Environment</td>
<td>Amount of legal and regulatory fines and settlements associated with financial fraud and percentage that resulted from whistleblowing actions(^6)</td>
<td>Quantitative</td>
<td>U.S. dollars ($), percentage (%)</td>
<td>FN0103-08</td>
</tr>
<tr>
<td></td>
<td>Number of inquiries, complaints, or issues received by legal and compliance office through an internal monitoring or reporting system, and percentage that were substantiated(^8)</td>
<td>Quantitative</td>
<td>Number (#), percentage (%)</td>
<td>FN0103-09</td>
</tr>
</tbody>
</table>

\(^7\) Note to FN0103-06 – Disclosure shall include a description of fines and settlements and corrective actions implemented in response to events.

\(^6\) Note to FN0103-08 – Disclosure shall include a description of fines and settlements and corrective actions implemented in response to events.

\(^8\) Note to FN0103-09 – Disclosure shall include a description of the nature of the inquiries, complaint, or issues, and of any corrective actions taken by the registrant in response to information received by its legal and compliance office through an internal monitoring and/or reporting system.

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## APPENDIX III: Sustainability Accounting Metrics | Asset Management & Custody Activities (Cont.)

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>ACCOUNTING METRIC</th>
<th>CATEGORY</th>
<th>UNIT OF MEASURE</th>
<th>CODE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Systemic Risk Management</strong></td>
<td>(1) Registered and (2) unregistered assets under management</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0103-10</td>
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<tr>
<td></td>
<td>Value of collateral received from securities lending and amount received from repurchase agreements involving clients’ assets</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0103-11</td>
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<tr>
<td></td>
<td>Net exposure to written credit derivatives</td>
<td>Quantitative</td>
<td>U.S. dollars ($)</td>
<td>FN0103-12</td>
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<tr>
<td></td>
<td>(1) Tier 1 common capital ratio</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0103-13</td>
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<tr>
<td></td>
<td>(2) Tier 1 capital ratio</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0103-13</td>
</tr>
<tr>
<td></td>
<td>(3) Total risk-based capital ratio</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0103-13</td>
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<tr>
<td></td>
<td>(4) Tier 1 leverage ratio</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
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<td></td>
<td>Basel III Liquidity Coverage Ratio (LCR)</td>
<td>Quantitative</td>
<td>Ratio in U.S. dollars ($)</td>
<td>FN0103-14</td>
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<tr>
<td><strong>Integration of Environmental, Social, and Governance Risk Factors in Investment Management &amp; Advisory</strong></td>
<td>Discussion of how environmental, social, and governance (ESG) factors are integrated into investment analysis and decisions and of how this integration intersects with fiduciary duties</td>
<td>Discussion and Analysis</td>
<td>n/a</td>
<td>FN0103-15</td>
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<td></td>
<td>Percentage of assets under management, by major asset class, that employ: (1) Integration of ESG factors (2) Sustainability themed investing (3) Screening (exclusionary, inclusionary, or benchmarked) (4) Impact or community investing</td>
<td>Quantitative</td>
<td>Percentage (%) in U.S. dollars</td>
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<td>Percentage of total proxies voted, and number of proxy votes supporting environmental, social, and/or governance (ESG) shareholder proposals, including percentage resulting in company action</td>
<td>Quantitative</td>
<td>Percentage (%), number (#)</td>
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<td>Ratio of embedded carbon dioxide emissions of proved hydrocarbon reserves held by investees to total assets under management</td>
<td>Quantitative</td>
<td>Tons CO₂ / U.S. dollars ($)</td>
<td>FN0103-18</td>
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</table>
APPENDIX IV: Analysis of 10-K Disclosures | Asset Management & Custody Activities

The following graph demonstrates an aggregate assessment of how the top ten U.S. domiciled companies, by revenue, in the asset management & custody activities industry are currently reporting on material sustainability issues in the Form 10-K.

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<tr>
<th>ASSET MANAGEMENT &amp; CUSTODY ACTIVITIES</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
<th>30%</th>
<th>40%</th>
<th>50%</th>
<th>60%</th>
<th>70%</th>
<th>80%</th>
<th>90%</th>
<th>100%</th>
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<td>Management of the Legal &amp; Regulatory Environment</td>
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<th>INDUSTRY-SPECIFIC</th>
<th>METRICS</th>
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</table>

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References


3. Ibid.


6. Ibid.


11. Ibid.


References (Cont.)


