BETTER MARKETS

August 16, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (File No. S7-17-22, RIN 3235-AM96); 87 Fed. Reg. 36,654 (June 17, 2022)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release")[2] which would require investment companies, investment advisers, and other entities to disclose to investors, and report to the SEC, additional information regarding their environmental, social, and governance ("ESG") investment strategies. The Proposal, if adopted, would implement a variety of important improvements to the current fragmented disclosure framework for ESG investment funds. The Proposal would establish a standardized ESG disclosure framework that would create more reliable, consistent, and comparable disclosures for ESG funds based on the extent to which a fund considers ESG factors in its investment selection and issuer engagement processes. Specifically, the Proposal identifies three types of ESG funds—Integration Funds, ESG-Focused Funds, and Impact Funds—and would require varying degrees of disclosures that correspond to the extent to which a fund utilizes ESG factors in its investment selection and issuer engagement processes.

The Proposal's layered approach to ESG disclosure will assist retail and institutional investors, funds, advisers, and regulators by providing them with more reliable, consistent, and comparable ESG disclosures. The disclosures provided will satisfy growing investor demand for

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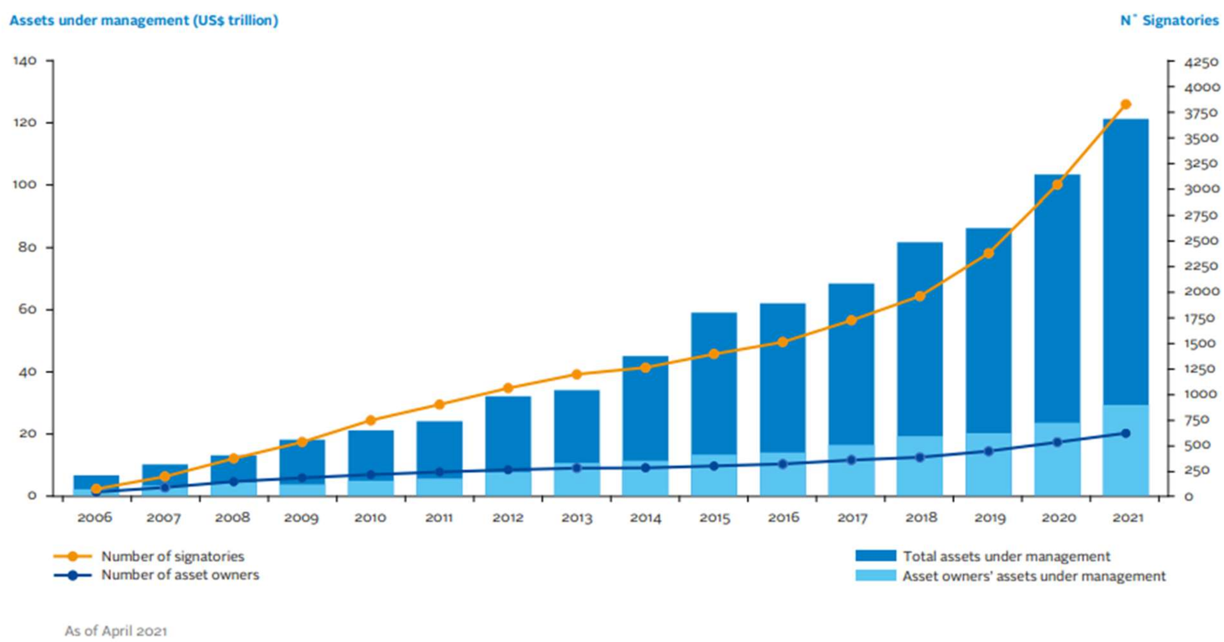
1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (June 17, 2022).

material information that can guide their investment decisions and at the same time protect them from misleading and abusive claims surrounding ESG investment strategies.

BACKGROUND

In 2006, leading asset managers from around the world, representing more than $2 trillion in assets under management, gathered at the New York Stock Exchange with the Secretary-General of the United Nations, Kofi Annan, to sign the Principles for Responsible Investment (PRI).[3] The PRI was a set of principles that, for the first time, recognized that environmental, social, and governance factors should play a more significant role in the investment strategies of capital allocators and asset managers. Ultimately, the PRI would help coin the phrase "ESG" and become a catalyst for what would be tremendous growth in ESG investing. Since the PRI was originally signed by a few dozen asset managers in 2006, there are now more than 3,400 signatories representing more than $121 trillion in assets under management as of March 31, 2021.[4]



[3] Press Release, Secretary-General Launches 'Principles for Responsible Investment' Backed by World's Largest Investors, U.N. Press Release SG/2111-ECO/106 (Apr. 27, 2006) (For its part, the United Nations Joint Staff Pension Fund, with nearly $30 billion in assets, would also sign the Principles).

[4] Annual Report 2021, Principles for Responsible Investment 7 (2021), https://dwtyzx6upklss.cloudfront.net/Uploads/s/u/b/pri_annualreport_2021_15698.pdf.

It has been more than fifteen years since the signing of the PRI, and despite its widespread adoption and the proliferation of other ESG-related protocols, there is still no standardized framework for informing investors how funds utilize ESG investing strategies. The absence of a standardized ESG framework has led to the development of several widely used yet disparate frameworks that focus on one or more ESG factors, including the Carbon Project; the Sustainability Accounting Standards Board, the Global Initiative, the Climate Disclosure Standards Boars, the International Reporting Council, and the Task Force on Climate-Financial Related Disclosures.[5]

The ESG factors are clearly material considerations that have a major influence on the investment decisions of an increasingly wide range of investors. Each of the three terms – environmental, social, and governance – can encompass a variety of important aspects and activities of a corporation or fund that investors increasingly want to know about before deciding whether or not to invest their money in that company or fund. For instance:

> **Environmental factors** may reflect how a company contributes to, or mitigates, degradation of the environment in specifical ways. The most prominent example is a company's approach to climate change caused by greenhouse gas emissions: How does the company contribute directly and indirectly to climate change, what risks does the company face from climate change, and how is the company addressing those risks and the climate change problem more generally? Environmental factors may also reflect a company's energy use, its handling of toxic waste and other pollutants, and its position on deforestation and other issues of natural resource conservation.

> **Social factors** may examine a wide range of issues about the social relations of or within the company. A significant aspect is how the company treats its employees and whether it provides them with fair compensation and benefits. These factors also reflect the composition of a company's workforce, including the racial and gender diversity of its workforce and corresponding inclusion policies. Additional social factors include concerns about whether the company's vendors and business partners reflect its own stated values and where the company stands on human rights issues.

> **Governance factors** may deal with how well a company is managed by its leadership and the sufficiency of controls in place to ensure management serves the interests of, and is accountable to, various company stakeholders. Important governance factors could include executive compensation policies that produces the right incentives for management, adequate board oversight, and robust auditing and other controls. Governance factors may also evaluate the company's treatment of its shareholders and whether it provides them with the full and fair right to participate in corporate governance by voting through the proxy process.

[5] Release at 36,703.

The components of ESG factors listed above are certainly not exhaustive nor are they intended to be a complete account of the factors a fund may consider or establish as a focus of its investing strategy.

Investment managers and investors continue to manage and invest more and more assets into funds that focus on the ESG factors. For example, according to financial services firm Morningstar, assets in funds that claim to focus on ESG factors or sustainability reached $2.78 trillion in the first quarter of 2022, compared to the less than $1 trillion invested in those same funds in 2020.[6] An analysis of more than 1,000 research papers published between 2015-2020 on the financial performance of ESG investment strategies conducted by the NYU Stern Center for Sustainable Business and Rockefeller Asset Management found an overall positive correlation between funds focused on ESG investment strategies and financial performance.[7] The report found that 59% of studies "showed similar or better performance relative to conventional investment approaches while only 14% found negative results.[8] The rate of investor assets flowing into these types of funds reflects the appetite of investors not only for reliable long-range financial returns but also for investment options that align with an investor's core values and beliefs. There is ample evidence that investors are increasingly taking into account ESG factors when making investment decisions. As highlighted below, a recent survey of investors found that 60 percent of all adults considered ESG ratings important when it came to investment decisions.[9]

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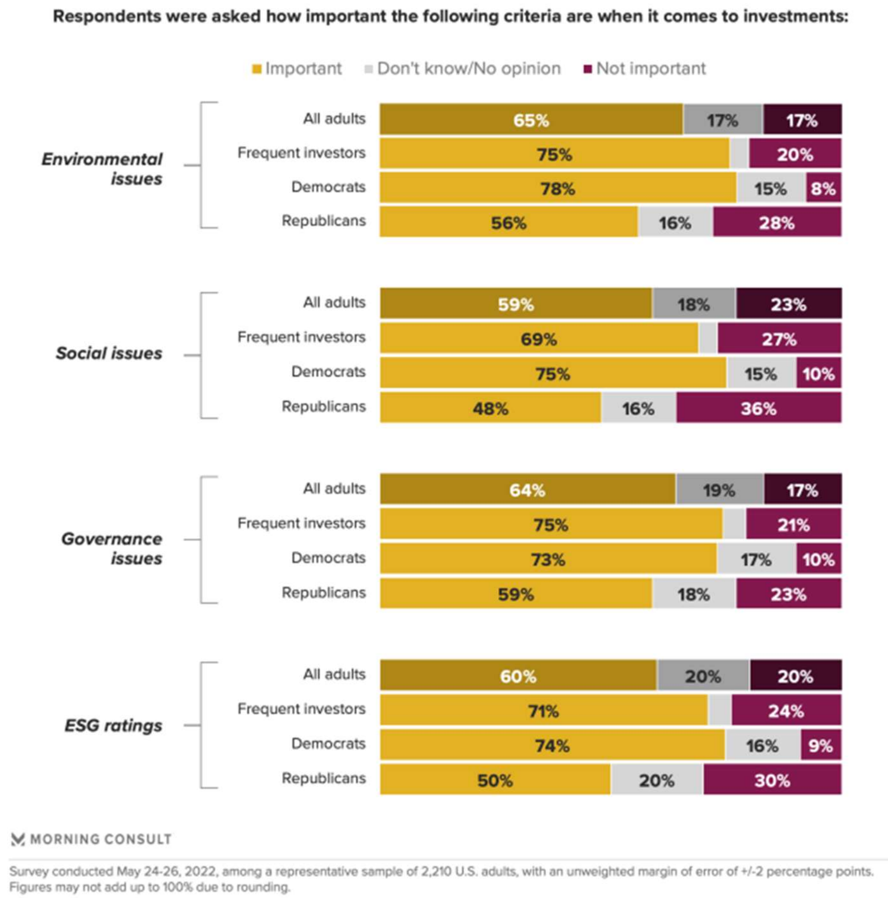
6 Dave Michaels, *SEC Is Investigating Goldman Sachs Over ESG Funds*, WALL ST. J. (June 10, 2022).

7 *See* Tensie Whelan, Ulrich Atz, Tracy Van Holt, and Casey Clark, *ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020,* NYU Stern Center for Sustainable Business and Rockefeller Asset Management (Feb. 2021), https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance.

8 *Id.* at 2.

9 Amanda Jacobson Snyder, *As SEC Closes In on ESG Rules for Funds, the Bulk of Frequent Investors Say They Value Such Standards*, MORNING CONSULT (July 12, 2022).



Likewise, a survey of asset managers found nearly universal agreement that "ESG is a critical part of their investment policy and day-to-day thinking."[10] Despite politically charged accusations and talking points by prominent politicians, ESG investing cuts across political ideologies, confirming the importance of ESG to a broad spectrum of both investors and asset managers in today's investing climate.[11]

While investors are increasingly pouring money into ESG funds, there is a strong consensus forming among these same investors that they need access to more reliable, consistent, and comparable disclosures regarding the role that the ESG factors play in fund investment strategies. A clear and comparable understanding of that role equips investors to make optimal

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10 Leslie Norton, *Pension Funds Forge Ahead With Sustainable Investing, Despite Politicization U.S.*, MORNINGSTAR (June 30, 2022), https://www.morningstar.com/articles/1100901/pension-funds-forge-ahead-with-sustainable-investing-despite-politicization-in-us.

11 *See e.g.*, Mike Pence, Op-ed, *Republicans Can Stop ESG Political Bias*, WALL ST. J., May 26, 2022 (In an op-ed, former Vice President Mike Pence decried ESG as a pernicious strategy to empower "an unelected cabal of bureaucrats, regulators and activist investors to rate companies based on their adherence to left-wing values" and compared ESG scores to social credit scores issued by the Chinese Communist Party).

financial judgments and to assess the veracity of the claims made by ESG funds using measurable data.

As ESG evolved and different funds began to focus on subtopics within the ESG apparatus, such as climate change, board diversity, etc., several different frameworks for disclosure have emerged for ESG funds. Some of the more popular frameworks used today include the United Nations PRI, the Carbon Project, the Sustainability Accounting Standards Board, the Global Initiative, the Climate Disclosure Standards Boars, the International Reporting Council, and the Task Force on Climate-Financial Related Disclosures.[12] While these varying disclosure frameworks are currently providing at least some standardization across the ESG industry, it is clear that investors want more. In another survey of investors by the Ernst Young Global Institutional Investor Survey, 89 percent of investors said they would like a mandatory set of globally consistent standards for the reporting of ESG performance.[13] There are numerous polls, surveys, and other data points that demonstrate investor demand for more reliable, consistent, and comparable disclosures regarding ESG investments.

These widespread and emphatic calls for more standardization regarding ESG disclosures and the challenges associated with the current hodgepodge of various voluntary frameworks has also been echoed by those within the SEC ecosystem. Specifically, a subcommittee of the SEC's Investor Advisory Committee and the SEC's Division of Examinations have both issued releases within the past few years highlighting the lack of standardization in ESG disclosures. In 2020, the SEC's Investor-as-Owner Subcommittee of the Investor Advisory Committee Relating to ESG Disclosure issued a recommendation to the Commission on the need to update reporting requirements to include decision-useful ESG disclosures.[14] Their recommendation further stated that "despite a great deal of information being in the mix, there is a lack of consistent, comparable, and material information in the marketplace and everyone is frustrated – Issuers, investors, and regulators."[15] This frustration is evident from a Risk Alert issued in April 2021 by the SEC's Division of Examinations. In that Risk Alert, the Division of Examinations found that the "rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks."[16]

The Risk Alert went on to discuss several specific "observations of deficiencies and internal control weaknesses" identified during the examinations of investment advisers and funds in regards to ESG investing.[17] These risks included unsubstantiated or misleading claims of ESG approaches, proxy voting inconsistent with ESG strategy, inadequate internal controls, weak or

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12 Release at 36,703.

13 Katie Kummer and Kyle Lawless, EY, Five Priorities to build trust in ESG (Jul 14, 2022), https://www.ey.com/en_gl/public-policy/five-priorities-to-build-trust-in-esg.

14 *See* SEC, Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (May 14, 2020).

15 *Id.* at 5.

16 SEC, Division of Examinations, The Division of Examinations' Review of ESG Investing 2 (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

17 *Id.*

unclear documentation, and more.[18] Clearly, despite the helpfulness of the various voluntary frameworks that have evolved within the ESG ecosystem, investors and regulators have well-documented frustrations with the current ESG disclosure regime.

For its part, the Commission announced the creation of the Climate and ESG Task Force within the Division of Enforcement to focus on inadequate disclosures and material misstatements in ESG-related disclosures.[19] As a result of the creation of this task force, the Commission has brought several enforcement actions against issuers and funds for misconduct in climate and ESG-related disclosures, including a case against financial giant BNY Mellon.[20] In that case, the Commission fined BNY Mellon $1.5 million for repeatedly making misleading statements regarding the screening of their investments for ESG quality review.[21] The Commission found that BNY Mellon repeatedly told investors that "each security being considered for investment by our global industry analysts must have an ESG quality review conducted by a member of [the Responsible Investment Team]."[22] Despite these statements, the Commission found that 67 of the 186 investments by BNY Mellon did not have an ESG-quality review screen prior to the decision to invest in the security, equaling roughly 25% of the assets of the fund. The Commission found BNY Mellon violated Section 206(2) and 206(4) of the Investment Advisers Act, in addition to Section 34(b) of the Investment Company Act.[23] As has become too customary with SEC enforcement actions, BNY Mellon was not required to admit or deny the findings by the Commission.[24] In addition to the BNY Mellon case, there are several reports of additional ESG-related enforcement actions being considered by the Commission.[25]

<u>OVERVIEW OF THE PROPOSAL</u>

The Commission has proposed amendments to rules and forms to require registered investment advisers, certain exempt advisers, registered investment companies, and business development companies to disclose information in their registration statements, annual reports, and adviser brochures regarding their ESG investment practices. Investment advisers and companies would need to disclose varying ESG information to investors based on the level of consideration given to ESG factors within the fund's strategy – a layered approach. The Proposal identifies three types of ESG funds: Integration Funds, ESG-Focused Funds, and Impact Funds. Open-end funds would be required to make disclosures via Form N-1A, while closed-end funds would be required to make disclosures via Form N-2.

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18 *Id.* at 2 – 7.
19 Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021).
20 *See* BNY Mellon Investment Adviser, Inc., No. 3-20867 (Securities and Exchange Commission May 23, 2022).
21 *Id.* at 7.
22 *Id.* at 5.
23 *Id.* at 6.
24 *Id.* at 1.
25 *See, e.g.,* Patricia Kowsmann, Corinne Ramey, and David Michaels, *U.S. Authorities Probing Deutsche Bank's DWS Over Sustainability Claims*, WALL ST. J. (Aug. 25, 2021); Dave Michaels, *SEC Is Investigating Goldman Sachs Over ESG Funds*, WALL ST. J. (June 10, 2022).

<u>ESG Investment Selection Process Disclosure</u>

<u>Integration Funds</u>

- An Integration Fund is a fund that incorporates one or more ESG factors into its investment strategy alongside non-ESG factors. The consideration of one or more ESG factors is generally not more significant than the consideration of non-ESG factors.

- An Integration Fund would be required to disclose to investors any ESG factors the fund considers and how the fund incorporates those ESG factors into its investment strategy. Specifically, open-end funds would be required to disclose this information in the summary section of the fund's prospectus, while closed-end funds would be required to disclose this information in the prospectus's general description of the fund. Additionally, in the case the Integration Fund incorporates GHG emissions as an ESG factor into its investment selection process, the fund would need to disclose how the fund incorporates that factor and the methodology used for its consideration.

<u>ESG-Focused Funds</u>

- An ESG-Focused Fund is a fund that utilizes one or more ESG factors in a manner that is significant or serves as the main consideration in its investment strategy or engagement strategy with issuers, including:

  - funds whose name includes terms to indicate an ESG focus;
  - funds whose advertisements or sales literature indicates that ESG factors are a significant component of their investment strategy;
  - funds that track an ESG-focused index;
  - funds that apply inclusionary or exclusionary screens based on ESG factors;
  - funds that include a policy to vote their proxies or engage with management in a manner to encourage ESG outcomes.

  An ESG-Focused Fund would be required to provide detailed disclosures to investors regarding its ESG investment strategy and include a new standardized ESG Strategy Overview Table in its disclosures. Specifically, an open-end fund would be required to include the ESG Strategy Overview Table in its risk/return summary of its prospectus, while a closed-end fund would be required to disclose its ESG Strategy Overview Table at beginning of the discussion of the fund's organization and operation.

Impact Funds

- An Impact Fund is an ESG-Focused Fund that seeks to make a specific impact or impacts on one or more components within ESG.

- An Impact Fund would be required to provide similar detailed disclosures as ESG-Focused Funds, in addition to how the fund measures its progress on its stated impact, the time period used to measure the progress, and the relationship between the stated impacts the fund is seeking to achieve and the financial returns of the fund. Specifically, these disclosures would be included in the ESG Strategy Overview Table and in more detail in the fund's prospectus. Additionally, an Impact Fund would be required to disclose in its investment objectives the ESG impact the fund seeks to generate with its investments.

- An Impact Fund would be required to disclose in its annual report on Form 10-K the fund's qualitative and quantitative progress on achieving its stated ESG impact during the reporting period.

Proxy Voting/Engagement Strategies

A fund that indicates in its ESG Strategy Overview Table that it uses proxy voting or engagement with issuers as a way to implement its ESG strategy would be required to disclose to investors the methods used by the fund to influence issuers. Additionally, funds that indicate they use proxy voting or engagement strategies would be required to disclose how the fund voted proxies relating to ESG issues and information about its engagement practices. Under the Proposal, if an ESG-Focused Fund does not indicate that it uses proxy voting or engagement with issuers as part of its investment strategy, it must disclose that to investors in the ESG Strategy Overview Table. Likewise, funds that invest in only non-voting securities should disclose this fact in its ESG Strategy Overview Table.

GHG Emissions Disclosures

ESG-Focused Funds that considers any environmental factors in its investment selection process on Form N-CEN will be required to disclose the carbon footprint and weighted average carbon intensity of the entire fund's portfolio, unless they indicate in their ESG Strategy Overview Table that they do not consider GHG emissions.

Form ADV

The Proposal requires registered investment advisers to disclose their ESG practices in Form ADV Part 2A. Specifically, advisers are required to include specificity regarding their ESG investing approaches, including the use of inclusionary or exclusionary screens, focus on ESG impacts, and engagement with issuers.

<u>Disclosure to SEC</u>

The Proposal would require funds and advisers to report similar information that is disclosed to investors to the SEC via Form N-Cen and ADV Part 1A.

<u>Inline XBRL Reporting</u>

Finally, the Proposal would require funds to use Inline eXtensible Business Reporting Language data tagging to provide investors with machine-readable data for their ESG disclosures.

<u>COMMENTS</u>

I. <u>The Proposal will provide investors with reliable, consistent, and comparable disclosures regarding a fund's ESG investment strategy that are desperately needed.</u>

The primary goal of the Proposal is to provide investors with reliable, consistent, and comparable disclosures regarding a fund's and an adviser's ESG investment strategy. As stated above and in the Proposal itself, there is a robust amount of evidence of the compelling need for reliable, consistent, and comparable ESG disclosure requirements. Not only have investors demonstrated a clear need for these enhanced disclosures, funds and advisers themselves will be best served by a better-defined set of rules and regulations to ensure they do not run afoul of existing securities laws and regulations. Investors will have more reliable, consistent, and comparable disclosures regarding a fund's ESG investment strategy if the Proposal is finalized.

The Proposal's enhanced ESG disclosure framework for ESG funds and advisers is consistent with the Commission's longstanding disclosure regime. Broadly speaking, the Commission's disclosure regime is critical to the integrity and trust that upholds the U.S. capital markets. As one commentator has pointed out, "[i]nvestor trust is therefore critical for the securities markets to work, and disclosure helps to facilitate that trust. Ultimately, disclosure decreases investor risks and protects the public interest."[26] In other words, a robust disclosure regime is essential to the proper functioning of the securities markets; investors must know that the law requires meaningful and accurate disclosures and that failure to provide them will result in meaningful enforcement actions to punish and deter wrongdoers. As President Franklin Roosevelt said in a message to Congress when passing the Securities Act of 1933, a disclosure regime for securities "adds to the ancient rule of caveat emptor, the further doctrine, 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest

[26] Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward A More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 155 (2006).

dealing in securities and thereby bring back public confidence."[27] The Proposal's enhanced ESG disclosure framework for ESG funds and advisers is wholly consistent with the Commission's longstanding mandatory disclosure regime that President Roosevelt so eloquently envisioned with the initial passage of our nation's securities laws.

Regardless of anyone's personal views on the merits of ESG investing strategies, it is irrefutable that it has become a popular investment strategy, with total U.S. domiciled assets that incorporate ESG investment strategies growing from $639 billion in assets under management in 1995 to $17.1 trillion in 2020.[28] Based on the sheer size of the industry and the lack of a standardized disclosure framework, the Commission is rightfully concerned about the effectiveness of current disclosures by advisers and funds to clients and investors related to ESG investment strategies. As cited above and throughout the Proposal, the lack of a standardized ESG disclosure framework has been a constant source of frustration among issuers, investors, and regulators. Reliable, consistent, and comparable disclosures will better enable investors to allocate capital in a manner that conforms with their own judgments about optimizing financial returns. In addition, as the flow of assets into ESG funds over the past two decades has demonstrated, investors are increasingly using ESG factors in their investment calculations to better align their investment strategies with their own core values. Accordingly, investors are seeking and ultimately need access to reliable information about the degree to which funds are incorporating ESG considerations into their investment strategies. These disclosures are crucial to enabling investors to better tailor their investment decisions and allocate their capital in ways they think are most effective in advancing their financial goals as well as their core values.

More reliable, consistent, and comparable ESG disclosures will also increase competition among funds performing similar functions and level the playing field between funds that are providing full and fair disclosures on ESG factors to investors versus funds that are taking advantage of the lack of a standardized ESG disclosure framework. The Risk Alert issued by the Commission's Division of Examinations on April 9, 2021 clearly demonstrated that while staff observed "compliance deficiencies and weakness relating to ESG investing" during examinations, they also observed some advisers and funds that had "accurately conveyed material aspects of the firms' approaches to ESG investing."[29] The current lack of standardization in the ESG disclosure framework enables advisers and funds to use more discretion in their disclosures to investors, which examiners have found, in some cases, to be "unsubstantiated or otherwise potentially misleading."[30] As the Proposal correctly explains, "such exaggerations can impede informed decision-making," causing some investors to believe they are investing in a sustainable product,

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27 S. Rep. No. 73-47, at 6-7 (1933) & H.R. Rep. No. 73-85, at 1-2 (1933).

28 Release at 36,655 n.2.

29 SEC, Division of Examinations, The Division of Examinations' Review of ESG Investing 5 (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

30 *Id.* at 4.

when in fact, they are paying higher fees for an ESG product that is substantially similar to a non-ESG product.[31]

The Proposal's enhanced ESG disclosure framework is a logical extension of our nation's fundamental approach to securities regulation and the Commission's well-established disclosure regime. There is a clear and demonstrable need for a standardized ESG disclosure framework, as evidenced by the frustration that investors, issuers, and regulators experience when dealing with the current fragmented ESG disclosure framework. That framework is unwieldy and ill-suited to comparison and analysis. Moreover, it leaves far too much disclosure discretion to funds and advisers to potentially exaggerate or even falsify their fund's ESG claims to investors. The Proposal will result in an ESG disclosure framework that is more reliable, consistent, and comparable, one that will advance the Commission's mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

II. **The Proposal adopts an appropriately layered approach to ESG disclosures, based on the extent to which funds consider ESG factors.**

The Proposal takes the right approach by layering ESG disclosure requirements that are properly tailored to correspond with the level to which funds are incorporating ESG factors into their investment strategies. In contrast, a one-size-fits-all approach could enable a fund to, inadvertently or subtly, overemphasize or underemphasize the role ESG factors play in their investment strategies. For purposes of the disclosures at issue in this Proposal, it is appropriate to adopt a layered approach to ESG disclosures for funds and fund advisers.

Integration Funds

To start, the Proposal defines an Integration Fund as a fund that "considers one or more ESG factors along with other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process."[32] Funds that meet this definition would be required to include in their prospectuses to clients and investors a summary of how stated ESG factors are incorporated into the investment selection process.[33] For the reasons cited in the Proposal, we believe a summary of non-determinative ESG factors that the fund takes into account will adequately and efficiently provide clients and investors with the information necessary to understand how the fund incorporates ESG factors into its investment selection process.

In addition, this level of specificity and detail will help avoid potential misperceptions or distortions arising from the ESG disclosures relating to Integration Funds. As the Proposal finds, requiring "a more detailed discussion of ESG factors could cause an Integration Fund to overemphasize the role that ESG factors play in the fund's investment selection process by adding

[31] Release at 36,658.
[32] Release at 36,660.
[33] Release at 36,660.

ESG disclosure requirements that could result in a more detailed description of ESG factors than other factors."[34] Therefore, it is logical that if a fund were required to provide more detailed information about non-determinative ESG factors, investors could be misled into believing the supposedly non-determinative ESG factors were in fact more determinative than other factors the fund takes into account in the investment selection process, when in fact, by definition, the factors are meant to be in parity. Whether factors are ESG or non-ESG, the treatment of them should be similar in the case of Integration Funds as to not overemphasize a certain factor over another as it pertains to the investment selection process.

The Proposal would require "more detailed information" to be disclosed to investors if the Integration Fund considers greenhouse gas (GHG) emissions, in particular.[35] On the one hand, this requirement would respond to the generally high level of investor desire for climate-related information, and specifically GHG emissions, and it would also help investors make more discerning judgments about which funds they would prefer as investment vehicles. However, by requiring a more detailed description of a specific ESG factor for an Integration Fund, as the Proposal seeks to do with GHG emissions, it could impede informed investment decisions due to the overemphasis on GHG emissions that do not actually play a central role in the fund's strategy. The Proposal seeks to differentiate GHG emissions from other ESG factors as the subjects of more specific disclosures because it "will assist investors in better understanding how the fund integrates GHG emissions in its investment selection process and compare that process to that of other Integration Funds."[36] But the same reasoning could apply to any other ESG factor a fund decides to focus on in its investment selection process. This more detailed disclosure requirement could not only lead to funds' overemphasizing their reliance on GHG emissions as a factor in their investment selection process but also open the door to arguments for treating various factors within the ESG framework differently. By treating GHG emissions differently from other factors within ESG, is the Commission implicitly placing more importance or weight on one ESG factor over others? For example, are disclosures of GHG emissions for funds that consider GHG emissions among the environmental factors more important to investors than enhanced disclosures about racial and gender board diversity for funds that consider racial and gender diversity?

On balance, and in light of all these considerations, we believe the ESG factors should be treated on a level playing field to avoid the appearance of favoring disclosure of one factor over another. To achieve this form of parity in the Proposal's disclosure requirements, the Commission should increase the disclosure obligations for Integration Funds that consider other specific components within the ESG factors. Thus, for example, if a fund considers racial diversity and in particular board diversity, then the final rule should require greater disclosure about that factor, to a degree commensurate with the proposed enhanced disclosure requirement for GHG emissions.

ESG-Focused Funds

[34] Release at 36,660.

[35] Release at 36,661. Specifically, the Proposal would require Integration Funds that consider GHG emissions as a non-determinative factor in its investment selection process to disclose the particular methodology used when analyzing investments utilizing the GHG emissions factor.

[36] Release at 36,661.

The Proposal defines an ESG-Focused Fund as a fund that "focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments or (2) in its engagement strategy with the companies in which it invests."[37] These funds would be required to provide more specific disclosure on the use of the one or more ESG factors the fund considers in their investment selection process, including funds that track an ESG-focused index or those that apply ESG investment screens to include or exclude investments as a result of those screens.[38]

Because the ESG-Focused Funds are the funds that market themselves as funds for investors that seek greater ESG emphasis, it is reasonable to apply more detailed disclosure requirements to these funds. The proposed ESG Strategy Overview Table[39] will help to ensure investors receive reliable, consistent, and comparable disclosures regarding how ESG factors are used in the investment selection process. The ESG Strategy Overview Table will provide investors more clarity regarding the use of ESG factors in the investment selection process prior to the decision to invest, and it will enable existing clients to ensure that funds and advisers' marketing of the fund matches the actual investment selection process as stated by the fund. This will also undoubtedly assist regulators in exercising oversight of these ESG-Focused Funds to ensure an honest, competitive, and level playing field among market participants that offer these types of funds.

<u>Impact Funds</u>

Finally, the Proposal further defines an ESG-Focused Fund that "seeks to achieve a specific ESG impact or impacts" as an Impact Fund.[40] Impact Funds would be required to make similar disclosures as ESG-Focused Funds, with some additional elements. Specifically, Impact Funds would need to disclose how the fund measures progress on the impact it seeks to make, the period of time used to measure that progress, and the effect of the stated impacts on the fund's returns.[41] In keeping with a layered approach to ESG disclosures, the Proposal requires more disclosures and more specificity in those disclosures the more the fund incorporates or focuses on ESG factors. The Proposal asks "Should we, as proposed, require an Impact Fund to disclose the relationship between the impact the Fund is seeking to achieve and financial return(s)?"[42] The answer to this question must be in the affirmative. By requiring the disclosure of the relationship between the stated impact the fund is seeking versus the fund's returns, the Proposal will better enable investors to evaluate investment in the fund according to their priorities, financial or otherwise.

III. <u>The Proposal must retain the required disclosure of proxy vote and engagement strategies employed by ESG-Focused and Impact Funds.</u>

37 Release at 36,662.
38 Release at 36,662.
39 Release at 36,663.
40 Release at 36,662.
41 Release at 36,663.
42 Release at 36,669.

One of the bedrocks of U.S. capitalism is joint stock ownership of publicly traded companies. When individuals invest their money in a publicly traded company, they are not only entitled to any financial returns from their ownership of that stock but also entitled to participate in the governance of the company by voting in proportion to the number of shares they own. Voting on corporate governance matters, typically via proxy voting, is an essential component of our capital markets. The pooled investor voting power represented in funds is a powerful tool for influencing corporate policy and often effectuating change within publicly traded companies. For example, for decades hedge funds and activist investors have built minority but still influential ownership stakes in publicly traded companies to effectuate changes in how the underlying company operates or is managed. In that same vein, ESG funds and advisors to those funds have successfully utilized proxy voting and other engagement strategies to make their desired impact on a publicly traded company.

However, as is noted in a Risk Alert issued by the Division of Examinations, Commission staff have also observed "inconsistencies between public ESG-related proxy voting claims and internal proxy voting policies and practices."[43] For those reasons, it is essential that the Proposal retain its required disclosure by ESG funds and advisors on the use of proxy voting and other engagement strategies used to seek the stated goal of the fund.

There have already been several examples of the power of proxy voting when used within the ESG context. Partly in response to a survey of 475 institutional investors which found that 68 percent of respondents implemented ESG criteria into their investment strategies to improve returns, State Street Global Advisors used its enormous proxy voting power to advance corporate board diversity, specifically gender diversity.[44] In 2017, State Street Global Advisors used their proxy voting power to vote against the re-election of board members at 400 companies due to a failure by those companies to appoint any women to their all-male boards.[45] This is a concrete example of the power of proxy voting as a means to effectuate an impact on an ESG factor, specifically gender board diversity. This is also an example of a particular strategy that some ESG funds can and have deployed in the past, and it is a strategy that investors should understand via the disclosure process prior to making an investment decision.

IV. The economic analysis in the Proposal amply satisfies the SEC's statutory duty.

Industry opponents of new SEC rules frequently claim that they fail a cost-benefit test, and specifically that they will prove too costly. The Proposal will inevitably be subject to these attacks. As a general matter, however, these arguments are unfounded, both legally and factually. They distort the Commission's legal obligation to conduct economic analysis; they exaggerate the alleged costs and burdens of compliance with the new rules; and they downplay if not ignore the

43 SEC, Division of Examinations, The Division of Examinations' Review of ESG Investing 4 (Apr. 9, 2021), https://www.sec.gov/files/esg-risk-alert.pdf.

44 Betsy Atkins, *Demystifying ESG: Its History & Current Status*, FORBES (June 8, 2020), https://www.forbes.com/sites/betsyatkins/2020/06/08/demystifying-esgits-history--current-status/?sh=d0137742cdd3.

45 *Id.*

enormous benefits that the rules will confer, both individually and as part of a collection of rules that will work together to achieve market reforms. But this strategy should not sway the Commission or persuade it to dilute the much-needed reforms in the Proposal. Throughout the rulemaking process, the Commission must be guided above all by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

As we have explained repeatedly,[46] under the securities laws, the Commission has no statutory duty to conduct cost-benefit analysis. In reality, it's far more limited obligation is simply to consider, "***in addition to the protection of investors***, whether the action will promote efficiency, competition, and capital formation."[47] The Supreme Court has long recognized that statutorily mandated ***considerations*** "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty."[48] The SEC has easily satisfied its statutory duty in the Proposal.[49] Ultimately, the SEC reasonably determined that the Proposal would promote efficiency, competition, and capital formation. Thus, the SEC has fully discharged its statutory duty with regard to economic analysis.

The Release contains many examples confirming the SEC has performed the requisite "ECCF" analysis:

- As to the standardization of disclosures, the Release explains: "When funds or advisers use inconsistent methods in reporting disclosures, the resulting lack of standardization can be costly for investors and clients, who may be unable to accurately compare across funds or advisers as a result. While agency problems, as noted above, can exacerbate these inconsistencies, such irregular reporting can arise any time there are multiple reasonable, but distinct and not easily comparable, approaches in presenting information chosen by different sets of funds or advisers—as appears to be the case in the current environment for ESG-related disclosures. Standardization limits such inconsistencies, allowing investors to identify funds and clients that are closely aligned with their investment objectives and therefore facilitating more efficient capital allocation. ***Standardization that***

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46 For example, in 2012, we issued a report examining and exposing the largely successful attempt to foist more stringent cost-benefit analysis requirements upon the SEC, even though the securities laws include no such mandate. *See, e.g.,* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (July 30, 2012), https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf. In addition, we have updated the report; BETTER MARKETS, COST-BENEFIT ANALYSIS IN CONSUMER AND INVESTOR PROTECTION REGULATION: AN OVERVIEW AND UPDATE (Dec. 8, 2020), https://bettermarkets.com/sites/default/files/Better_Markets_WhitePaper_CBA_Consumer_Investor_Investor_Protection_Dec-2020.pdf . We incorporate those two reports by reference as if fully set forth herein.

47 *See* Release at 36,697-98; *see also, e.g.,* 15 U.S.C. § 77b(b); 78 U.S.C. § 78c(f) (emphasis added); 15 U.S.C. § 80a-2(c); 15 U.S.C. § 80b-2(c).

48 *Sec'y of Agric. v. Cent. Roig Ref. Co.,* 338 U.S. 604, 611 (1950).

49 *See* Release at 36,706-19.

enhances transparency and comparability of such disclosures is also likely to promote competition among investment advisers and funds.” [50]

- As to disclosures that reveal how a fund tracking an index uses ESG factors, the Release explains: “If an ESG-Focused Fund tracks an index, its prospectus would describe the index and how the index utilizes ESG factors in determining its constituents. The proposed disclosures about the index that the fund tracks would likely benefit investors by providing insights into how the fund allocates capital and by providing an ESG-specific benchmark against which similar funds can be compared. These disclosures could ***increase competition among ESG-Focused Funds that track an ESG-related index, facilitate efficient capital allocation, and further promote capital formation***.”[51]

- As to disclosures regarding a funds strategy for engaging with issuers, the Release explains: “The proposed rules also require an ESG-Focused Fund that engages with issuers to provide qualitatively an overview of how it engages or expects to engage with its portfolio companies on ESG issues, including through the fund’s voting of proxies and meetings with management. Shareholder engagement strategies have gained traction lately and many investors now view shareholder engagements as a crucial element in ESG investing. Specific information about funds’ voting policies and voting records would likely assist investors in selecting funds and advisers, and enable an investor to effectively monitor funds and advisers in connection with whether they exercise voting rights in a manner aligned with the investor’s objectives. This could ***increase competition among ESG-Focused Funds and further facilitate capital formation in ESG Focused Funds that engage with issuers***.”[52] It adds that “increased transparency about engagement activities and proxy voting would ***enhance efficiency, promote competition and facilitate capital formation by equipping investors with necessary information to select funds that effectively engage with the issuers***.” [53]

- As to disclosures regarding how funds achieve their objectives, the Release explains: “The proposed fund report disclosure requirements would allow investors to monitor the fund’s progress toward stated ESG-related objectives over time easily as well as across competing funds by enhancing transparency and comparability. In this regard, the proposed amendments would ***promote competition among ESG-Focused Funds***. In addition, the proposed disclosures would provide investors information to more ***efficiently identify*** funds better aligned with their ESG related preferences (e.g., funds pursuing the same ESG impacts), which would ***facilitate capital to be allocated in accordance with***

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[50] Release at 36,707.
[51] Release at 36,709.
[52] Release at 36,709.
[53] Release at 36,709; 36,711.

investors' ESG-related preference, thus, enhance the efficiency in capital allocation. Furthermore, the increased transparency about how funds achieve their stated ESG-related objectives would ***bolster capital formation by improving investor confidence in this space, and promote competition among ESG-Focused Funds.***" [54]

- As to disclosures regarding funds' use of ESG providers, the Release explains: "The information collected on use of ESG providers would benefit investors, other market participants, and the Commission in helping to better compare and analyze how ESG strategies differ across ESG providers. For instance, the proposed amendments to Form N–CEN would allow investors to more easily compare ESG providers and assess the effectiveness of strategies employed by funds using such providers. As a result, investors would be able to better select funds based on providers used, which could lead to ***increased competition among ESG providers***. Moreover, such increased competition among ESG providers could encourage the development of new methodologies in ESG ratings and in indexes tracking ESG factors, which could stimulate more innovation in this area. ***Enhanced transparency and comparability among ESG providers and indexes would improve investors' confidence in these instruments, thus facilitate capital formation***."[55]

- As to disclosures in Form ADV Part 1A: We also believe that the additional information would benefit current and prospective clients of SMAs and investors in private funds. In particular, SMA clients and investors in private funds would benefit from the proposed amendments to Form ADV Part 1A because they would be able to ***more efficiently select an adviser who meets their needs based on the additional information reported. This enhanced efficiency could in turn promote competition among advisers providing ESG-related services***."[56]

The SEC has also voluntarily undertaken its customary assessment of the potential costs and benefits of the Proposal, addressing "the likely economic effects of the proposed amendments, including the anticipated and estimated benefits [and] costs."[57] Indeed, that discussion illustrates the insurmountable challenges involved in cost-benefit analysis, particularly when analyzing rules such as the Proposal. The Proposal explains that "Many of the benefits and costs discussed below are difficult to quantify," adding that "in some cases, data needed to quantify these economic effects are not currently available and the Commission does not have information or data that would allow such quantification."[58] Therefore, the Proposal states, "much of the discussion of the

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[54] Release at 36,711.
[55] Release at 36,718.
[56] Release at 36,719.
[57] Release at 36,698.
[58] Release at 36,698.

economic effects is qualitative in nature."[59] All of that should come as no surprise. The Proposal will clearly provide real benefits to the broad spectrum of investors who seek more reliable, consistent, and comparable information about how funds and advisers weigh the ESG factors in their investment decisions. But it is difficult to even attempt to begin placing a precise dollar amount on that benefit. How do you quantify the monetary, let alone non-monetary benefits, to investors of enhancing the quality and quantity of information available to them as they navigate a complex financial market?

These are appropriate observations about the inevitable difficulties surrounding attempts at quantitative cost-benefit analysis; they are not failings of the Commission that suggest any legal infirmities in the Proposal itself. As the D.C. Circuit has explained, in *Nat'l Ass'n of Mfrs. v. SEC*,[60] "An agency is not required to measure the immeasurable, and need not conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so"—a burden that Congress never saw fit to impose on the Commission. Indeed, Better Markets has consistently argued that quantitative cost-benefit analysis is, for a host of reasons, a poor methodology for evaluating financial regulation: it is unreliable, speculative, and biased in favor of industry's relentless concerns with minimizing compliance costs while maximizing profits. Moreover, it consumes far more in agency resources than it is worth and ultimately sets the stage for a court challenge instigated by the disgruntled members of industry.[61]

The plain fact is that the Commission has no statutory duty to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit before promulgating it. The rationale for Congress's decision to impose only a flexible obligation to consider three discrete economic factors is clear: requiring the Commission to conduct a resource-intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives. The industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") does not change the securities laws, the reasoned basis for those laws, or the underlying policy. The Commission was established for the purpose of implementing the securities laws, and its primary duty is to achieve the legislative objectives of those laws: protecting investors and the public interest.[62]

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59 Release at 36,698.

60 748 F. 3d 359 (D.C. Cir. 2014).

61 *See, e.g.,* Better Markets, Cost-Benefit Analysis in Consumer and Investor Protection Regulation: An Overview and Update (Dec. 8, 2020), https://bettermarkets.org/sites/default/files/Better_Markets_WhitePaper_CBA_Consumer_Investor_Investor_Protection_Dec-2020.pdf=; Better Markets, Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC (July 30, 2012), https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.

62 The SEC should routinely make clear that while it is considering the costs and benefits as part of the rulemaking process, it is not doing so pursuant to its interpretation of any statutory requirements. Otherwise, the rule may be struck down for failure to "properly" conduct a quantitative cost-benefit analysis, although none is explicitly required by statute. *See, e.g., Am. Equity Inv. Life Ins. Co.*, 613 F.3d 166, 177 (D.C. Cir. 2010).

<u>CONCLUSION</u>

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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