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C O M M E N T

REGULATION OF ESG INVESTING IS STILL NECESSARY

by Stephen Hall

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I. Introduction

Environmental, social, and governance (ESG) investing is a strategy for allocating investment funds on the basis of the extent to which the operations of a company, or a portfolio of companies, affect the environment, advance social justice, or follow good corporate governance practices. It is of intense and increasing interest to millions of investors who seek to minimize financial risks and maximize their financial returns. It also appeals to investors who seek to align their investments with their core personal values.

An important question is how the Securities and Exchange Commission (SEC)—and to a lesser degree, the U.S. Department of Labor (DOL)—should regulate ESG investment offerings in mutual funds and other types of funds. Three distinguished scholars have conducted some empirical analysis to gauge the need for additional regulatory oversight in this area.[1] Taken at face value and without delving into any aspect of the methodology, the findings themselves are encouraging, at least as far as they go. Their analysis indicates that ESG mutual funds really do offer their investors increased ESG exposure, vote shares in ways that support the ESG principles, and do so without increasing costs or reducing returns for investors. If true, these findings bode well for the ESG investment movement.

But a key question is what conclusions follow from these findings. The authors contend that, in light of their study, there is no reason to single out ESG funds for special regulation or what they refer to as "regulatory intervention."

Here, we part company, at least to a degree. First, let's note some common ground. To the extent the authors oppose regulatory attempts to limit investor access to ESG products or to curtail their use by Employee Retirement Income Security Act (ERISA) fiduciaries, we agree. For that reason, we opposed the DOL's ideological and misguided attempt to inhibit the use of ESG investments by ERISA fiduciaries. Fortunately, the DOL under the Joseph Biden Administration has amended that rule, and in March it survived a Congressional Review Act resolution of disapproval thanks to President Biden's veto.

However, our core point is that there are still good reasons for additional regulatory requirements governing ESG funds. Such measures are necessary for at least three reasons: to protect investors from abuse; to bring order to a complex and confusing market by requiring clear, standardized, and comparable disclosures; and to maintain investor confidence in the integrity of this evolving market so that ultimately it can fulfill its potential. In short, regulation in the ESG market is necessary not only to protect investors, but also to foster an environment in which it can thrive. And indeed, the SEC has headed in this direction by proposing two important rules, one to prevent the use of misleading fund names and the other to provide investors in ESG funds with more detailed, consistent, and comparable disclosures.

II. The Nature of the ESG Market Makes Regulation Necessary and Appropriate

Before briefly fleshing out these points, it is important to highlight the attributes of ESG investing that influence our thinking on the need for additional regulation. ESG investing is in huge demand; it is experiencing explosive growth; it is attracting trillions of dollars of investor funds; it has spawned a confusing and complex ESG investment industry; it offers attractive profits for funds that can take advantage of investors' enormous appetite for ESG investing; and there is every reason to believe that the trend will continue, as the vast majority of millennials favor ESG investing.

At the same time, investors are confronted by a daunting array of investment options and a lack of clear and consis-

Author's Note: Better Markets is a nonprofit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets. A substantial amount of our advocacy is focused on improving the securities markets, and that includes fighting for important investor protections, including anti-fraud provisions and clear and comprehensive disclosures that investors need to make informed financial decisions.

1. *See* Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?* 120 Mich. L. Rev. 393 (2021).

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tent information about those options. There are hundreds of ESG mutual funds, hundreds of ESG rating providers using different methodologies, and countless ESG indexes that track companies using various ESG metrics. And as the authors note in their article, there isn't even a common, clear definition of exactly what ESG means.

Given this backdrop, the threat of investor abuse remains high. In addition, the need for greater clarity, uniformity, and comparability in the disclosure of information about ESG investing should be clear.

The case gets even stronger given the appropriate role for preventive regulation. The authors' perspective reflects too much of the "fingers crossed, let's leave well enough alone" approach. Given the massive scale, popularity, and importance of ESG investing, the optimal approach is to get ahead of potential and foreseeable problems. As the U.S. Court of Appeals for the District of Columbia (D.C.) Circuit has said, regulatory agencies have the latitude to "adopt prophylactic rules to prevent potential problems before they arise. An agency need not suffer the flood before building the levee."[2] Thus, even if the ESG fund marketplace were generally in good order, the SEC would be justified in establishing guardrails to head off future problems.

Let's now turn to the three specific reasons why regulation relating to ESG funds is warranted—investor protection, disclosure, and market confidence.

III. Targeted Regulation Will Help Curb Abuses

With respect to investor protection, there have been and continue to be patterns of misconduct in the world of ESG-focused funds, warranting vigilant enforcement as well as additional regulatory measures. The SEC's actions reflect these concerns.

In March 2021, 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.[3] One month later, in April 2021, the SEC's Division of Examinations issued a Risk Alert. It 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."[4] The Alert went on to discuss several specific "observations of deficiencies and internal control weaknesses" identified during the examinations of investment advisers and funds with respect to ESG investing. These risks included unsubstantiated or misleading claims of ESG approaches, proxy voting inconsistent with ESG strategy, inadequate internal controls, weak or unclear documentation, and more. The Commission has also issued a number of Investor Bulletins and other releases focused on concerns surrounding ESG investing. It continues to bring enforcement actions against issuers and funds for misconduct in climate and ESG-related disclosures, including cases against BNY Mellon[5] in May 2022 and against Goldman Sachs[6] in November 2022.

Beyond enforcement, the SEC has also taken regulatory action to address potential abuses in the ESG marketplace. In June 2022, it published a rule proposal to fortify what is known as the Names Rule.[7] That rule already requires funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund name suggests. The recent proposal would expand this requirement and apply it to fund names suggesting a focus on investments that have particular characteristics, including names indicating that the fund's investment decisions incorporate one or more ESG factors. The rule would also require enhanced disclosures about how fund names track their investments, prospectus definitions of the terms used in a fund's name, and the retention of records regarding how a fund complies with the rule.

This effort to curtail the use of misleading fund names stems from the reality that fund names have an exceptionally powerful influence on investors. Evidence shows that with the mere mention of the ESG factors in a name, funds can almost instantly attract huge inflows from investors.[8]

IV. Targeted Regulation Will Ensure Investors Receive the Clear and Consistent ESG Disclosures They Need and Want

Another area where regulatory intervention is especially important is in the realm of disclosure. The fact is that investors do not have access to clear, consistent, and comparable information on which to base their investment decisions when it comes to ESG investments. The SEC has moved on this front as well. In June 2022, along with the Names Rule, it published a proposal that would require investment companies to disclose to investors, and report to the SEC, additional information regarding their ESG investment strategies, depending on the extent to which a fund uses the ESG factors in its investment selection and

2. Stilwell v. Office of Thrift Supervision, 569 F.3d 514, 519 (D.C. Cir. 2009).
3. U.S. Securities and Exchange Commission, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, https://www.sec.gov/news/press-release/2021-42 (last visited May 21, 2023).
4. U.S. Securities and Exchange Commission Division of Examinations, *The Division of Examinations' Review of ESG Investing* 2, https://www.sec.gov/files/esg-risk-alert.pdf (Apr. 9, 2021).
5. U.S. Securities and Exchange Commission, *SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Consideration*, https://www.sec.gov/news/press-release/2022-86 (last visited May 21, 2023).
6. U.S. Securities and Exchange Commission, *SEC Charges Goldman Sachs Asset Management for Failing to Follow Its Policies and Procedures Involving ESG Investments*, https://www.sec.gov/news/press-release/2022-209 (last visited May 21, 2023).
7. Investment Company Names (File No. S7-16-22, RIN 3235-AM72); 87 Fed. Reg. 36594 (June 17, 2022), https://www.sec.gov/rules/proposed/2022/33-11067.pdf.
8. *See* Better Markets, *Re: Investment Company Names (File No. S7-16-22, RIN 3235-AM72); 87 Fed. Reg. 36,594 (June 17, 2022)* [Better Markets' Aug. 16, 2022 Comment Letter to the SEC on Investment Company Names], https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_SEC_Investment_Company_Names.pdf (last visited May 21, 2023).

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engagement process, framed in terms of integration funds, ESG focused funds, and ESG impact funds.[9]

The rule would require additional specific disclosures regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures; implement tabular disclosures to allow investors to compare ESG funds at a glance; and require certain environmentally focused funds to disclose the greenhouse gas emissions associated with their portfolio investments. Finally, the Proposal would require funds to use formats that provide investors with machine-readable data for their ESG disclosures.[10] The SEC's release clearly sets forth the rationale for the rule:

> The proposed amendments to these forms and associated rules seek to facilitate enhanced disclosure of ESG issues to clients and shareholders. The proposed rules and form amendments are designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry.[11]

V. Targeted Regulation Will Help ESG Thrive

The SEC's reference to innovation is a good segue to the last reason why we support additional reform in the ESG investment market: Strong regulation of ESG funds will actually help this important movement thrive. New protections and requirements, including those the SEC has recently proposed, will satisfy investor demand for the accurate and complete information they need to make optimal investment decisions, and it will fortify investor confidence in the integrity of the ESG market. In short, strong regulation means investor trust, which means greater investor participation, which means more robust and efficient capital allocation, better returns, and more social good. These benefits accrue whether investors are seeking ESG-related investments to save the planet or to reap better financial returns from companies that are positioned to adapt and profit from climate change and other trends.

VI. The Industry's "Sky Is Falling" Strategy Is Baseless

It is important to emphasize one more point that underlies much of the debate surrounding the wisdom of new regulation. So often, attempts to fend off new rules are premised on the notion that regulation imposes crushing burdens on the financial industry or even harms investors by reducing choices and stifling innovation.

These dire predictions are seldom if ever borne out. Recall just this one early example: When the state and federal securities laws first emerged a century ago, they were greeted with howls of protest portraying them as attacks on legitimate businesses that would stifle capitalism. Yet, it is precisely those laws that have created the environment in which our markets and ultimately our economy have thrived. The SEC and all of us must view these attacks with skepticism and follow the goals that underlie the securities laws, which are protecting investors, preserving the integrity of the markets, and promoting robust capital formation.

9. 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. 36654 (June 17, 2022), https://www.sec.gov/rules/proposed/2022/33-11068.pdf.

10. *See* Better Markets, *Re: Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices* [Better Markets' Aug. 16, 2022 Comment Letter to the SEC on Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices], https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_ESG_Disclosures.pdf (last visited May 21, 2023).

11. 87 Fed. Reg. at 36654.