COMMITTEE ON CAPITAL MARKETS REGULATION

August 15, 2022

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

VIA ELECTRONIC MAIL: rule-comments@sec.gov

Re.: File Number S7-17-22 – Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices

The Committee on Capital Markets Regulation (the "**Committee**") is grateful to the Securities and Exchange Commission (the "**SEC**") for the opportunity to comment on the proposed amendments to rules and forms under the Investment Advisers Act of 1940 (the "**Advisers Act**") and the Investment Company Act of 1940 (the "**Investment Company Act**") to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies, to provide additional information regarding their environmental, social, and governance ("**ESG**") investment practices (together, the "**Proposed Rule**").[1]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee supports the SEC's goals of "promot[ing] consistent, comparable, reliable—and therefore decision useful" information about ESG investing strategies for investors.[2] We agree that "greenwashing" — that is, the marketing of ESG strategies by exaggerating ESG practices or the extent to which investment products or services take ESG factors into account[3] — is undesirable. However, we are concerned that certain aspects of the Proposed Rule could frustrate the SEC's goals of promoting useful information about ESG strategies and *increase* greenwashing rather than discourage it. The following discussion briefly summarizes the Proposed Rule and then describes certain concerns with the Proposed Rule. We set forth recommendations that we believe would better

[1] SEC. & EXCH. COMM'N ["**SEC**"], Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 FR 36654, https://www.federalregister.gov/documents/2022/06/17/2022-11718/enhanced-disclosures-by-certain-investment-advisers-and-investment-companies-about-environmental [the "**Proposed Rule**"].
[2] Proposed Rule at 36,659.
[3] *Id.* at 36,655.

align the Proposed Rule with its intended goals and encourage ESG-focused funds to disclose clear and precise information that substantiates how their investment activities serve the fund's ESG goal.

I. The Proposed Rule Creates Three Types of ESG Funds

The Proposed Rule would require investment companies registered under the Investment Company Act ("**funds**") to include disclosures in their prospectuses and annual shareholder reports concerning the fund's implementation of ESG factors in its principal investment strategies. The Proposed Rule creates three definitions that classify funds according to the "extent to which the fund considers ESG factors in its investment process":

1) "Integration Fund" would mean "any fund that considers one or more ESG factors along with other, non-ESG factors in its investment decisions, such that those ESG factors are generally no more significant than other factors in the investment selection process."[4]

2) "ESG-Focused Fund" would mean "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" as well as any fund that markets itself as such through its name, advertisements, or sales literature. [5]

3) "Impact Fund" is defined as any ESG-Focused Fund that seeks to achieve a specific ESG impact, such as, for example, financing the construction of affordable housing units.[6]

The Proposed Rule does not however define "ESG" or its constituent terms.

The level of detail required of the ESG disclosure in a fund's prospectus and annual shareholder report depends on which if any of these three definitions applies to the fund. Integration Funds are subject to the most limited disclosure requirements, and ESG-Focused Funds and Impact Funds are subject to broader and more detailed requirements.

An Integration Fund is required to summarize in its prospectus the ESG factors that it considers and how it incorporates those factors into its investment selection process.[7] An Integration Fund that considers greenhouse gas ("**GHG**") emissions of portfolio companies in its investment selection process must also describe the methodology the fund uses as part of its consideration of such emissions.[8]

An ESG-Focused Fund would be required to provide a detailed overview of the fund's ESG strategy and to describe in detail how the fund incorporates ESG factors in its investment decisions, including how it votes proxies or engages with companies on ESG issues.[9]

[4] *Id*. at 36,660.
[5] *Id*. at 36,662.
[6] *Id*. at 36,659.
[7] *Id*. at 36,671.
[8] *Id*. at 36,661.
[9] *Id*.

ESG-Focused Funds for which proxy voting is a significant means of implementing their ESG strategies would be required to disclose in their shareholder reports the percentage of ESG-related voting matters that the fund supported. ESG-Focused Funds that engage with issuers on ESG issues through means other than proxy voting as a significant means of implementing their ESG strategy would be required to disclose in their shareholder reports the number or percentage of issuers with which the fund held "ESG engagement meetings" during the reporting period.[10]

ESG-Focused Funds that consider environmental factors must also calculate and disclose certain quantitative metrics with respect to the Scope 1, 2, and 3 GHG emissions of their portfolio companies.[11]

An Impact Fund would be required to provide the same disclosures as other ESG-Focused Funds, in addition to disclosing the impact(s) the fund is seeking to achieve and how it seeks to achieve those impact(s).[12] This disclosure must address how the fund measures progress toward the specific impact, including the "key performance indicators" the fund analyzes, the time horizon the fund uses to analyze progress, and the relationship between the impact(s) the fund is seeking to achieve and financial returns.

II. Analysis of the Proposed Rule

In this section, we raise five concerns with the Proposed Rule and set forth recommendations to address these concerns. As a more general note, the inherent ambiguity of "ESG" and its constituent terms and the lack of governing definitions tend to underlie or exacerbate the specific concerns discussed below.

1) ESG-Focused Funds: Scope and Management Engagement

The Proposed Rule's definition of "ESG-Focused Fund" would include not only any fund that focuses on ESG factors as a significant or main consideration in selecting investments, but also any fund that focuses on ESG factors as a significant or main consideration in its "engagement strategy with the companies in which it invests."[13] This reference to ESG engagement strategies is likely to result in a significantly overbroad definition that is unlikely to deliver useful information to investors.

This overbreadth is primarily attributable to the definition's failure to consider how asset managers engage with issuer management on behalf of their funds. Engagement with issuer management is typically conducted by an asset manager on behalf of multiple funds that invest in the same issuer. It is likely therefore to be difficult to attribute an asset manager's ESG-related engagement activities to specific funds. An asset manager's ESG engagement activities on behalf of one fund might thus trigger the definition of "ESG-Focused Fund" with respect to other funds that invest in the same issuer.

In addition, the proposed definition is likely to be particularly overbroad with respect to governance-related engagement. Because the "G" in ESG refers to "governance," and the definition of "ESG-

[10] *Id.* at 36,674.
[11] *Id.* at 36,678.
[12] *Id.* at 36,668.
[13] *Id.* at 36,662.

Focused Fund" includes any fund that "focuses on one or more ESG factors by using them as a significant or main consideration . . . in its engagement strategy with the companies in which it invests," the term "ESG-Focused Fund" would by implication include any such fund that engages with portfolio companies on "governance" issues. This results in an overbroad definition that may effectively encompass all or most funds and thus render the "ESG-Focused Fund" designation unhelpful to investors seeking to understand the relative importance of ESG factors to a particular fund.

More specifically, since the Proposed Rule does not define ESG or its constituent terms, the term "governance" as used in the definition of "ESG-Focused Fund" could be construed broadly to encompass any corporate governance matters, including more traditional matters such as effective board oversight of long-term financial and strategic goals.[14] Engagement with portfolio companies on traditional governance matters is extremely common, if not universal, among funds. However, the reference to "governance" in ESG is often understood as referring to a subset of governance matters that relates less directly to financial matters and instead implicates ethical or social matters, such as board diversity.[15]

For the foregoing reasons, the definition of "ESG-Focused Fund" could include a significant number of funds that do not market themselves as "ESG" funds and therefore result in a categorization that is too broad to be meaningful to investors. It would also create a significant and unnecessary compliance burden for such funds, which would be required to amend and supplement their disclosure to meet the form and content requirements of the Proposed Rule despite not marketing themselves as "ESG" funds.

Recommendation: We recommend that engagement on ESG matters not trigger the definition of ESG-Focused Fund unless the fund has a clear and unambiguous strategy of using engagement on such matters as its sole means of implementing its ESG focus and markets itself to investors as such. We also recommend that the definition of ESG-Focused Fund be clarified to exclude engagement on traditional corporate governance matters.

2) Disclosure of Proxy Voting Statistics

The proposed quantifications of an ESG-Focused Fund's proxy voting record are potentially misleading or uninformative.

ESG-Focused Funds for which proxy voting is a significant means of implementing their ESG strategies would be required to disclose in their shareholder reports the percentage of ESG-related voting matters during the reporting period for which the fund voted in furtherance of the initiative. However, this percentage may well give investors an inaccurate impression of the extent of a fund's commitment to certain ESG considerations. A fund manager might vote against an ESG-related initiative for well-founded reasons that are consistent with the manager's ESG strategies. For example, fund managers that pursue ESG objectives still have a duty to pursue long-term financial value for their investors, and a manager might determine that a particular ESG proposal is not likely

[14] *See, e.g.*, BLACKROCK, Our approach to engagement on board quality and effectiveness (2022), https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-board-quality.pdf.
[15] *See, e.g.*, R. BOFFO & R. PATALANO, OECD, ESG INVESTING: PRACTICES, PROGRESS AND CHALLENGES (2020), https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf.

to create long-term value for investors (e.g., because it pressures a company to implement an overly prescriptive or unrealistic business strategy on an unreasonable timeline).[16] Disclosure of the percentage of ESG-related proposals for which a fund voted in favor will not capture this important nuance and may thus underestimate a fund's commitment to a particular ESG factor.

Recommendation: We therefore recommend that the requirements to disclose proxy voting statistics be removed from the Proposed Rule.

3) Disclosure of ESG Engagement Meeting Statistics

The proposed quantifications of an ESG-Focused Fund's "ESG engagement meeting" record are likely to be impracticable for funds to interpret consistently and to generate imprecise information for investors.

ESG-Focused Funds for which engagement with issuers on ESG issues is a significant means of implementing their ESG strategy would be required to disclose in their shareholder reports the number or percentage of issuers with which the fund held "ESG engagement meetings" during the reporting period related to one or more ESG issues and the total number of these meetings.[17] An "ESG engagement meeting" for this purpose would mean a "substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given time period, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal."[18]

As the Proposed Rule acknowledges, its definition of "ESG engagement meeting" entails a significant degree of subjectivity, which will "diminish the comparability across funds of the statistics reporting pursuant to this instruction."[19] A fund adviser's meeting with a portfolio company's management is, moreover, rarely focused on a single topic or a single fund. Instead, as noted above, engagement with issuer management is typically conducted by an asset manager on behalf of multiple funds. It will therefore be difficult for fund managers to determine consistently whether a meeting qualifies as an ESG engagement meeting, and to attribute the meeting to particular funds. Such a statistic may also give the impression that a fund that conducts many short engagement meetings is more effective than a fund that conducts a lesser number of in-depth engagement meetings. The resulting disclosures will thus likely be inconsistent among funds and difficult for investors to interpret and compare to an extent that renders the resulting disclosure unhelpful to investors.

Recommendation: We therefore recommend that the requirements to disclose ESG engagement meeting statistics be removed from the Proposed Rule.

[16] *See, e.g.*, BLACKROCK, 2022 climate-related shareholder proposals more prescriptive than 2021 (2022), https://www.blackrock.com/corporate/literature/publication/commentary-bis-approach-shareholder-proposals.pdf.
[17] Proposed Rule at 36,674.
[18] *Id.*
[19] *Id.* at 36,675.

4) GHG Emissions Disclosure Requirements

ESG-Focused Funds that consider "environmental" factors as part of their investment strategies are required to disclose Scope 1 and Scope 2 emissions of the companies in which they invest as well as Scope 3 emissions to the extent they are disclosed by those companies.

However, a focus on environmental factors does not necessarily mean that portfolio company GHG emissions are an accurate proxy for the fund's success in implementing its environmental strategy. For example, a fund that invests substantially in solar energy producers as part of a clean energy investment strategy may report higher levels of portfolio company GHG emissions relative to other funds with environmentally focused strategies that do not invest in energy producers. This is because energy production is generally associated with higher levels of GHG emissions (for example, GHG emissions associated with the production, recycling, and transport of solar panels) even when the type of energy being produced is ultimately important to the transition to a low-GHG emission economy.[20] In this case, the clean energy fund's higher GHG emissions levels are not an indication that it is less successful in implementing its environmental strategy relative to environmentally focused funds that do not invest in energy production.

Moreover, even for funds for which the minimization of portfolio GHG emissions is directly relevant to the achievement of their environmental strategies, consistent reporting of Scope 1 and 2 emissions will not be possible unless and until the SEC's proposed rule on climate-related disclosures by public companies comes into effect. The Proposed Rule acknowledges that, although there are voluntary reporting standards pursuant to which certain issuers report their Scope 1 and 2 emissions, "some" portfolio companies still do not make this information publicly available.[21] This is however an understatement of the problem that funds will face. In its 2022 report on sustainability practices, the Conference Board notes that 29% of the constituent issuers of the S&P 500 currently do not report GHG emissions.[22] Among smaller firms, the percentage of non-reporting issuers only grows. Among the midcap S&P400, 82% of issuers do not report GHG emissions.[23] Funds will thus be required to rely to a large extent on their own estimates, which, as the Proposed Rule acknowledges, may be based on varying methodologies across funds. These estimates may therefore produce inconsistent results that are of limited or no utility to investors.

As the Committee previously noted in its comment letter in response to the SEC's proposal on climate-related disclosures by public issuers,[24] measures of Scope 3 emissions are inherently too speculative and unreliable to be useful to investors. For example, an article by professors at the Harvard Business School and Oxford School of Government conclude that the difficulty of tracking

[20] *See, e.g.*, U.S. ENERGY INFORMATION ADMINISTRATION, Solar energy and the environment, https://www.eia.gov/energyexplained/solar/solar-energy-and-the-environment.php (last visited Aug. 12, 2022).
[21] Proposed Rule at 36,681.
[22] THE CONFERENCE BOARD, SUSTAINABILITY DISCLOSURE PRACTICES 2022 EDITION: GETTING OFF THE SIDELINES (2022), https://www.conference-board.org/press/climate-disclosures-gap.
[23] *Id*.
[24] COMMITTEE ON CAPITAL MARKETS REGULATION, Comment Letter Re. File Number S7-10-22: The Enhancement and Standardization of Climate-Related Disclosures for Investors (2022), https://www.capmktsreg.org/2022/06/17/committee-submits-comment-letter-on-the-secs-proposal-on-climate-disclosure/.

Scope 3 emissions from multiple suppliers and customers makes it a "virtual impossibility" for companies to estimate Scope 3 numbers reliably.[25] The imprecision of the Scope 3 methodology will "open the door to bias and manipulation."[26] They also point out that the Scope 3 reporting concept requires multiple issuers to estimate and report emissions from the same activity, which is inefficient and duplicative, and "an obvious defect in any accounting system."[27]

Recommendation: We therefore recommend that the Proposed Rule only require disclosure of Scope 1 and 2 emissions by ESG-Focused Funds that consider GHG emissions specifically as a significant element of their environmental strategies, and that this requirement become effective only if and when public issuers are required by the SEC to disclose Scope 1 and 2 emissions. Moreover, the Proposed Rule should not require funds to disclose Scope 3 emissions.

5) Integration Fund Disclosure Requirements

Requiring ESG-specific disclosures of Integration Funds that consider ESG factors only to a limited extent could cause investors to overestimate the importance of ESG considerations relative to non-ESG factors for which similar disclosures are not required. This may contribute to, rather than counteract, greenwashing, by requiring many funds to overemphasize ESG topics in their disclosures.

As the Proposed Rule acknowledges, there may be non-ESG factors, such as macroeconomic trends or portfolio companies' price-to-earnings ratios,[28] that are equally or more important than ESG factors to a fund that considers ESG factors, but which the fund is not required to discuss specifically in its description of its investment strategy. The Proposed Rule purports to address this concern by limiting the detail of the ESG-specific disclosure required of Integration Funds.[29] An Integration Fund is required only to summarize the ESG factors that it considers and how it incorporates those factors into its investment selection process, as well as the methodology the fund uses in its consideration of GHG emissions, if relevant to the fund's strategy. However, even if a fund only includes concise disclosure addressing ESG topics, but does not include disclosure addressing other factors that it considers in its investment decisions that are of equal or greater importance than ESG factors, investors may have an exaggerated impression of the importance of ESG considerations in a fund's investment strategy.

Recommendation: We therefore recommend that the "Integration Fund" category and associated disclosure requirements be removed from the Proposed Rule.

[25] Robert S. Kaplan & Karthik Ramanna, *Accounting for Climate Change* (2021), https://hbr.org/2021/11/accounting-for-climate-change. ("The difficulty of tracking emissions from multiple suppliers and customers across multiple value chains makes it virtually impossible for a company to reliably estimate its Scope 3 numbers.").
[26] *Id.*
[27] *Id.*
[28] Proposed Rule at 36,657.
[29] *Id.*

*   *   *

Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

Robert Glenn Hubbard

John L. Thornton	Hal S. Scott	R. Glenn Hubbard
CO-CHAIR	PRESIDENT	CO-CHAIR