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August 16, 2022

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

RE: File Nos. S7-11-22 and S7-16-22

Dear Ms. Countryman:

We are writing in response to S7-11-22, “Enhanced Disclosure by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices” (the “ESG Rule”) and S7-16-22, “Investment Company Names” (the “Names Rule,” and, together with the ESG Rule, the “Proposed Rules.”)

The Shareholder Commons (TSC) is a nonprofit advocate for diversified investors.

A. Introduction

We submit this letter in response to the Securities and Exchange Commission’s (the “Commission”) requests for comment on the Proposed Rules. The Proposed Rules would require certain investment companies and advisers to provide greater transparency regarding their use of environmental, social and governance information in their investment practices, including a requirement with respect to the names of investment companies.

We strongly support the Proposed Rules. As noted in the Releases, trillions of dollars are being invested in funds that use “ESG,” “sustainability,” or similar terms in their fund names, promotional materials, and SEC filings. In order to ensure that investors are not misled by the use of this vocabulary, it is critical that there be greater transparency regarding the incorporation of ESG factors by these funds.

However, in order to further enhance the intended transparency, the Proposed Rules should be modified to recognize the distinction between using ESG-related tools to improve the financial performance of individual companies (“enterprise value ESG investing”) and using such tools in order to preserve social and environmental systems, and thereby improve overall securities market performance (“systems-centered investing.”) In addition, the Names Rule should be modified to recognize the heightened importance of voting and engagement with respect to systemic stewardship by allowing the appropriate

use of ESG terminology for funds that focus on ESG stewardship, even if they do not use ESG factors to select 80% of their investments.

Without such clarifications, there is a risk that investors will continue to invest in funds that they believe are designed to improve society and the environment, but that are in fact designed only to outperform other investments. Ironically, that focus on outperformance may lead to both poorer social and environmental systemic health and to lower returns for investors.

B. Two levels of risk: alpha and beta

The companies that make up an investor's portfolio exist in a complex web of social, environmental, and economic systems. The natural environment provides inputs for business like water and minerals, while social institutions support a healthy and educated workforce, as well as the social stability necessary for long-term investment. Threats to these systems can pose threats to companies' financial performance. Conversely, however, company activities can pose threats to these systems.

The interactions between companies and systems creates two distinct types of risks for investors. First, threats to these systems can pose risks to the relative financial performance of individual companies as compared to other companies ("alpha"). Threats to alpha may arise because a social or environmental system upon which a business model depends is degraded; but threats to alpha may also arise if a company's business model threatens those systems, because such a company is subject to the risk that its reputation will be tarnished or that its activities will be subject to increased regulation. These risks that systemic concerns pose to the performance of individual companies are sometimes called "outside-in" risk; addressing such risks is the province of enterprise value investing.

The second type of ESG risk to which investors are exposed is "inside-out" risk—the risk that companies pose to social and environmental systems. These systemic risks threaten the performance of financial markets overall, chiefly by threatening the performance of the global economy ("beta.")¹ As discussed in more detail below, systemic risk to beta presents a greater threat to long-term, diversified portfolios than do the risks of poor performance by individual companies. Addressing such systemic risks to beta is the goal of systems-centered investing.

In order for investors to understand the strategy of funds that incorporate ESG investing into their models, it is critical that the Proposed Rules require funds to address the distinction between enterprise value ESG investing and systems-centered investing. This is especially important because a fund can aim to achieve outperformance by divesting itself of companies that pose alpha risk, and while this could have the effect

¹ "Beta" in this sense differs from the formal use of the term in the financial literature, where it refers to the specific risk of a security or securities not attributable to the market. More recently, literature addressing the importance of broad market returns to diversified investors has used the term to refer to the overall return of the market, in contrast to alpha, which is the performance of a particular security or portfolio in comparison to overall market return. See, e.g., JON LUKOMNIK & JAMES P. HAWLEY, MOVING BEYOND MODERN PORTFOLIO THEORY: INVESTING THAT MATTERS (2021).

of improving the fund's relative performance, its decision not to address beta risks may be of greater relevance to investors who cannot escape broad market risks caused by ESG factors.

The tension between enterprise value ESG investing and systems-centered investing is also exacerbated by the fact the alpha performance is salient to investors in a way that contribution to beta is not. Investors can always compare the performance of a fund to its benchmark; thus, a fund that successfully creates alpha can claim success by pointing to historical returns. Contribution to beta, on the other hand, benefits all diversified investors equally, and does not show up in comparisons among funds. In order to counter the salience bias towards alpha, it is important that the Proposed Rules require a discussion of a fund's systems-centered investing or its absence.

C. Security selection v. stewardship

In addition to the two levels of investment risk, there are two primary methods by which investors can seek to mitigate them. The first, which largely addresses alpha-level risk, involves choosing securities that effectively mitigate the risk that companies will underperform the market due to their social or environmental concerns: for example, if an investor believes that a certain company will underperform because of its greenhouse gas (GHG) emissions, that company can be avoided or underweighted in a portfolio, or other securities can be purchased that pose non-correlated risks, thereby hedging the alpha risk ("security selection.") But although such a choice might lower the fund's climate risk, its act of selling (or not buying) outstanding stock does not directly change the overall level of GHG emissions—it just transfers the ownership of the emitting company to a different owner.

In theory, security selection by a critical mass of investors can drive down a company's share price or increase its borrowing costs; this could impact the cost of capital for the company, and thereby persuade it to improve its ESG practices, having an impact on beta through an improved social or environmental impact. The evidence for such systemic impacts is limited, however, particularly with respect to purchases and sales in the secondary market (e.g., the buying and selling of outstanding shares of publicly listed stock).² In our experience, ESG discussions are not always clear about whether the goal of security selection is improvement of alpha or beta, even though the distinction is critical to investors.

As an alternative to security selection, investors can seek to mitigate social or environmental risk by using their rights as investors to change company behavior ("stewardship.") A climate-related example of stewardship would be last year's campaign by Exxon Mobil shareholders to replace some of the directors

² Julian F. Kölbel et al., *Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact*, 33 ORGANIZATION & ENVIRONMENT 554–574 (2020); Ellen Quigley, *Universal Ownership in Practice: A Practical Positive Investment Framework for Asset Owners*, SSRN JOURNAL (2020), <https://www.ssrn.com/abstract=3638217> (last visited Aug 9, 2022).

with directors more likely to address the company's capital allocation to continued fossil fuel investment. This campaign's explicit aim was to address an outside-in risk to Exxon's own alpha.³

In contrast to the Exxon Mobil campaign's express purposes, investors seeking to optimize their returns might employ stewardship to mitigate the inside-out risk a portfolio company's GHG emissions or other actions posed to the economy as a whole. The portfolio-enhancing goal behind such a strategy is not to improve the performance of the individual company, but rather to protect other portfolio companies from the risk it poses to them. Shareholder advocacy organization Majority Action's "Proxy Voting for a 1.5°C World" campaign exemplifies this strategy, which it describes as follows:

In 2021, Majority Action issued company-specific director vote guidance at 19 U.S. oil and gas, electric power, and financial services companies that were demonstrably out of alignment with limiting warming to 1.5°C.⁴

Majority Action explains that shareholders should support its stewardship campaign to mitigate risk across their portfolios, rather than as a matter of managing specific risks to individual companies:

The physical and financial risks posed by climate change to long-term investors are systemic, portfolio-wide, unhedgeable, and undiversifiable. Therefore, the actions of companies that directly or indirectly impact climate outcomes pose risks to the financial system as a whole and to investors' entire portfolios. In order to manage this systemic portfolio risk, investors must move beyond disclosure and company-specific climate risk management frameworks and focus on holding accountable the relatively small number of large companies whose actions are a significant driver of climate change.⁵

Of course, some stewardship may be undertaken with the twin goals of improving individual company performance and improving overall market performance. But it is inevitable that the two will be in opposition in some cases: sometimes companies are able to improve their own performance by externalizing social and environmental costs, which threaten broad economic performance, and thus the long-term performance of diversified portfolios.

³ It is also possible that some supportive investors believed that the continued investment by a major petroleum exploration company in new fossil fuel projects posed a threat to beta as well, by making it more likely that GHG emissions would lead to a level of warming that threatened the global economy.

⁴ PROXY VOTING FOR A 1.5° WORLD, <https://www.proxyvoting.majorityaction.us> (last visited Aug 15, 2022).

⁵ *Id.*

D. Pathways for ESG investing activity

Table 1 matches the two types of risk with the two strategies for mitigating such risks.

Table 1

	ALPHA: RISKS TO THE RELATIVE PERFORMANCE OF INDIVIDUAL COMPANIES AND FUNDS	BETA: RISKS TO THE ECONOMY THAT WILL BE FELT BY ALL DIVERSIFIED INVESTORS
SECURITY SELECTION	Security selection to address company-specific risks involves avoiding companies that are more exposed to social and environmental risks and choosing companies with less such exposure. This includes avoiding companies that have business plans that depend upon externalizing social and environmental costs if the investor determines that such plans create significant regulatory or reputational risk to the business.	Security selection on the secondary markets may not be an effective method for addressing inside-out social and environmental risks that companies impose on the economy, because other owners may permit such companies to continue its practices. Divestment strategies can be counterproductive, leaving the control of companies in the hands of owners not concerned with systemic risk. Denying companies new funding (or increasing its cost), however, can theoretically address beta concerns by raising the cost of capital.
STEWARDSHIP	Voting and engaging with individual companies can induce them to address social and environmental risks that threaten their relative financial performance.	Shareholders can engage and vote their shares to push companies to mitigate their contributions to systemic risk. This may mean ending practices that, even if optimal for the company, threaten the economy and thus overall market returns.

The left two quadrants imply a need for funds to disclose the methods they use to address risks to individual company relative performance. Fund investors can use such information if they are interested in funds that achieve alpha through both security selection and stewardship.

The right two quadrants relate to the need for information that allows investors to determine whether a fund is using ESG investing to address overall market risks, particularly through stewardship. Critically, the chart illustrates that funds may engage in significant ESG investing, but only focus on alpha. Such a fund may not make any significant contribution to mitigating the risks that companies pose to social and environmental systems or to overall market returns; indeed, as indicated by the bolded language in the lower right quadrant, voting to support company conduct that maximizes alpha may be in opposition to optimizing beta. Discussions in fund documents that focuses solely on alpha thus could mislead diversified investors, for whom the primary risk of social and environmental impact is the threat to overall

market returns. We address the centrality of systems stewardship and beta to investors in the following section.

E. The importance of systems stewardship to protecting diversified shareholders

1. Modern Portfolio Theory requires diversification

Modern investing principles emphasize the importance of portfolio diversification.⁶ Diversification allows investors to reap the increased returns available from risky securities, but to greatly reduce that risk; this insight defines Modern Portfolio Theory.⁷

This core principle is reflected in federal law, which requires fiduciaries of federally regulated retirement plans to “diversify[] the investments of the plan.”⁸ Similar principles govern investment fiduciaries under other legal regimes.⁹ The wisdom of a diversified investment strategy was summarized by the late John Bogle, founder of Vanguard, one of the largest mutual funds companies in the world: “Don’t look for the needle in the haystack; instead, buy the haystack.”¹⁰

2. The performance of a diversified portfolio depends upon beta

Diversification is thus required by accepted investment theory and imposed by law on investment fiduciaries. As a consequence, many fund investors are largely diversified, either through the purchase of single, widely diversified funds, or through the purchase of multiple funds. However, once an investor is diversified, the most important factor determining return will not be how the companies in its portfolio perform relative to other companies (or how funds in the portfolio perform relative to other funds), but rather how the market performs as a whole. Beta is more important to diversified investors than is alpha.

Craig Lazzara, an S&P Dow Jones Indices executive, provided a timely hypothetical to illustrate the power of the beta effect, arguing that diversified shareholders with a COVID-19 vaccine manufacturer (“X”) in their portfolios could financially benefit if the manufacturer sacrifices potential financial returns:

Why? From a narrow perspective, X should charge quite a lot for its vaccine, since it’s obviously worth a great deal. But from a universal owner’s¹¹ perspective, X should give the stuff away (or at least sell it for

⁶ BURTON GORDON MALKIEL, *A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING* (2020).

⁷ *Id.*

⁸ 29 USC Section 1104(a)(1)(C).

⁹ See UNIFORM PRUDENT INVESTOR ACT, SECTION 3. (“[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.”)

¹⁰ JOHN C. BOGLE, *THE LITTLE BOOK OF COMMON SENSE INVESTING: THE ONLY WAY TO GUARANTEE YOUR FAIR SHARE OF THE STOCK MARKET* (2007).

¹¹ The term “universal owner” is used to refer to investors that are required to invest for long time periods and who must broadly diversify to avoid the idiosyncratic risk of particular companies. Pension funds, endowments, and foundations and their beneficiaries are quintessential universal owners, but similar logic applies to retail investors saving for the long term..

marginal variable cost, which would be close to the same thing). X might well lose money, but an effective and plentiful vaccine would arguably cause the whole market to move upward sharply. Index funds would profit far more from the beta effect on their portfolios than from the alpha on a single stock.

....

This argument is not altruistic. It may well be “socially responsible” for X to give the vaccine away, but that’s not why universal owners are putatively for it. The argument that they should disregard X’s profitability to boost the world’s stock markets is entirely self-interested.¹²

The essay notes that a plan need not be indexed for the effects of beta to outweigh alpha—that will be the case whenever a portfolio is adequately diversified. As one work describes this, “[a]ccording to widely accepted research, alpha is about one-tenth as important as beta [and] drives some 91 percent of the average portfolio’s return.”¹³

Moreover, from the perspective of the diversified investor, it is not the performance of the assets held by a particular manager that matters, but rather the aggregated performance of all of the diversified assets being held by or on their behalf. For example, if a 401(k) saver has several different stock funds in her portfolio, it would not be helpful for the manager of one fund to pursue positive alpha but permit poor ESG performance that threatened the systems that support the companies in all of the funds held by the saver. While that individual manager might claim success because of the alpha achieved within its non-diversified portfolio, it would really be harming its ultimate client, the 401(k) saver who is relying on beta to support her entire diversified portfolio.

One business-press columnist recently described the situation as follows:

In modern markets, the paradigmatic shareholder is broadly diversified, and there is less reason to care about what any particular company does. ... Companies are just data points; what you care about is aggregates.¹⁴

¹² Craig Lazzara, *Alpha, Omicron: Why? – Indexology® Blog | S&P Dow Jones Indices*, <https://www.indexologyblog.com/2021/12/02/alpha-omicron-why/> (last visited Aug 11, 2022).

¹³ STEPHEN DAVIS, JON LUKOMNIK & DAVID PITT-WATSON, *WHAT THEY DO WITH YOUR MONEY HOW THE FINANCIAL SYSTEM FAILS US AND HOW TO FIX IT* (2016).

¹⁴ Matt Levine, *Matt Levine’s Money Stuff: Goldman Compliance Analyst Slipped Up*, <https://news.bloomberglaw.com/mergers-and-acquisitions/matt-levines-money-stuff-goldman-compliance-analyst-slipped-up> (last visited Aug 11, 2022).

3. *Beta depends upon global economic performance*

Over long time periods, beta is influenced chiefly by the performance of the economy itself, because the value of the investable universe is equal to the percentage of the productive economy that the companies in the market represent.¹⁵ Of course, valuation multiples of stocks (i.e., the ratio of share price to earnings or other valuation metrics) rise and fall, but they ultimately revert to a mean, leaving GDP as the key determinant of the value of a diversified portfolio:

[T]he long-term price of a universally-owning institutional investor's portfolio represents the Universal Owner's part of the appropriately discounted sum of all future GDP proportions of corporations. ...

[T]he relationship between GDP and the price of the portfolio of a Universal Owner is linear in the long term.¹⁶

While the quoted work puts this idea into a mathematical proof, Warren Buffet, the world's most famous investor, uses common-sense language to make the same point, explaining that the ratio of total market capitalization to GDP "is probably the best single measure of where valuations stand at any given moment."¹⁷ In other words, a healthy GDP means healthy diversified portfolios.

4. *Global economic performance depends upon healthy social and environmental systems*

It seems intuitive that a productive economy—and consequent GDP growth—is built upon healthy social and environmental systems. It would be difficult to do business in a society that lacked trust, cohesion, order, and a shared sense of norms. By the same token, if the natural systems upon which we depend are failing, it is difficult to grow the economy.

Recent economic literature reinforces this intuition. The World Economic Forum estimates that more than half the world's GDP is dependent on nature and the services it provides:

Our research shows that \$44 trillion of economic value generation – more than half of the world's total GDP – is moderately or highly dependent on

¹⁵ RICHARD MATTISON, MARK TREVITT & LIESL VAN AST, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, (2010), https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf (last visited Jul 13, 2022).

¹⁶ *Id.*

¹⁷ Warren Buffett & Carol Loomis, *Warren Buffett On The Stock Market What's in the future for investors--another roaring bull market or more upset stomach?*, FORTUNE MAGAZINE, 2001, https://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/10/314691/index.htm (last visited Aug 11, 2022); JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* (2000).

*nature and its services, and therefore exposed to risks from nature loss.*¹⁸

A 2011 article estimated the value of services provided by the earth's ecosystem at \$125 trillion.¹⁹ The same article estimated that land use had reduced the value of eco-services by \$4.3 trillion to \$20.2 trillion per year between 1997 and 2011.²⁰ The *Dasgupta Review*, a 2021 study of the economics of biodiversity commissioned by the United Kingdom Treasury, explained the nature of this dependence:

*We rely on Nature to provide us with food, water and shelter; regulate our climate and disease; maintain nutrient cycles and oxygen production; and provide us with spiritual fulfilment and opportunities for recreation and recuperation, which can enhance our health and well-being. We also use the planet as a sink for our waste products, such as carbon dioxide, plastics and other forms of waste, including pollution. Nature is therefore an asset, just as produced capital (roads, buildings and factories) and human capital (health, knowledge and skills) are assets.*²¹

Social systems support productivity just as do environmental systems: "a lack of social development, including poverty, inequality and weak rule of law, can hamper business operations and growth."²² Examples of specific social and environmental risks that threaten GDP are included in the following section.

The relationship between GDP, social and environmental systems, and market returns means that the centrality of beta cannot be avoided simply by picking stocks that outperform. Diversified investors cannot avoid certain common risks almost all companies face. These are the risks to the social and environmental systems in which the economy is embedded. One recent work explained that these systematic risks inevitably "swamp" any alpha strategy:

*It is not that alpha does not matter to an investor (although investors only want positive alpha, which is impossible on a total market basis), but that **the impact of the market return driven by systematic risk swamps virtually any possible scenario created by skillful analysis or trading or portfolio construction.***²³

¹⁸ Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy, WORLD ECONOMIC FORUM (2020), https://www3.weforum.org/docs/WEF_New_Nature_Economy_Report_2020.pdf.

¹⁹ Robert Costanza, et al, *Changes in the Global Value of Ecosystem Services*, 26 *Global Environmental Change* 152 (2014).

²⁰ *Id.*

²¹ PARTHA DASGUPTA, *THE ECONOMICS OF BIODIVERSITY: THE DASGUPTA REVIEW - ABRIDGED VERSION* (Updated: 2 February 2021 ed. 2021), <https://www.gov.uk/government/publications/final-report-the-economics-of-biodiversity-the-dasgupta-review>.

²² Social Sustainability | UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/our-work/social> (last visited Aug 12, 2022).

²³ LUKOMNIK AND HAWLEY, *supra* note 1.

A recent report from the international law firm Freshfields Bruckhaus Deringer explains how the reality of externalized costs reverberates in the fiduciary duties of investment trustees across jurisdictions:

In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial, and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore damage the performance of a portfolio as a whole and all portfolios exposed to those systems.²⁴

5. Systemic health depends upon investee behavior

The foregoing sections have established that (1) in accord with modern investing principles, many of the investors that the SEC is charged with protecting are likely diversified, (2) they therefore rely on beta, (3) beta relies on a healthy economy, and (4) a healthy economy relies on critical social and environmental systems. In this section, we show that the companies at which funds can engage in systems stewardship are responsible for whether those systems thrive, due to the social and environmental impacts they externalize.

A recent study determined that, in 2018, publicly listed companies around the world imposed social and environmental costs on the economy with a value of \$2.2 trillion annually—more than 2.5 percent of global GDP.²⁵ This cost was more than 50 percent of the profits those companies reported.

Climate change represents the quintessential beta risk. A 2021 report by Swiss Re, the world's largest reinsurer, examined likely temperature scenarios and estimated the impact of those scenarios on GDP as of 2050.²⁶ Working with current country-by-country climate mitigation pledges, they determined that warming by 2050 was likely to be 2.0-2.6°C, with 3.2°C as a severe but potential trajectory. They also concluded that action could still be taken to limit warming in that time frame to well below 2.0°C, an outcome that many have concluded is the upper limit to prevent a critical level of economic damage. Swiss Re estimated that the latter trajectory, which would mean crossing the 1.5°C threshold by mid-

²⁴FRESHFIELDS BRUCKHAUS DERINGER, *A Legal Framework for Impact: Sustainability impact in investor decision-making*, (2021), <https://www.freshfields.us/4a199a/globalassets/our-thinking/campaigns/legal-framework-for-impact/a-legal-framework-for-impact.pdf> (last visited Jul 13, 2022). The report, which ran to 558 pages, studied the law of jurisdictions significant to global capital markets, including the United States, and the conclusions cited in this comment letter extend to U.S., trustee law.

²⁵ Andrew Howard, *Sustainex*, (2019), <https://prod.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf>.

²⁶ SWISS RE INSTITUTE, *The Economics of Climate Change: No Action Not an Option*, (2021), <https://www.swissre.com/dam/jcr:e73ee7c3-7f83-4c17-a2b8-8ef23a8d3312/swiss-re-institute-expertise-publication-economics-of-climate-change.pdf> (last visited Jul 13, 2022).

century, would result in a 4.2 percent GDP loss compared to no climate change (0°C of warming), while a 2.0°C trajectory would lead to an 11 percent GDP decline. On the higher end, Swiss Re estimated losses of 13.9 percent would be realized by 2050 at 2.6°C and, using the most severe but still possible scenario of 3.2°C, losses to GDP would reach 18.1 percent globally.

These potential GDP differentials are critical to diversified investors: as shown in the ground-breaking study, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors*, the value of a diversified portfolio of equities is directly proportional to GDP.²⁷ Thus, the reductions in GDP described in the Swiss Re report imply trends toward similar reductions in equity portfolio value over time. This relationship holds because common equity represents a right to future cash flows from companies, so that ownership of a portfolio of equities represents the right to the future cash flows of the proportion of the economy that those shares represent. Of course, the multiples at which shares trade may rise and fall, but over the long term, the relationship between portfolio price and GDP is linear.²⁸ Moreover, the climate trajectory can be changed only by changing the way business operates. In the United States, for example, 87 percent of total GHG emissions come from the transportation, electricity generation, industrial, and agricultural sectors,²⁹ all heavily driven by investor-owned companies' decisions.

Climate change is not the only systemic issue where corporate activity has enormous effects on global economic performance. For example:

- *Obesity.* The World Health Organization assesses the unpriced social burdens of obesity as equaling almost 3 percent of global GDP annually.³⁰ The food and beverage business bears significant responsibility for this issue.³¹

²⁷ MATTISON, TREVITT, AND VAN AST, *supra* note 15.

²⁸ *Id.* ("the relationship between GDP and the price of the portfolio of a [long-term, diversified investor] is linear in the long term.") The cited work extends only to the equity portion of an investor's portfolio, but because its premise is the observation that the value of companies equals the value of their future cash flows, we believe that its logic should extend to the debt portion of portfolios as well, because the total return on companies financed with outside capital is equal to the combined cash flows to both debt and equity. Accordingly, an investor's entire debt and equity portfolio, not just the latter, should move together with the value investable universe those companies compose. This reinforces the importance to investors of using their influence to ensure that companies do not degrade broad economic value.

²⁹ OAR US EPA, *Sources of Greenhouse Gas Emissions*, (2015), <https://www.epa.gov/ghgemissions/sources-greenhouse-gas-emissions>.

³⁰ Andrew Howard, *supra* note 25.

³¹ Sugary Drinks, THE NUTRITION SOURCE (2013), <https://www.hsph.harvard.edu/nutritionsource/healthy-drinks/sugary-drinks/>.

- *Inequality*. It has been estimated that inequality has reduced demand by 2 to 4 percent of GDP in recent years.³² In the United States, corporate depression of wages for low-income workers and exploding executive pay are expanding inequality.³³
- *Racial and gender disparities*. Gender and racial gaps created \$2.9 trillion in losses to U.S. GDP in 2019,³⁴ and racial disparities are projected to cost the U.S. economy \$5 trillion over five years.³⁵ Corporations have means to address this issue should they choose to do so.³⁶
- *Antimicrobial Resistance*. The World Bank projects that antimicrobial resistance will reduce global GDP by as much as 3 percent by 2030 and almost 4 percent by 2050; at an intermediate discount rate, this will amount to economic losses by 2050 with a current value of \$54 trillion.³⁷ A UK government-commissioned study puts the figure at \$100 trillion.³⁸ Scholarship links this increasing resistance in part to commercial pressures in agriculture and consumer packaged goods industries.³⁹
- *Democracy at risk*. Social media companies, in their search for platform traffic and advertising revenues, have been fundamental to the rise of far right and authoritarian politicians and governments.⁴⁰ The election of Jair Bolsonaro as president of Brazil is due in part to this phenomenon, and is hastening the climate crisis.⁴¹

In short, the greatest financial risk to the investors whom the Commission is charged with protecting comes from companies pursuing their own financial success by engaging in conduct that puts the entire economy at risk. This chart illustrates the relationships creating this connection:

³² Josh Bivens, *Inequality is slowing US Economic Growth Faster Wage Growth for Low- and Middle-Wage Workers is the Solution*, ECONOMIC POLICY INSTITUTE 28 (2017).

³³ Pizzigati Sam, *Putting the Brakes on Corporate America's Inequality Engine*, INEQUALITY.ORG (2019), <https://inequality.org/great-divide/putting-the-brakes-on-corporate-americas-inequality-engine/> (last visited Aug 11, 2022).

³⁴ Federal Reserve Bank of San Francisco et al., *The Economic Gains from Equity*, ERWP 1.000-30.000 (2021).

³⁵ Lara Ouaroff & Aaron Liu, *Closing the Racial Inequality Gaps The Economic Cost of Black Inequality in the U.S.*, (2020).

³⁶ *Id.*

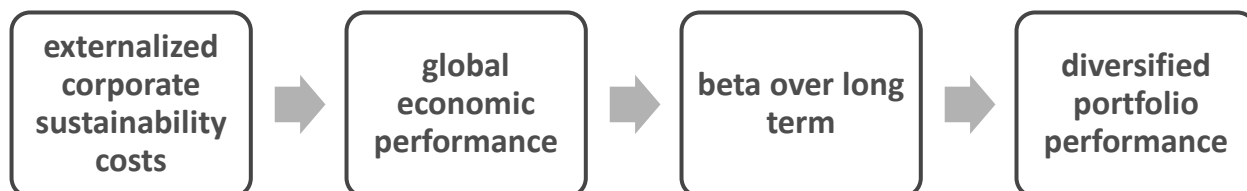
³⁷ WORLD BANK, *Drug-Resistant Infections: A Threat to Our Economic Future*, (2017), <https://documents1.worldbank.org/curated/en/323311493396993758/pdf/final-report.pdf>.

³⁸ JIM O'NEILL, *Antimicrobial Resistance: Tackling a crisis for the health and wealth of nations*, (2014), https://amr-review.org/sites/default/files/AMR%20Review%20Paper%20-%20Tackling%20a%20crisis%20for%20the%20health%20and%20wealth%20of%20nations_1.pdf.

³⁹ Carolyn Anne Michael, Dale Dominey-Howes & Maurizio Labbate, *The Antimicrobial Resistance Crisis: Causes, Consequences, and Management*, 2 FRONT PUBLIC HEALTH 145 (2014).

⁴⁰ Heidi Beirich & Wendy Via, *Democracies Under Threat How Loopholes for Trump's Social Media Enabled the Global Rise of Far-Right Extremism*, (2021), https://www.politico.eu/wp-content/uploads/2021/03/16/GPAHE_Democracies-Under-Threat.pdf (last visited Aug 15, 2022).

⁴¹ Jonathan Watts, *Amazon rainforest 'will collapse if Bolsonaro remains president'*, THE GUARDIAN, July 14, 2021, <https://www.theguardian.com/environment/2021/jul/14/amazon-rainforest-will-collapse-if-bolsonaro-remains-president> (last visited Aug 11, 2022).



While other factors (including alpha) also affect portfolio performance, the above relationships are very strong. In particular, beta is a more important factor in portfolio performance than alpha, and the pursuit of alpha by individual companies can threaten beta.

6. *Pursuit of alpha without prioritizing system stewardship may not address systemic risks*

Given the very different relationships alpha and beta have to portfolio performance, investors should have the tools to determine whether funds pursuit of positive alpha fails to address corporate behavior that threatens beta, the aspect of return matters most to the returns of diversified investors.

Thus, investors have an interest in understanding whether funds are addressing companies that optimize their own financial returns by externalizing social and environmental costs. The costs might include harmful emissions, resource depletion, and the social instability and lost opportunities caused by poor treatment of employees. Diversified investors internalize the collective costs of such externalities (more than \$2 trillion in 2018 according to the Schroders report cited above) because these costs degrade and endanger the stable, healthy systems upon which economic growth and corporate financial returns depend.⁴²

PRI, an investor initiative whose members have \$121 trillion in assets under management, recently described a variety of corporate practices that can boost individual company returns while threatening the economy and diversified investor returns:

A company strengthening its position by externalising costs onto others. The net result for the [diversified] investor can be negative when the costs across the rest of the portfolio (or market/economy) outweigh the gains to the company;

A company or sector securing regulation that favours its interests over others. This can impair broader economic returns when such regulation hinders the development of other, more economic companies or sectors;

⁴² DASGUPTA, *supra* note 21. ("The inability of societies to honour [extra-legal] property rights even when they can be defined gives rise to externalities, which are the unaccounted-for consequences for others, including future people, of actions taken by one or more persons.")

A company or sector successfully exploiting common environmental, social or institutional assets. Notwithstanding greater harm to societies, economies, and markets on which investment returns depend, the benefits to the company or sector can be large enough to incentivise and enable them to overpower any defence of common assets.⁴³

Thus, while individual companies driven by alpha alone can profitably externalize costs from their own narrow perspective (and the perspective of a shareholder of just that company), a diversified investor will almost surely pay these costs through lowered return on their diversified portfolios for the reasons discussed above.

This conflict between alpha and beta does not just exist at the company level. If a fund is overweight in a portfolio company that engages in beta-threatening practices in order to generate alpha, the fund's comparative performance may be enhanced and rewarded, while any beta damage affects all investors equally, so that the market will not attribute the damage to any particular fund's decision not to engage in systems stewardship.

Even if an ESG fund selects companies that do not externalize costs in order to avoid the alpha risks created by such behavior, that aspect of ESG investing may fail to have any impact on the continued cost externalization by the disfavored companies, and thus may not address the systemic threats to beta, which should be the top priority for diversified investors. This failure has two sources. First, a fund may select out of companies where cost externalization creates alpha risk, even while continuing to own companies that contribute to systemic, beta risk. Second, even if the security selection process screens out companies that contribute to beta risk, such screening may not reduce such risk, since the companies involved can continue the same behavior even while owned by other investors.⁴⁴

7. System stewardship is a critical facet of managing a diversified portfolio

Because funds have the power to vote on directors and other matters at investees that endanger systems critical to all companies, they have the power—and the responsibility—to steward companies away from such practices. The PRI report cited above described the investor action necessary to manage social and environmental systems:

Systemic issues require a deliberate focus on and prioritisation of outcomes at the economy or society-wide scale. This means stewardship

⁴³ Susheela Peres da Costa, & Paul Chandler, *Active Ownership 2.0: The Evolution Stewardship Urgently Needs* (2019), <https://www.unpri.org/download?ac=9721>; Addressing Climate as a Systemic Risk: A call to action for U.S. financial regulators, CERES (2020), <https://www.ceres.org/resources/reports/addressing-climate-systemic-risk>. (“The SEC should make clear that consideration of material environmental, social and governance (ESG) risk factors, such as climate change, to portfolio value is consistent with investor fiduciary duty.”) Ceres is a non-profit organization with a network of investors with more than \$29 trillion under management.

⁴⁴ Quigley, *supra* note 2.

*that is less focused on the risks and returns of individual holdings, and more on addressing systemic or 'beta' issues such as climate change and corruption. It means prioritising the long-term, absolute returns for universal owners, including real-term financial and welfare outcomes for beneficiaries more broadly.*⁴⁵

In a similar vein, the Freshfields report suggests that alpha-oriented strategies (e.g., enterprise value ESG investing) are of limited value to diversified shareholders, and that systems stewardship is the best way for investors to improve performance:

The more diversified a portfolio, the less logical it may be to engage in stewardship to secure enterprise specific value protection or enhancement. Diversification is specifically intended to minimise idiosyncratic impacts on portfolio performance...

*Yet diversified portfolios remain exposed to nondiversifiable risks, for example where declining environmental or social sustainability undermines the performance of whole markets or sectors... Indeed, for investors who are likely to hold diversified portfolios in the long-term, the question is particularly pressing since these are likely to be the main ways in which they may be able to make a difference.*⁴⁶

For similar reasons, Professor John Coffee, the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance, predicted that systems stewardship would surpass ESG integration in a recent law review article:

*This latter form of activism [systems stewardship] is less interested in whether the target firm's stock price rises (or falls) than in whether the activist investor's engagement with the target causes the total value of this investor's portfolio to rise (which means that the gains to the other stocks in the portfolio exceed any loss to the target stock). This recognition that change at one firm can affect the value of other firms in the portfolio implies a new goal for activism: namely, to engineer a net gain for the portfolio, possibly by reducing "negative externalities" that one firm is imposing on other firms in the investor's portfolio.*⁴⁷

⁴⁵ *Id.*

⁴⁶ See FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 24.

⁴⁷ John C. Coffee, *The Coming Shift in Shareholder Activism: From*, (2021), <https://papers.ssrn.com/abstract=3908163> (last visited Aug 11, 2022).

The logic expressed by these authorities is undeniable: given the critical importance of overall market return, and the danger to that return from corporate activity that damages social and environmental systems, investors who buy funds that use ESG factors should have an understanding whether the funds are acting to protect their investors from individual companies that focus on their own performance to the detriment of overall market return.

However, the financial system is not necessarily structured in a manner that accommodates systems stewardship. The Commission can address this structural concern by requiring funds that use ESG factors to provide investors with information concerning their efforts to limit threats to the social and economic systems upon which other companies in their portfolios rely.

8. Investment professionals have structural incentives to focus on alpha and enterprise value ESG investing, but ignore beta and system stewardship

There is a risk that funds and their advisors may focus on enterprise value ESG investing in preference to systems centered investing because the former is much more salient when gauging the performance of portfolios. Alpha—both positive and negative—is assessed in relation to the performance of others. Thus, the alpha that funds achieve will always be known, and low positive or negative alpha may trigger lower compensation, client loss, or employment termination for responsible individuals.

In contrast, measuring contribution to beta is very difficult because all diversified portfolios share the benefits (and losses) of beta changes. Thus, investment professionals may perceive little career or relative compensation risk in ignoring beta threats since their relative performance will not suffer. As Lukomnik and Hawley put it:

*[T]he benefit to the industry as a whole does not neatly translate to any individual firm. Because impacts of [systems stewardship] are market-wide, this does not allow firms to differentiate themselves the way trading (alpha seeking) does. This is a traditional “free-rider” problem, in which those firms that do not contribute to [system stewardship] will still benefit . . .*⁴⁸

Disclosures that clarify a fund’s alpha and beta strategies can help to remedy this imbalanced salience in order to help address the free rider problem.⁴⁹

⁴⁸ DASGUPTA, *supra* note 21 at 108. The authors point out that there is an overall compensation benefit to asset managers of lifting beta, because asset management fees are a function of the value of the assets being managed

⁴⁹ Although beyond the scope of the Commission’s request for comments, this salience concern suggests that the Commission should consider requiring all funds to disclose the extent to which their strategies favor alpha over beta. Funds may well be promoting positive alpha in their disclosure but failing to disclose that the portfolio companies contributing to those returns are endangering beta, and thus the absolute returns of the funds’ diversified clients.

F. Proposed Changes

We urge that the Proposed Rules be revised to reflect the importance of systems stewardship and to require that funds explain whether their strategy focuses on alpha, beta, or both, how they deal with situations where the two are in conflict, and how their style of investing is likely to impact diversified investors.

1. Names Rule

The Names Rule would require that 80% of the securities owned in a fund with a name indicating the use of ESG investing factors be invested according to such factors.

This requirement would exclude a fund with a beta-oriented strategy focused on improving corporate impact through stewardship, the strategy most directly designed to change corporate behavior. We urge that the Names Rule be altered to clarify that if a fund actively uses its corporate governance rights to steward companies to improve their social and environmental impacts, it should be able to use a name that so indicates, even if it does not select securities on an ESG basis.

If funds are permitted to use an “ESG” label for funds that have no intention to improve environmental impacts through stewardship, but only to use ESG factors as security selection tools to improve fund alpha, then funds that are intentionally designed to improve social and environmental outcomes through stewardship (and thereby provide the greatest potential ESG benefits to diversified shareholders) will be severely prejudiced. Not only would this be unfair to stewardship-oriented funds, but it would also have a potentially negative impact on society, the environment and market returns, by discouraging systems stewardship.

If there is a concern that using the ESG label for funds that focus on stewardship rather than security selection would be confusing, the Names Rule could require that funds that do not meet the 80% basket test be required to engage in a certain level of stewardship and disclosure regarding its stewardship strategy. Alternatively, such funds could be required to use a term such as “stewardship” in their name, in order to indicate their ESG strategy is based on voting and engagement, rather than security selection.

2. ESG Rule

As discussed above, there is an ambiguity inherent in the use of “ESG” or similar terminology that allows the term to be used for funds having very different purposes: ESG factors can be used solely to improve a fund’s alpha or they can be used to improve the environment and society (and by doing so, improve investment outcomes for all diversified investors). This ambiguity can be misleading, because many investors believe that by purchasing ESG funds, they are having a positive social and environmental impact, whereas ESG investing can be used without any intention of improving overall environmental and social outcomes or absolute investment returns.

Accordingly, we propose that ESG integration funds and ESG-focused funds be required to discuss whether each of their investment decisions and proxy voting and/or engagement is intended to (a) improve the fund's relative performance, (b) improve the impact that companies have on social and environmental systems, (c) improve overall market performance so as to benefit diversified shareholders or (d) provide some combination of (a)-(c). The discussion should include an explanation of overall strategy for achieving these goals, and, to the extent the fund aims to achieve some combination of such goals, the discussion should address how the fund would resolve any conflict among them.

* * * *

For all the reasons expressed above, we urge that the Proposed Rules be modified to provide greater clarity around the intent of a fund in using ESG factors by articulating the extent to which the fund focuses on enterprise value ESG investing, systemic stewardship, or a combination of the two. Such enhancements will provide important information to investors who desire to invest through funds that use ESG factors, and will help to ensure that the salience of alpha in fund performance does not overcome the ability of investors to pick funds that commit resources to improving beta

Sincerely,



Frederick Alexander
CEO