Dimensional

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August 16, 2022

Vanessa A. Countryman, Secretary
US 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

Dear Ms. Countryman,

Dimensional Fund Advisors LP ("Dimensional") appreciates the opportunity to provide the US Securities and Exchange Commission (the "Commission") with our views on its proposal to enhance disclosures by funds and advisers about environmental, social, and governance ("ESG") investment practices.[1] Dimensional is registered investment adviser and manages 147 registered mutual funds and exchange-traded funds in the US,[2] including several with a focus on sustainability or social issues.

We share the Commission's concern that funds and advisers may be incentivized to exaggerate the extent to which their strategies take into account ESG considerations, and we support the Commission's goal of facilitating enhanced disclosure of ESG issues for the benefit of investors. To that end, we strongly believe that the Commission's regulatory focus should be on funds that emphasize non-financial benefits. When a fund only pursues financial goals, investors already have the information they need to evaluate whether the fund is delivering on those goals—they can review a variety of return-related metrics. However, without adequate reporting, it can be much too difficult for investors to assess whether a fund has achieved any *non*-financial goals that it seeks to pursue, such as having a positive impact on the environment or aligning its investments with certain values. When a fund markets non-financial benefits, we believe it is vital that the fund provide information that enables investors to assess the non-financial characteristics of the fund.

For these reasons, we encourage the Commission to consider whether its proposed definitions of Integration Fund, ESG-Focused Fund, and Impact Fund sufficiently address the Commission's concerns about greenwashing. We also urge the Commission to adopt a principles-based approach to both disclosure and reporting for ESG-Focused Funds. If, instead of being required to report prescribed one-size-fits-all metrics, ESG-Focused Funds are permitted to provide reporting that the fund has determined is appropriate and relevant to an investor's understanding of how the fund's ESG strategy has performed, we believe investors will be better

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1 US Securities and Exchange Commission, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, Release Nos. IA-6034, IC-34594 (May 25, 2022) (the "Proposing Release").

2 As of the date of this letter.

equipped to evaluate whether such funds are delivering the non-financial benefits that they claim to pursue.

I. Proposed Definitions

A. Integration Funds

The Commission proposes to define the term "Integration Fund" as a fund "that considers one or more ESG factors alongside 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, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio."[3] We believe this definition is overly broad, and we submit that a definition of Integration Fund is unnecessary to achieve the Commission's goals.

In our view, the challenge in defining the term Integration Fund is how to draw the line between an Integration Fund and a fund that does not consider ESG at all. For example, the Commission notes that funds that engage in fundamental-oriented analysis have long considered governance factors in their investment selection process.[4] As proposed, we believe the definition of Integration Fund would include such funds, regardless of whether they hold themselves out as Integration Funds. Furthermore, if investors view Integration Funds in a positive light, then this could lead to greenwashing, as funds will be incentivized to do the bare minimum to be categorized as an Integration Fund. If a fund that applies a single governance-related exclusionary screen can call itself an Integration Fund, it would deprive the term of its meaning and utility to investors.

However, there are also difficulties in trying to limit the universe of Integration Funds by prescribing a set of minimum criteria to qualify as an Integration Fund. Because there are many different kinds of ESG strategies, it is extremely challenging to suggest minimum criteria that would be relevant, useful, and equally applicable to all strategies. Minimum criteria would have to be very prescriptively defined, which would risk stifling innovation and competition. For example, requiring that a minimum proportion of a fund's investment universe be excluded based on ESG considerations would pose interpretive problems, as it would depend on how the starting investment universe is defined. With an index fund, it may be possible to demonstrate that an ESG-screened index differs by a certain percentage from an unscreened index, whereas for an actively managed fund, it would be far more difficult to assess. For example, if a growth fund does not invest in oil and gas stocks because they do not meet the fund's definition of growth stocks, would it be appropriate to count those names toward the fund's proportion of the universe excluded on sustainability grounds?

We recognize the challenge the Commission faces in crafting a definition of Integration Fund that appropriately draws the line between an Integration Fund and a fund that does not consider ESG. However, we respectfully submit that the Commission's goals can be achieved without defining the term Integration Fund at all. In our view, the main benefit in defining the term Integration Fund is that it enables the Commission to prohibit such funds from using ESG terms

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[3] Proposed Form N-1A, Item 4(a)(2)(i)(A).

[4] Proposing Release at 30.

in their names.[5] We support this proposed prohibition, and we agree that if a fund does not use ESG as a significant or main consideration, it should not be able to use ESG terms in its name. This goal could also be achieved by reframing the proposed rule so that only ESG-Focused Funds are permitted to use ESG terms in their names. We believe this will resolve the Commission's concern that investors are being misled by fund names in cases where ESG considerations do not play a central role in the fund's strategy.

If only ESG-Focused Funds can use ESG terms in their names, then we do not see any additional benefit in defining the term Integration Fund and requiring such funds to include specific disclosures. All funds are already required to disclose their principal investment strategies and the principal risks of investing in the fund, and we believe that in some cases, the proposed additional disclosure requirements could mislead investors. For some Integration Funds, including "a few sentences" in the fund's summary prospectus to describe how the fund incorporates ESG could *overemphasize* the extent to which the fund considers ESG factors.[6] The amount and location of ESG-related disclosure should be commensurate with the extent to which the fund considers ESG, and the determination of how much disclosure to include and where is better left to each fund, rather than mandated by an overly prescriptive rule.

Finally, as noted above, we strongly believe that the Commission's focus should be on ESG-Focused Funds, rather than on Integration Funds. Because ESG-Focused Funds tend to emphasize non-financial benefits, it can be more difficult for investors to assess whether such funds are achieving the non-financial benefits that they claim to pursue. Integration Funds do not typically seek non-financial benefits, and investors can already easily assess the efficacy of an Integration Fund's strategy by reviewing its financial performance. For these reasons, we strongly encourage the Commission to reconsider whether it is necessary to define the term Integration Fund.

B. <u>ESG-Focused Funds and Impact Funds</u>

The Commission proposes to define the term "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[7] or (2) in its engagement strategy with the companies in which it invests."[8] As drafted, we believe that a significant number of funds—including virtually any fund that has an engagement strategy—could qualify as ESG-Focused Funds. Under the second prong of the definition, funds that use ESG factors as a significant or main consideration in their engagement strategy would be considered "ESG-Focused Funds." Engagement strategies vary from fund to fund, but they tend to have one goal in common: maximizing shareholder value. If a risk is financially material to a company, then the company's shareholders should want the company to pay close attention to that risk, so that the company can minimize losses and maximize profits. And since many ESG issues can be financially material, the engagement strategies of many funds

[5] *See* US Securities and Exchange Commission, *Investment Company Names*, Release No. IC-34593 (May 25, 2022).

[6] *See* Proposed Form N-1A, Item 4(a)(2)(ii)(A).

[7] We recommend replacing "in selecting investments" with "in the investment decision process" to more accurately reflect that funds may consider ESG both in the security selection process and in making decisions as to how to weight those securities.

[8] Proposed Form N-1A, Item 4(a)(2)(i)(B).

necessarily focus on one or more ESG factors. At Dimensional, for example, we strive to enhance and protect shareholder value by focusing on foundational governance principles, including board structure and composition, risk management, shareholder rights, and executive compensation. This is the focus of our strategy for engagement with any portfolio company, not only when engaging on behalf of funds that consider sustainability or social issues as part of their principal investment strategies.[9]

As proposed, the definition of "Impact Fund" also appears to be rather broad. An "Impact Fund" would include "an ESG-Focused Fund that seeks to achieve a specific ESG impact or impacts."[10] Based on a reading of the definition alone, it would seem that an ESG-Focused Fund could simply add a fund level ESG impact goal to its investment objective and qualify as an Impact Fund. For example, a fund could state that the specific ESG impact it seeks is a reduction in fund level exposure to companies with low ESG ratings. In the Proposing Release, the Commission describes impact strategies as those that "generally seek to target portfolio investments that drive specific and measurable environmental, social, or governance outcomes,"[11] which suggests that the Commission may have had a narrower range of funds in mind. We note that there is much debate among academics and practitioners as to what extent portfolio allocation decisions drive real-world outcomes,[12] and how "impact investment" should be defined.[13] We encourage the Commission to revisit whether its proposed definition accurately describes the funds that it had envisioned.

With respect to both definitions, it is unclear to us whether the Commission intentionally drafted broad definitions so as to elicit ESG-related disclosures from a wide swath of funds. Another approach would be to adopt narrower definitions, which would limit the universe of funds that could call themselves ESG-Focused Funds or Impact Funds. In our view, investors may find the latter approach more useful. If an extremely varied range of funds can easily qualify as Impact Funds or ESG-Focused Funds, then the usefulness to investors of these labels will be diminished. Narrower definitions may also help limit the risk that a fund's actual consideration of ESG issues does not match up with investor expectations.

Regardless of the Commission's definitional approach, we urge the Commission to clarify that the disclosure requirements for ESG-Focused Funds and Impact Funds apply only if a fund holds itself out as an ESG-Focused Fund or an Impact Fund in its prospectus, marketing materials, or otherwise. In our view, it would be appropriate for the definitions to apply on an "opt-in" basis

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9 Dimensional may discuss governance matters with portfolio companies to represent client interests; however, regardless of such conversations, Dimensional on behalf of its clients acquires securities solely for the purpose of investment and not with the purpose or intended effect of changing or influencing the control of any portfolio company.

10 Proposed Form N-1A, Item 4(a)(2)(i)(C).

11 Proposing Release at 15.

12 *See*, for example, Berk, Jonathan B. and Jules H. van Binsbergen, *The Impact of Impact Investing* (August 21, 2021), available at https://ssrn.com/abstract=3909166.

13 *See*, for example, Busch, Timo, Peter Bruce-Clark, Jeroen Derwall, Robert Eccles, Tessa Hebb, Andreas Hoepner, Christian Klein, Philipp Krueger, Falko Paetzold, Bert Scholtens & Olaf Weber, *Impact Investments: A Call for (Re)orientation* (Jan. 11, 2021), available at https://link.springer.com/article/10.1007/s43546-020-00033-6.

so as not to require funds that do not claim to pursue an ESG-related strategy to include ESG-specific disclosures.

II. Disclosure Requirements for ESG-Focused Funds

Under the proposed rules, an ESG-Focused Fund would be required to include an ESG Strategy Overview Table at the beginning of the Risk/Return Summary in its Summary Prospectus. The table would contain an overview of the fund's ESG strategy, "check the box" disclosures relating to how the fund implements its ESG strategy, and descriptions of how the fund incorporates ESG factors in its investment decisions and how the fund votes proxies and/or engages with companies about ESG issues. We believe investors would benefit from a more principles-based approach.

One example of overly prescriptive disclosures is the proposed "check the box" disclosures in the ESG Strategy Overview Table, and the instruction that a fund may only check the "proxy voting" and "engagement with issuers" boxes if they are a "significant means" of implementing the fund's strategy. Besides being an example of prescriptive disclosure, this has the potential to mislead investors. The "significant means" standard only applies to two of the six checkbox options, and this distinction is not made anywhere in the ESG Strategy Overview Table itself. If a fund votes proxies and engages with issuers extensively but does not use these tools as a "significant means" of implementing the fund's ESG strategy, an investor would see that the fund has not checked the "proxy voting" or "engagement with issuers" boxes and may incorrectly assume that the fund does not vote proxies or engage with issuers at all. An ESG-Focused Fund will already be required to describe "how the Fund votes proxies and/or engages with companies about ESG issues" in the third row of the proposed ESG Strategy Overview Table, and we believe that this disclosure should be sufficient to indicate to investors how the fund uses proxy voting or engagement with issuers to implement its ESG strategy.

We also urge the Commission not to require funds to disclose third-party vendor methodologies. In our experience, third-party providers' methodologies are extremely complicated and much too extensive to be summarized in a meaningful way. In general, we do not believe that including a summary of a third-party's methodology would add to an investor's understanding of how we manage our portfolios.

III. Reporting Requirements for ESG-Focused Funds

As described above, we believe that an ESG-Focused Fund should provide reporting that enables investors to assess whether the fund is delivering the non-financial benefits that it seeks to achieve. Rather than requiring all ESG-Focused Funds to report the same one-size-fits-all proxy voting, engagement, and climate-related metrics, we encourage the Commission to take a principles-based approach and require funds to provide reporting that is appropriately tailored and directly relevant to the fund's ESG strategy.

A. ***Proxy voting and engagement metrics***

Under the proposed rules, an ESG-Focused Fund that uses proxy voting as a significant means of implementing its ESG strategy would be required to disclose the percentage of ESG voting matters for which the fund voted in furtherance of the initiative. We believe this disclosure would not be useful to investors and could be misleading. Proxy voting is a complex matter, and it is too simplistic to judge the efficacy of a fund's proxy voting strategy by looking solely the number of times a fund votes "for" or "against" an ESG-related initiative. There are many instances where a "no" vote on an ESG-related vote does not necessarily mean that a fund is voting against the ESG matter. For example, in the case of so-called "say on climate" votes, where a company asks investors for their "say" on the company's climate transition plans, an investor might vote "no" not because the investor disagrees that the company should have a transition plan, but because they do not believe the company's proposed plan does enough to mitigate the company's impact on the environment, or because the company already has a transition plan in place. There are also cases where there might be two climate-related proposals on the ballot that present two different options for achieving the same goal, in which case an investor may vote "yes" on the proposal that it believes is more appropriate and "no" on the other. Requiring disclosure of proxy voting metrics may also lead to a form of greenwashing—funds can look "good" by voting against management on non-binding, broad disclosure-based proposals, regardless of whether they are holding directors accountable for the management of environmental or social issues.

We see similar issues with the proposed requirement that certain ESG-Focused Funds disclose metrics relating to the number of ESG engagement meetings held. The success of an engagement strategy is subjective and not easily reduced to statistics. Requiring funds to report the number of ESG engagement meetings held may incentivize funds to have more "easy" meetings with more companies that they can count in their annual reports, rather than engage on more difficult issues with companies where the engagement could have a deeper impact.

Instead of requiring quantitative proxy voting and engagement metrics, the Commission could require an ESG-Focused Fund that uses proxy voting or engagement as a significant means of implementing its ESG strategy to provide narrative disclosure explaining how it has used proxy voting and engagement to implement its ESG strategy. A fund could then choose to supplement its narrative disclosure with metrics, if appropriate and relevant to how the fund uses proxy voting and engagement. We believe this approach would be more informative to investors and enable them to better assess the efficacy of a fund's proxy voting or engagement strategy.

B. ***Climate-related metrics***

The proposed rules would require environmentally focused funds to disclose the carbon footprint and weighted average carbon intensity of the fund's portfolio, as well as the Scope 3 emissions, if available, for each industry in which the fund invests. We strongly believe that environmentally focused funds should not be required to report a standard set of climate-related metrics. To be clear, we agree that there is value in reporting portfolio level climate-related metrics. However, we believe it would better serve investors if a fund can determine which climate-related metrics would be most relevant to an investor's understanding of how the fund seeks to achieve its climate-related goals.

We recognize that the Commission's goal in requiring disclosure of a standard set of metrics is to promote comparability among environmentally focused funds. However, our concern is that the proposed rules will result in a false sense of comparability. First, greenhouse gas emissions ("GHG") data is dependent on the data provider's methodology. The Commission prescribes a specific hierarchy of emissions data to be used, however prescribing a hierarchy could undermine the reliability of reported metrics.[14] For example, under the proposed hierarchy, if a company includes emissions data in its regulatory reports, funds would be required to use that data. However, under the Commission's proposed rules, public companies can choose which method of calculating its Scope 2 emissions to use (*e.g.*, location-based, market-based, or another method).[15] Because companies can use different methodologies even in regulatory reports filed with the Commission, it could be more reliable for a fund to look to other sources of data so that the fund can calculate its portfolio level emissions using the same method across all portfolio companies. Funds should have the flexibility to determine what data would lead to the most reliable climate-related metrics, and therefore we support allowing funds to use the data that they believe in good faith to be the most reliable.

We are particularly concerned with the proposed requirement that funds report Scope 3 emissions on an industry level basis for certain portfolio companies. It is our understanding that most companies are not able to estimate their Scope 3 emissions with reasonable reliability at this time. In its proposal to require public companies to include climate-related disclosures, the Commission recognizes the difficulties in calculating Scope 3 emissions and has not proposed to require all public companies to disclose their Scope 3 emissions.[16] For the same reasons, we do not think it would be appropriate to require funds to report the Scope 3 emissions of their portfolio companies at this time.

If the Commission proceeds with its proposal to require funds to disclose standard climate-related metrics, we recommend that sovereign bonds, as well as any government-related bonds such as agencies, local authorities, and supranational organizations, be excluded from the calculation of any portfolio level metrics. In our experience, GHG emissions data for government-related entities tends to be less readily available, and the way that government-related entities calculate their emissions data can differ from the way that corporate entities calculate emissions. As a result, we do not think it is generally appropriate to include emissions of government-related entity in portfolio level metrics.

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With respect to the proposed disclosure requirements for advisers on Form ADV, we similarly believe that the Commission's focus should be on advisers that manage strategies where ESG is a significant or main consideration. As with Integration Funds, requiring advisers to include

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14 We also note that in Question 124 of the Proposing Release, the Commission asks whether it should limit a fund's ability to invest in companies that do not report emissions to 20% of the fund's net asset value. We strongly oppose limiting a fund's ability to invest in a company based on whether the company reports emissions. This would unnecessarily limit the universe of companies in which a fund could invest, to the detriment of investors.

15 US Securities and Exchange Commission, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, Release Nos. 33-11042; 34-94478 (Mar. 21, 2022) at 204.

16 *Id*. at 182.

additional disclosure about how they integrate ESG may result in an overemphasis on how an adviser uses ESG. We encourage the Commission to revisit its proposed amendments to Form ADV with this in mind.

Finally, many of the concerns we express in this letter relate to the risk that overly prescriptive requirements will result in an overemphasis on ESG in fund disclosures. These concerns stem from our conviction that markets already price ESG-related risks. We believe that increasing the prominence of ESG-related disclosure and potentially overemphasizing a fund's consideration of ESG could inadvertently mislead investors by implying that a fund can outperform the market by evaluating ESG criteria. There is a wealth of evidence that the market typically does a better job than most individual investors at evaluating risks and opportunities. This is supported by numerous studies demonstrating that most traditional active managers underperform the market,[17] and there is no compelling evidence that things should be different when the market is assessed through an ESG lens.

Despite our concerns, we believe the Commission can achieve its goal of facilitating enhanced disclosure of ESG issues for investors by adopting a principles-based approach to both disclosure and reporting for ESG-Focused Funds. We also encourage the Commission to carefully consider whether its proposed definitions of Integration Fund, ESG-Focused Fund, and Impact Fund sufficiently address the Commission's objectives for this proposed rule, including its concerns about greenwashing. Finally, we urge the Commission to consider whether the costs of requiring funds and advisers to comply with prescriptive and burdensome disclosure requirements are expected to justify the perceived benefits to investors. If we can be of further assistance, please do not hesitate to contact Stephanie Hui, Vice President and Counsel. We would welcome the opportunity to expand on our discussion of these issues.

Sincerely,

Gerard O'Reilly
Co-CEO and Chief Investment Officer

Jim Whittington
Head of Responsible Investment and Senior Portfolio Manager

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17 See, for example, Dimensional Fund Advisors, *The Fund Landscape*, available at https://tinyurl.com/vsbruxw4; S&P Dow Jones Indices, *SPIVA Scorecards*, available at https://www.spglobal.com/spdji/en/research-insights/spiva/; Fama, Eugene and Ken French, "Luck versus Skill in the Cross-Section of Mutual Fund Returns," *The Journal of Finance*, Vol. LXV, No. 5 (October 2010), available at https://mba.tuck.dartmouth.edu/bespeneckbo/default/AFA611-Eckbo%20web%20site/AFA611-S8C-FamaFrench-LuckvSkill-JF10.pdf.