accountability counsel | IDI Inclusive Development International | Friends of the Earth United States

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

August 16, 2022

Re: Comments on SEC proposed rule on enhanced disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices

Dear Ms. Countryman:

Inclusive Development International (IDI), Accountability Counsel, and Friends of the Earth US submit this letter to provide our comments regarding SEC Release No. 33-11068, published on May 25, 2022, regarding the fiduciary standards for investment advisers (IA) and investment companies (IC) related to their Environmental, Social, and Governance (ESG) practices.

Inclusive Development International is a US non-profit organization that works to advance social, economic, and environmental justice by supporting communities around the world to defend their human rights and environment in the face of harmful corporate activities.[1]

Accountability Counsel is a US non-profit organization that amplifies the voices of communities around the world to protect their human rights and environment. As advocates for people harmed by internationally financed projects, Accountability Counsel employs community-driven and policy-level strategies to access justice.[2]

Friends of the Earth US is a US non-profit organization that conducts policy analysis and advocacy campaigns to change the rules of our economic and political systems that create injustice and destroy nature.[3]

We commend the SEC for proposing rules regarding ESG practices for IAs and ICs. As the SEC noted in its proposed release: the Commission's goal in promulgating this rule is to provide "consistent, comparable, and reliable" information regarding the factors that IAs and ICs use in relation to so-called ESG funds. For too long, funds have taken advantage of the lack of regulation to market themselves as "ESG" friendly when, in fact, the corporations within their portfolios have contributed to significant, adverse, impacts in relation to one or more of the three components of ESG – environmental, social, and governance issues. Having the SEC promulgate rules that require these actors to disclose information regarding their methodology in considering ESG criteria provides vital information for investors seeking to invest in ethical funds that provide an environmental and social return in addition to a financial one.

[1] Learn more at: https://www.inclusivedevelopment.net.
[2] Learn more at: https://accountabilitycounsel.org.
[3] Learn more at: https://foe.org.

We also note that the SEC's proposed rules align with the Biden Administration's current work regarding revising its National Action Plan on Responsible Business Conduct to include a "whole of government approach" to handling issues that "emphasiz[e] and accentuat[e] the positive contributions businesses can make to economic, environmental, and social progress."[4]

By requiring ICs and IAs to identify and summarize their methodologies – including their use of ESG rating agencies and other third party service providers – the SEC will help shed light on what is currently a black box of investment practices that has, as the SEC notes, "rapidly increased in recent years with significant inflows of capital to ESG-related services and investment products."[5]

Through painstaking research, IDI has uncovered evidence regarding the perils of allowing so-called ESG funds to operate without regulation or oversight. For instance, in March 2022, IDI (along with ALTSEAN-Burma) published an exposé that demonstrates how, by using the label of "ESG," funds raise enormous amounts of capital - from unsuspecting investors seeking to invest with their values – using portfolio companies that are complicit in some of the most egregious human rights abuses and international crimes. The investigation produced the Myanmar ESG Files, which shows how "ESG-labeled funds have funneled billions into companies arming, funding, and legitimizing the Myanmar military, the perpetrator of the Rohingya genocide and a violent crackdown on the country's pro-democracy movement."[6] These companies include weapons dealers that are arming the regime, tech firms serving the military-controlled national police force, and others that direct profits to the military, allowing it to surveil and violently crush dissent. The investigation found that funds carrying the ESG label held at least $13.4 billion worth of shares in 33 companies linked with the Myanmar military. The funds were tied to various ESG indexes, on which the 33 companies were listed, based on opaque, inconsistent and flawed ratings and criteria.

To begin to address the false and misleading marketing of many ESG funds, and the flawed data and assumptions upon which their portfolios are constructed, we propose three specific recommendations for changing the SEC's proposed rule:

(1) Move beyond a disclosure-based framework and specifically define what should and should not be included in an ESG fund (or, at a minimum, require ICs to provide specific, delineated, criteria for each aspect of ESG).
(2) Increase the SEC's oversight to include third party data providers.
(3) Adopt a standard of materiality that goes beyond financial impact, and includes impacts on people and the environment.[7]

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[4] *See* National Action Plan on Responsible Business Conduct: Notice of Opportunity to Submit Written Comments (Feb. 28, 2022) *available at* https://www.federalregister.gov/documents/2022/02/28/2022-04178/national-action-plan-on-responsible-business-conduct-notice-of-opportunity-to-submit-written

[5] *See* SEC Release No. 33-11068, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (May 25, 2022)(*hereinafter* SEC Proposed Rule)

[6] Myanmar ESG Files: How "responsible investment" is enabling a military dictatorship, Inclusive Development International and ALTSEAN-Burma (March 2022), at: https://www.inclusivedevelopment.net/myanmaresgfiles/

[7] Note that the SEC has already taken the first step by acknowledging that investors might make investing decisions for reasons other than purely profit. It should therefore ensure investors have access to the data relevant to such decision making. *See* SEC Proposed Rule, *supra* note 5 at 20 (stating that "investors might be more likely to have an interest in …

I. The SEC should adopt a substantive standard that defines ESG rather than one that relies on a disclosure-based framework.

In the SEC's Proposed Rule, the Commission, rather than setting forth specific criteria or even a minimum standard for what constitutes an ESG fund, instead simply requires ICs to explain the factors that it is choosing to use. While such a standard is an improvement over the current lack of disclosure in this area, the Proposed Rule still allows for too much discretion regarding what selection criteria an IC can use in determining which companies are, in essence, ESG compliant.[8] For instance, the standard under the Proposed Rule would allow ICs to include companies in their ESG funds as long as they meet the IC's self-determined criteria, even if those portfolio companies have a dismal record on one or more ESG issues, including human rights. This allows "ESG-Focused funds" and "Impact Funds" (as they are currently defined in the Proposed Release) to include portfolio companies within their investment strategies even if there are aspects of the company that are an affront to ESG related issues. As an example:

> ABC Impact Fund focuses on investing in securities that focus on reducing carbon emissions. To that end, ABC has acquired XYZ Corporation's securities as part of its fund portfolio because XYZ has pledged to reduce its carbon output to zero by the year 2030. However, XYZ has consistently been engaged in well-documented, negative human rights impacts, such that would impinge upon that company's "S" criteria related to ESG factors. In addition, XYZ has also caused deforestation, pollution of rivers and other localized environmental damage that would affect other aspects of its "E" performance. Under the SEC's Proposed Rule, ABC is still able to include XYZ within its portfolio of investments. Even more troublesome, ABC would not be required to disclose – to investors (and IAs would not have to disclose to its clients) - that XYZ has caused these negative impacts so long as they were not part of ABC's calculations.[9]

This is not just a hypothetical scenario but rather a commonplace occurrence in the holdings of the most prominent funds in the ESG market. IDI has followed the money behind more than 200 large projects in Asia and Africa that are implicated in serious human rights violations and environmental destruction[10] and has consistently found that the public companies behind these projects get high ESG marks, landing them on key indices and funds. For instance, SK Holding is a Korean company that is responsible for one of the worst development disasters in the Southeast Asia region - the collapse of the Xe Pian Xe Namnoy dam in 2018. This disaster killed at least 71 people and left thousands homeless. To this day, most of the survivors are still languishing in temporary camps with dire conditions. United Nations human rights experts have publicly criticized the company's negligence, which led to the humanitarian disaster, as well as its failure to provide any

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ensur[ing] that the [IC's] process aligns with the ESG-related values or priorities of the investor, rather than simply as a means for gauging effectiveness of the end result of financial return.")

[8] This will also likely result in an IC relying more on third party data providers, an issue we take up in Part 2.

[9] *See* Dustin Roasa, *Opinion: How a Laos dam collapse exposes flaws in ESG investments*, Thomson Reuters News (Dec. 16, 2021) *available at* https://news.trust.org/item/20211216162549-rz27f/

[10] https://www.inclusivedevelopment.net/following-the-money/

remedy to the affected communities. At the time of the dam burst the company had been in many of ESG indexes and funds with, in the case of MSCI a "moderate" BBB rating. However, the company's ESG rating did not decrease following the event. Rather, three months after the dam collapse the company's rating had increased to an A and, within three years, the rating had increased to AA, the second-highest score offered by MSCI.[11] Why? We asked MSCI and they posited that it was because the company had made a net zero carbon emissions commitment.[12]

In addition, the fact that the Proposed Rule does not require the IC to further delineate between the "E" the "S" and the "G" will invariably lead to conflation and obfuscation of these specific criteria. This will once again thwart the SEC's efforts in this area by providing another layer of inconsistent criteria, posing even more difficulties for investors who care about **all** aspects of ESG. In contrast, requiring ICs to discuss and measure all three criteria separately in their prospectus would assist investors in making reasonably informed decisions regarding what factors to prioritize within their own investment decisions. Therefore, at a minimum we suggest that ICs and IAs offering products that carry the ESG label be required to separately disclose what factors they use to assess each specific aspect of environment, social, and governance issues.

The first question that the Commission asked in its Proposed Rule was whether it should "seek to define "ESG" or any of its subparts in the forms?"[13] We believe that establishing a definition or taxonomy is crucial to repairing the fundamental flaws of the ESG investment industry. Indeed, since the SEC's stated goal is to provide "investors with clear, consistent, and decision-useful-information,"[14] the best way to promote consistency would be for the SEC to provide a clear and substantive ESG standard against which funds can be assessed before they can be categorized as "ESG-focused funds."[15] Unfortunately, the disclosure-based model that underlies the SEC's Proposed Rule only requires funds to disclose what *they* consider ESG to mean. As such, this will not help advance the SEC's goal of consistency and will not prevent "greenwashing" or misleading claims about the real world impacts of portfolio companies and funds.

II. Broaden the SEC's oversight to include third party data providers

As the SEC's Proposed Rule notes "Investment advisers and fund managers often collect, digest, and evaluate information on ESG factors other than that disclosed by corporate issuers to incorporate in their investment decision."[16] Typically, they do so by relying on third party ESG providers.[17] The rule, as currently written, would require ESG-focused funds to provide an "overview of the fund's ESG strategy," including a description of the fund's incorporation of any ESG factors in investment decisions. "[I]f the fund uses … a third-party data provider … in evaluating, selecting

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[11] *See* Dustin Roasa, *Opinion: How a Laos dam collapse exposes flaws in ESG investments*, Thomson Reuters News (Dec. 16, 2021) *available at* https://news.trust.org/item/20211216162549-rz27f/

[12] https://sk-perspectives.com/posts/sk-at-ces-2022-will-you-join-us-on-the-net-zero-journey

[13] SEC Proposed Rule, *supra* note 5 at 25.

[14] SEC Proposed Rule, *supra* note 5 at 253.

[15] Indeed, this is the approach that the European Commission is taking in its taxonomy for sustainable activities. *See* EC Taxonomy, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

[16] SEC Proposed Rule, *supra* note 5 at 200.

[17] *Id.*

or excluding investments, the fund's disclosure … describe[s] how the fund uses the methodology, third-party data provider, or combination of both as applicable."[18] While this is a helpful first step that the Commission can undertake (in that it increases the overall transparency surrounding this industry) we do not believe that the Proposed Rule goes far enough.

Currently, ESG data providers have absolute freedom to define criteria and adopt their own proprietary and undisclosed methodology for data collection and rating of companies. The result is that non-specialists make decisions on whether things like forced displacement or deforestation are serious enough to affect a company's rating. Moreover, the data considered in such assessments is limited to that which is easily accessible with desk research, which is often automated. The result is a frequent failure to capture companies' *actual* impact on the environment, people and communities.

In fact, the Proposed Rule acknowledges as much. As the SEC states:

> "we understand that different … third-party data providers conducting internal analyses can disagree on how to analyze how companies fare on various ESG factors. Accordingly, funds that have similar ESG strategy and focus could have different, sometimes even contradicting, views on an investment depending on the analysis the funds conduct or the third-party data provider they use."[19]

To that end, in a series of questions in its Proposed Rule the Commission has asked for feedback regarding fund disclosure of third party ESG data providers and ESG indexes, including "what types of information should be disclosed," and how the requirements could be tailored to ensure the disclosure of decision-useful information.[20] In this respect, we encourage the SEC to add a requirement that funds disclose whether their third party ESG ratings firms and index providers maintain grievance mechanisms or communication channels through which external stakeholders may input relevant information. Such information could include: (1) data regarding a portfolio company's practices; (2) the ability to raise concerns about the portfolio company's ESG performance; and, (3) a mechanism to challenge the veracity of a portfolio company's ESG rating or inclusion on an ESG index in light of its practices. Such mechanisms or communication channels help to ensure that ESG ratings firms have access to critical data that allow them to accurately assess a company's performance on E, S and G criteria. The existence, or lack thereof, of such communication channels and mechanisms can inform investors about the quality and reliability of data gathered by ESG ratings firms, and the veracity of their ratings and index products.

We commend the SEC for proposing requirements to disclose information about internal and third-party methodologies, and we encourage as much transparency around third party ESG data and index providers' methodology as possible. Bringing these methodologies into the public eye would allow investors to scrutinize how a given ESG data and index provider (such as MSCI and S&P Dow Jones) defines and measures ESG, and how they obtain the information on companies to make their

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[18] *Id.* at 43.
[19] *Id.* at 46.
[20] *Id.* at 53 -55.

assessments of them. This is absolutely critical to allow an investor to understand how the given fund approaches ESG, and the veracity of that approach.

Indeed, as IDI uncovered during its investigation, the current lack of information surrounding these data providers is a significant problem. As detailed in the Myanmar report, ESG data providers (*e.g.*, MSCI) have no common approach or standard and therefore produce wildly divergent, sometimes contradictory results. For instance, as we note in the Myanmar files "the U.S. oil giant Chevron, which in addition to pumping revenue into the Myanmar military is also the second-largest corporate driver of climate change, gets a good BBB from MSCI, but a Severe Risk rating from Sustainalytics." This is so even though **both** providers purport to capture similar things. Moreover, nearly every data provider that IDI examined defines ESG differently, and very few of them define ESG as something that actually aims to capture a company's environmental and social impact.[21] The lack of consistency and veracity plaguing the ESG investing industry comes directly from the third party data firms and will not be solved merely through disclosure at the fund level. Rather, it will only be addressed through regulatory oversight of the third-party data providers that are producing the ESG scores and the index providers that underlie both passive and active ESG funds.

Unfortunately, the lack of regulation and oversight of these entities means there is little recourse if the data that they provide to ICs or IAs are inaccurate and misleading in a manner that is inconsistent or at odds with a retail investor's strategy. The SEC's Proposed Rule does not provide for any relief. Rather it appears that the SEC is relying on indirect pressure from ICs and IAs to demand consistent information from these third parties so that ICs and IAs may, in turn, disclose that to their clients. However, as one commentator notes, these third party providers wield "enormous influence over investment allocation decisions."[22] Indeed, the International Organisation of Securities Commission (IOSCO) has called upon regulatory bodies such as the SEC to extend its mandate over these entities.[23]

We urge the SEC to address head-on the issue of these data providers with the aim of ensuring that these critical ESG investment industry actors provide accurate, meaningful, and consistent information about companies' performance and impact on people and the environment. The flaws of the ESG industry cannot be remedied without regulating the data and index providers that underlie it.

III. Incorporate a "double materiality" standard into investment decisions for IAs and ICs

Currently, the SEC's Proposed Rule requires funds to "disclose factors that materially impacted the fund's financial performance and operations."[24] Indeed, the Proposed Rule discusses the use of materiality both within the context of IC and IA investment criteria and in terms of the decision making process of individual investors. While the SEC has not, in this release, defined the standard of

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[21] *See* David Pred & Natalie Bugalski, *Opinion: Why ESG investing is bad for human rights and what we can do about it*," BUSINESS AND HUMAN RIGHTS RESOURCE CENTRE (Mar. 21, 2022) *available at* https://www.business-humanrights.org/en/blog/why-esg-investing-is-bad-for-human-rights-what-we-can-do-about-it/

[22] Khalid Azizuddin, *IOSCO: ESG Ratings and Data Regulatory Oversight to 'Increase Trust,'* RESPONSIBLE INVESTOR, (Nov. 23, 2021) *available at https://www.responsible-investor.com/iosco-esg-ratings-and-data-need-regulatory-oversight-to-increase-trust/*

[23] *Id.*

[24] SEC Proposed Rule *supra* note 5 at 70.

materiality, we assume that the SEC is incorporating the standard of materiality that is well-hewn in securities jurisprudence – namely one that focuses on the "total mix of information from the perspective of the reasonable investor."[25] This standard, while flexible, tends to focus primarily on financially material information and is *always* ascertained from the perspective of the reasonable investor.

It doesn't have to be like this.

Indeed, many stakeholders from across the globe have long been calling on companies to use a standard of double materiality when disclosing risks or evaluating investment criteria. In fact, European regulators have begun the process of examining and incorporating a "double materiality" standard into investment decisions.[26] Under this standard, ICs and IAs would not only examine the impact of a portfolio company's ESG performance on the company's (and, in turn, the fund's) financial performance and operations but would also examine how the portfolio company's operations would be disclosed "for reasons other than the effect on a firm's bottom line."[27] This standard is even more relevant within the context of ESG criteria for retail investors. As the SEC acknowledged in its Proposed Rule, many investors are engaging with ESG funds for reasons other than purely financial returns and are seeking to contribute to improved environmental and societal outcomes, or at least wish to do no harm through their investments. Moreover, as the IDI investigation has shown, ICs and IAs often advertise ESG funds to investors as a way to invest according to their values, often misleadingly.[28] Therefore, adopting a double materiality standard that explicitly reflects the interests of ESG investors – and helps prevent them from being misled – will be crucial. Indeed, it is seemingly illogical to, on the one hand, note that ESG funds attract a typical type of investor who would like their investments to 'do good', while, on the other hand, fail to ensure that these same investors have access to the very type of information that is necessary to making these investment choices.

At a minimum, we would ask that the SEC broaden its definition of materiality to provide for even greater flexibility regarding the various types of information that would matter to investors.[29]

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[25] Paul Munter, Assessing Materiality: Focusing on the Reasonable Investor when Evaluating Errors (Mar. 9 2022) *available at* https://www.sec.gov/news/statement/munter-statement-assessing-materiality-030922#:~:text=Since%20the%20concept%20of%20materiality,lens%20of%20the%20reasonable%20investor. The Supreme Court first discussed materiality within the context of the reasonable investor in *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The standard was expressly adopted in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[26] "Emerging EU ESG Requirements: Transatlantic Implications for Multinational Companies," The National Law Rev. (Jul. 11, 2022)(discussing the proposed double materiality standard and noting that "the European Union (EU) is at the vanguard of emerging requirements focused on climate-related information and broader ESG-aligned information.") *available at* https://www.natlawreview.com/article/emerging-eu-esg-requirements-transatlantic-implications-multinational-companies

[27] Henry Engler, *"Double Materiality": New Legal Concept Likely to Play in Debate Over SEC's Climate Plan*, THOMSON REUTERS (Apr. 12, 2022) *available at* https://www.thomsonreuters.com/en-us/posts/investigation-fraud-and-risk/sec-double-materiality-climate/

[28] *See, e.g.*, Carrie Schwab-Pomerantz, *Looking for Ways to Invest According to your Values?*, CHARLES SCHWAB (Jan. 13, 2021) *available at* https://www.schwab.com/learn/story/looking-way-to-invest-according-to-your-values (noting that "for today's investors, it's easier than ever to invest green.")

[29] There is precedence for this in matters related to information outside of the ESG context. *See, e.g.*, SEC Standard Accounting Bulletin (Aug. 12, 1999) (rejecting "the rule of thumb" that auditors had applied to financial misstatements that fell under 5% of the company's income or earnings per share and stating that "quantifying, in percentage terms, the

In closing, we again reiterate the critical importance of the SEC's actions in this area. Investors, like many other stakeholders, aim to have their investments impact more than just their wallet, but rather, their community, their society, and the world. We applaud the SEC's recognition of this and encourage the agency to use every means at its disposal to help investors effectuate these changes.

For further discussion of our recommendations, please contact Natalie Bugalski at [redacted] and Coleen Scott at [redacted]

Sincerely,

Inclusive Development International
Accountability Counsel
Friends of the Earth United States

magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations.") To that end, we also applaud the SEC's recent decision to charge Vale, S.A., with misleading investors on information related to Vale's ESG information. *See* SEC Release 2022-72, SEC Charges Brazilian Mining Company with Misleading Investors about Safety Prior to Deadly Dam Collapse (April 28, 2022) *available at* https://www.sec.gov/news/press-release/2022-72