AJC American Jewish Committee

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Re: File Number S7-17-22
Enhanced Disclosure by Certain
Investment Companies

Submitted via: www.sec.gov/rules/submitcomments.htm
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To Whom It May Concern:

I.

Please accept the following comments of the American Jewish Committee ("AJC") with regard to the proposed Commission regulations, *Enhanced Regulations by Certain Investment Advisors and Investment Companies About Environmental, Social and Governance Investment Practices*, 87 Fed. Reg. 36654 (June 17, 2022).

AJC is an organization of American Jews founded in 1906 to protect the rights of American Jews and all Americans. It today focuses on combatting antisemitism, defending Israel's place in the world, and defending democratic values. As part of its defense of Israel, it has for more than half a century opposed various efforts to eliminate the state of Israel through an economic boycott.

The effort began with the Arab boycott of Israel. That effort continues through its latest incarnation (even as many of the countries that formerly boycotted Israel have made peace with it), the Boycott, Divestment and Sanctions ("BDS") movement. That the BDS movement seeks the elimination of the State of Israel, is a goal made explicit by the founder of the movement, Omar Barghouti in his programmatic manifesto BDS – The Global Struggle for Palestinian Rights (2011).

As a general matter, AJC would not comment on many of the issues posed by the Securities and Exchange Commission ("SEC") in this rulemaking proceeding. Financial and regulatory matters are not areas in which AJC has either a special interest or competency. Nevertheless, we believe it appropriate to comment on several aspects of the proposed rule, particularly focusing on the "S" element of ESG investment. (We note that we earlier commented on another proposed SEC rule about ESG investment.)

The impetus for our comments is two-fold. The first impetus comes from AJC's experience combatting the BDS movement described above. We, and others in the Jewish community who have commented on these rules have come to learn that activists of various stripes critical of Israel flying under the banner of corporate social responsibility, use a multiplicity of techniques addressed by the instant proposal to pressure companies and investment advisors to discourage them from doing business with, or investing in, Israel. Many, if not most, of these techniques are invisible to investors in timely fashion.

We do not seek to have the SEC bar those efforts to boycott Israel. People have the right to urge their moral vision on companies in which they invest, including urging participation in what we believe to be the unwise, even immoral boycott of Israel. But other people have a right to know of those efforts, and to oppose them to the extent that they affect their own investment decisions, whether because they don't want to support that boycott, or because those efforts might trigger state anti-boycott laws. To be effective in those efforts, investors need to know in real time who is urging what decisions on companies, funds, and investment advisors.

The second impetus for our comments is that AJC is itself an investor with endowment funds of almost 150 million dollars. It does not want to invest in ways that reflect the priorities of the BDS movement. These regulations, even as proposed, are essential to allow AJC to have visibility into its investments.

We reiterate that we do not believe it is the place of the SEC to decide which side is right about the Israel/Palestine conflict. It is, however, distinctly the

province of the SEC to insist on fairness and transparency in the ESG investment and investment advisory space.

To the extent that the current proposal furthers that purpose, we applaud it. To the extent that we believe further regulation is necessary, we make suggestions below to that end.

This comment begins with a general overview of our reactions to the proposed regulations. Later, we address some of the specific questions posed by the Commission.

II.

We agree with the decision not to propose a one-size-fits-all political points of view definition of ESG (87 Fed. Register at 36660). In each of the three components of ESG investments, there are substantial disagreements about what constitutes a program designed to further that goal (or even whether it is a desirable goal). The debate is perhaps less obvious regarding the environment, but it is surely present with regard to corporate governance (*e.g.*, should there be hard goals (= quotas) for board diversity?) and, *a fortiori*, it is true with regard to the S—or social justice—element.

Different investors will have different views of what constitutes social justice. That is what a democratic polity are all about. Elected governments are chosen to implement a vision of social justice, but they are not elected, or, for that matter, empowered, to require acceptance of those views beyond those embodied in law.

There are self-proclaimed social justice activists who are quite certain that they know precisely what social justice means and that any departure from their orthodoxy is an unacceptable heresy. Just as surely, there are other activists who think that the views of the first group of activists not only do not further social justice; on the contrary, they believe that those views are themselves social injustice.

There is a legitimate reason for the SEC to protect investors by requiring transparency in what an investment advisor or financial manager means by using the term ESG. It is equally appropriate to ensure that ESG claims are not mere window dressing to entice investors without delivering the substance of what is promised.[1]

It is quite another thing for the SEC, which has no legislative mandate or agency expertise in defining social justice writ large, to treat one or the other conception of social justice[2] in the corporate sector as THE ONLY meaning of that term; or at least THE ONLY meaning that investors, with all their political differences, ascribe to the term.

The term social justice is also not so clearly defined in common usage that it might be said to be a term of art, or a term with a broadly accepted, uncontroverted, meaning. The broader public knows what greenhouse gases are; it does not have such a common understanding of what social justice is. Think for a minute of public debate over abortion, affirmative action, criminal justice reform, or 'equitable' wealth distribution (the latter presumably a particular concern for investors).

Moreover, public views on controversial issues are fickle and change rapidly. Without detailed disclosure, investors will not always correctly understand what social justice criteria means in practice at a given time. A fixed definition of social justice or invocation of broad categories, such as racial justice or criminal justice reform, would not keep pace with shifts in investor (public) opinion and understanding. Without detailed information, labelling a particular set of views as social justice would likely mislead investors, not enlighten them.

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[1] See, *e.g.*, *Usler v. Vital* Farms, 1:21-CV-447-RP, 2022 WL 1514068 (W.D. Tex. Mar. 2, 2022) (pending). We express no view on the merits of that case.

[2] We offer no view as to whether the same is true of corporate governance, at least some of which might well fall within the special competence of the SEC.

There is a more fundamental reason why the government should not be in the business of defining social justice for the society as a whole. Over 75 years ago, the United States Supreme Court wrote in a much-cited passage:

> If there is any fixed star in our constitutional constellation it is that no official, high or petty, can prescribe what should be orthodox in matters of politics, nationalism, religion or other matters of opinion ....

West Virginia State Board of Education v. Barnette, 319 U.S. 624, 642 (1943). An attempt to define social justice as meaning this and not that runs afoul of this bedrock constitutional principal. It would place a heavy thumb on the scales of public debate, in effect declaring one side the victor, and silencing and handicapping the other.

Fortunately, as the Commission itself has tentatively concluded, it is unnecessary to venture into these constitutionally, politically, and practically treacherous waters. Full and complete disclosure by financial managers and investment advisors of the criteria on which they evaluate ESG investments, particularly with regard to "S" factors, will protect investors fully, and we think, better than would a single, SEC-imposed definition.

While AJC believes that the present proposal is an important step forward, it is not specific enough to allow investors sufficient insight into "S" investment decisions—who is making them, based on what 'facts' and by which criteria, and in reliance on what, if any, outside sources. And, we should add, it does allow insight into whether the decision-maker looks only to one-sided sources or does it deliberately seek out conflicting views. Because evaluating claims of advancing social justice depends on legal and ideological assumptions on the one hand and factual findings on the other, we believe it essential that mandated disclosure be sufficient to allow investors to judge for themselves whether they accept the ideological criteria and factual findings by which a particular "S" investment evaluation or decision is made.

In our view, adequate regulations would require disclosure of:

(i) The definition of social justice the fund manager or advisor uses. How does it apply those criteria to specific countries and companies?

(ii) If the fund or investment manager relies on an outside evaluator, who is the evaluator, and what criteria does it use? The criteria need to be laid out with some specificity, and not at the level of largely meaningless, high-level criteria (human rights, racial justice), but in detailed and meaningful ways.

(iii) On what factual or legal sources does either an outside evaluator or an investment advisor or fund manager rely in its decision-making? Does it use multiple sources of information? Does it seek out multiple perspectives? Is it aware that some sources might be unreliable, intended to bring about a predetermined result? Does it rely on factors that inadvertently or otherwise introduce bias? Does the advisor or investment manager use particular governmental or independent organizational criteria, and, if so, which ones?

(iv) In cases of controversy over application of the defined criteria, are dissenting views noted and considered? What about potential sources of bias?

(v) Are ratings tailored to meet ideologically biased expectations of specific clients (*e.g.*, foreign sovereign wealth funds)

(vi) Does the rater take into account any legal implications of its ratings—would they cause a company to be barred from doing business with any set of customers (*e.g.*, a loss of business with states that penalize or reward fossil fuel investments or boycotts of Israel)?

These questions do not arise in a vacuum. They are informed by an ongoing dispute with a large and significant ESG rating company, Sustainalytics, a subsidiary of Morningstar. A comment period is not the place to raise or resolve that dispute, except to the extent that it illuminates the present proposal and ways it ought to be improved.

An investment fund designed in large part to combat efforts to boycott and isolate Israel from financial markets and corporate activities (and, of course, to

make money besides) observed that ratings by the Morningstar subsidiary were systematically biased against Israel, supposedly reflecting in part biases of Sustainalytics' employees, as well as its disproportionate reliance on deeply biased sources. Morningstar initially dismissed those concerns, allegedly on reliance on an internal audit.

A complaint was subsequently filed with an Illinois state agency alleging that Morningstar through its subsidiary Sustainalytics, was engaged in a de facto boycott of Israel and thus subject to Illinois laws restricting the State's ability to do business with Morningstar. In response, Morningstar commissioned an investigation by an outside law firm, White and Case.

That investigation, while exonerating Sustainalytics from the charge that it was boycotting Israel, found significant deficiencies in the processes used to produce ratings about companies doing business in, or with, Israel. One of those deficiencies was the untutored and undifferentiated use of distorted and unreliable sources of information. White and Case made several suggestions for improvements, including discontinuing reliance on such services. Some of those proposals for change did not, in the view of many Jewish organizations (including AJC), go nearly far enough in correcting the bias baked into Morningstar's (Sustainalytics') ESG evaluations. (These objections are set out in the attached letter to Morningstar.[3])

But the point, again, is not to rehash that particular controversy, criticize the White and Case report, or ask the SEC to intervene in that dispute. Our point is, rather, that the controversy illustrates why disclosure needs to go beyond high-level, generalized description of ESG criteria. In the Morningstar case, the firm boasted of its objective evaluation of companies and countries, but an outside observer found its ratings to be, in significant part, subject to various biases.

Some of the criteria (number of press articles about a country, for example) could create a bias against countries with a free press, as opposed to countries where

[3] We will have more to say about one aspect of this controversy below in discussing engagement between advisors and companies.

press freedom is non-existent. Hiding behind terms like "human rights," "controversy," "international law") or citing ostensibly (but only ostensibly) reliable sources (U.N. Human Rights Council, for example) ESG evaluators reached conclusions that would be objectionable to many investors.

We acknowledge that other investors might prefer Sustainalytics' results and think that Morningstar's ratings as they stood were accurate. Mandatory detailed disclosure would allow investors to invest according to their own moral, political or ethical lights, not someone else's undisclosed point of view.

The SEC should not deny investors the right to make investment decisions we or other advocacy groups believe are biased or lack a moral or legal basis. What it should do—as appears to be the overall intent of the of the proposed regulations—is to insist on sufficient disclosure so that investors can make informed decisions about who is making decisions (or giving advice) about the S factor and on what substantive basis.

III.

In this section, address the question of what disclosures should be required when investment advisors or fund managers meet with companies to discuss ESG issues. (Again, this comment focuses only on the "S" factor.)

On the one hand, such meetings are customary in the corporate world, albeit more typically to address corporate strategy. Such meetings can serve salutary purposes, allowing companies funds and investment advisors to better understand each other. They can also take place long after documents describing a fund or the activities of an investment advisor are prepared. Because they are oral, in-person meetings, their content and direction cannot be fully predicted in advance. Moreover, the investment advisor or fund manager cannot unilaterally control the direction of the meeting. Disclosure requirements need to take account of those realities.

On the other hand, and for precisely the same reasons, such meetings can be a black box through which ESG advisors can circumvent parameters laid out in documents describing a fund's goals, activities and metrics and no one would be

the wiser. It would be terminally naïve to ignore the possibility that an ideologically driven advisor, fund manager or outside evaluator would take advantage of this black box to advance an undisclosed agenda, enlisting unwilling investors in furtherance of personal ideological campaigns.

Further, if, as was the case with Sustainalytics, separate fees were charged for rating services and corporate engagement—that is, meeting with companies to guide them into a higher (better) ESG rating—there is a potential for a blatant conflict of interest, as noted for example, in the White and Case report referenced above (p. 107)

At a minimum, to address corporate engagement and to address the 'black box' problem, the SEC should require detailed disclosure of methodologies in conversations with companies, and a statement whether in such meetings the investment advisor, fund manager or third-party ESG evaluator set forth red lines which would preclude investing in any company.

Moreover, as suggested by White and Case in its evaluation of Sustainalytics, (see White & Case report, p. 107) the regulations should ensure that there are no financial incentives to alter ratings so as to make it likely that an evaluator will be engaged at additional cost to interact with a company to improve ESG ratings.

IV.

In this section we respond to some of the questions specifically asked. We answer only questions not addressed by what we wrote earlier.

Question 16: The rules should provide that where a fund or advisor relies on a third-party evaluator, it should disclose that the evaluaor "has explicitly or implicitly endorsed" or uses specific criteria for evaluating ESG investments. Investment advisors or fund managers should not be permitted to hide behind non-disclosure agreements with third party evaluators, such that investors have no idea of how ESG factors are enunciated and compliance with these criteria monitored and evaluated. No

doubt, a contract with a third party to coverup some purely financial misdeed would be illegal. ESG disclosures should be treated no differently.

Question 30: It is essential that disclosure be made of what frameworks and criteria a third-party evaluator uses, and on which sources of information it relies. Not all frameworks or international bodies are created equal, and some have deep-seated biases of their own, or at least biases that might cause some investors to reach a different conclusion about the desirability of certain investments—an issue that surfaced in the White and Case evaluation of Morningstar, and on which Morningstar fell short.

Question 31: It is essential to require disclosure of whether the metrics used or advice given by ESG evaluators could plausibly cause a company or investment vehicle to run afoul of state laws, such as anti-BDS laws, and which affect the investment's desirability.

Question 35: We think disclosure about exclusion of companies who engage in specific activities are of particular importance to some investors. Thus, for example, any criteria that was intended to exclude Israel, or limited its ability to defend itself, would be of interest to some investors, including AJC, as it manages its endowments.

Question 44: All third party ESG evaluators should be disclosed. To allow only the primary evaluator to be disclosed would be to allow delegation of the evaluation of some controversial issue on which investors might have differing views to an undisclosed third party and its undisclosed criteria, wholly invisible to investors.

We believe also that disclosure should also be required of "evaluators of the data quality." Reliance on reports from politicized newspapers is different that reliance on

dispassionate scholarly work, and still different from relying on social media.

Question 50: We believe that agreements to hide the basis of ESG evaluators should not be permitted, as these would keep investors in the dark.

Questions 58-84: We do not comment on the specifics of the proposal as it relates to ESG engagement and voting proxies. We emphasize that lest those techniques become a black box in which a fund or investment advisor can go far beyond disclosures made about ESG investment strategy, a robust set of disclosures is essential. Therefore, disclosure of proxy policy and engagement need to be detailed enough to allow an investor to make a fair assessment of the funds' or advisor's activities.

Thank you for your attention to our views.

Sincerely,

Marc D. Stern
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American Jewish Committee