August 16, 2022

Via E-Mail (rule-comments@sec.gov)

Vanessa A. Countryman, Secretary
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 ("ESG") Investment Practices (File No. S7–17–22)[1]

Dear Secretary:

Environmental Defense Fund ("EDF")[2] respectfully submits the following comments to the Securities and Exchange Commission ("SEC" or "Commission") regarding the above-captioned proposed rule on fund and adviser ESG disclosures ("Proposal"). As detailed below, EDF supports the Proposal and its swift finalization, and additionally offers a set of recommendations.

I. Background and Need for the Proposal

The SEC is responsible for establishing a regulatory regime that elicits consistent, comparable, and reliable information for investors about how funds and their advisers make investment decisions, such as investment selections and valuations, voting decisions, or engagement practices. To this end, the SEC has long required investment advisers and registered investment companies to disclose their "investment strategies" and other material information about how they approach their investment decisions. For example, investment advisers "are required to provide information about their advisory services in narrative format on Form ADV Part 2 … describing their firm's methods of analysis and investment strategies, fees, conflicts, and personnel."[3]

[1] Sec. & Exch. Comm'n, Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (June 17, 2022) [hereinafter "Proposal"].
[2] One of the world's leading international nonprofit organizations, EDF creates transformational solutions to the most serious environmental problems. To do so, EDF links science, economics, law, and innovative private-sector partnerships.
[3] Proposal, *supra* note 1, at 36,658.

While ESG-related investment strategies must be disclosed pursuant to these general requirements, "there are no specific requirements about what a fund or adviser following an ESG strategy must include in its disclosures."[4] As a result, there is a risk that a fund or adviser's consideration of ESG factors and practices do not align with investor expectations.[5] The risks of these disconnects between what investors believe their funds and advisers are doing, and what is actually happening, can be exacerbated by the wide range in usage of ESG-related terminology and ESG-related practices.

The lack of consistent, comparable, and reliable information may undermine an investor's ability to:

- determine "whether a fund's or adviser's ESG marketing statements translate into concrete and specific measures taken to address ESG goals and portfolio allocation,"
- "understand how effectively the strategy is implemented over time," and
- "compare different ESG strategies across funds or advisers."[6]

The Proposal seeks to address these investor needs by requiring greater clarity and transparency regarding ESG-related claims from investment advisers and their funds.

II. Outline of Proposal

The Proposal would require disclosures regarding "ESG strategies to investors in fund registration statements, the management discussion of fund performance in fund annual reports, and adviser brochures," which technically means revisions to "Forms N-1A, N-2, N-CSR, N-8B-2, S-6, N-CEN, and ADV Part 2A."[7] It would also require all index funds – irrespective of the type of index the fund tracks – to report identifying information about the index on Form N-CEN. The Proposal would require funds to disclose "(1) how they incorporate ESG factors into their investment selection processes and (2) how they incorporate ESG factors in their investment strategies."[8]

While the Proposal does not define the term "ESG," it would create tiered disclosure requirements for funds based upon the fund's self-categorization as being an "Integration Fund," "ESG-Focused Fund," or "Impact Fund."

Integration Funds "consider one or more ESG factors alongside other, non-ESG factors in investment decisions such as macroeconomic trends or company-specific factors like a price-to-earnings ratio."[9] In a summary prospectus, an "Integration Fund" would have a "streamlined disclosure," which would include a few sentences on what ESG factors the fund considers and

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[4] *Id*.
[5] *Id.* at 36,655.
[6] *Id*.
[7] *Id.* at 36,659.
[8] *Id.* at 36,660.
[9] *Id.* at 36,657.

how it incorporates those ESG factors into its investment selection process.[10]

In a fund's full prospectus, an Integration Fund would have to provide greater details on what it considers and how. If an Integration Fund considers the GHG emissions of portfolio holdings as one ESG factor in the fund's investment selection process, it would have to describe how it does so, including "a description of the methodology that the fund uses as part of its consideration of portfolio company GHG emissions."[11]

ESG-Focused Funds "focus on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies."[12] These include funds that include or exclude investments based on screening criteria, such as carbon emissions or diversity, as well as funds designed to track ESG-related indexes.[13] ESG-Focused Funds would, as part of Item 9 of Form N-1A, be required to

> describe how the Fund incorporates ESG factors into its investment process, including: (a) The index methodology for any index the fund tracks, including any criteria or methodologies for selecting or excluding components of the index that are based on ESG factors. (b) Any internal methodology used and how that methodology incorporates ESG factors. (c) The scoring or ratings system of any third-party data provider, such as a scoring or ratings provider, used by the Fund or other third-party provider of ESG-related data about companies, including how the Fund evaluates the quality of such data. (d) The factors applied by any inclusionary or exclusionary screen, including any quantitative thresholds or qualitative factors used to determine a company's industry classification or whether a company is engaged in a particular activity. (e) A description of any third-party ESG frameworks that the Fund follows as part of its investment process and how the framework applies to the Fund.[14]

An ESG-Focused Fund "for which proxy voting is a significant means of implementing its ESG strategy" would be required to disclose

> in the MDFP or MD&A section of the annual report as applicable, the percentage of ESG-related voting matters during the reporting

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[10] *Id.* at 36,660.
[11] *Id.* at 36,661 ("For example, an Integration Fund that considers GHG emissions might disclose that it considers the GHG emissions of portfolio companies within only certain 'high emitting' market sectors, such as the energy sector. The fund in this example would also be required to describe the methodology it uses to determine which sectors would be considered 'high emitting,' as well as the sources of GHG emissions data the fund relied on as part of its investment selection process.").
[12] *Id.* at 36,657.
[13] *Id.* at 36,662.
[14] *Id.* at 36,749.

> period for which the Fund voted in furtherance of the initiative. The fund would be permitted to limit the disclosure to voting matters involving ESG factors that the fund incorporates into its investment decisions. Additionally, a fund would be required to refer investors to the fund's full voting record filed on Form N–PX by providing a cross reference, and for electronic versions of the annual report, including a hyperlink, to the fund's most recent complete proxy voting record filed on Form N–PX.[15]

An Impact Fund "seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits." These funds "generally seek to target portfolio investments that drive specific and measurable environmental, social, or governance outcomes."[16] An Impact Fund would have to "summarize its progress on achieving its specific impact(s) in both qualitative and quantitative terms, and the key factors that materially affected the fund's ability to achieve the impact(s), on an annual basis."[17]

Further, in fund annual reports, an Impact Fund "for which proxy voting or other engagement with issuers is a significant means of implementing its strategy" would have to disclose "information regarding how it voted proxies relating to portfolio securities on particular ESG-related voting matters and information regarding its ESG engagement meetings."[18]

Funds that self-identify as considering environmental factors in response to Item C.3(j)(ii) on Form N–CEN, and do not explicitly deny that they consider issuers' GHG emissions as part of their investment strategy, would be required to disclose "two greenhouse gas ('GHG') emissions metrics for the portfolio in such funds' annual reports": "carbon footprint" and "weighted average carbon intensity" ("WACI").[19] The Proposal defines "carbon footprint" as "the total carbon emissions associated with the fund's portfolio, normalized by the fund's net asset value and expressed in tons of CO2e per million dollars invested in the fund."[20] The Proposal defines WACI as "the fund's exposure to carbon-intensive companies, expressed in tons of CO2e per million dollars of the portfolio company's total revenue."[21]

Funds would be required to tag their ESG disclosures using the Inline eXtensible Business Reporting Language (XBRL).[22]

[15] *Id.* at 36,674.
[16] *Id.* at 36,657.
[17] *Id.* at 36,659.
[18] *Id.*
[19] *Id.* at 36,720-21.
[20] *Id.* at 36,678.
[21] *Id.*
[22] *Id.* at 36,659.

III. Analysis of Proposal

A. Overall Approach

The Proposal aims to direct open and closed-end funds, including business development companies, to identify whether, how, and to what extent they consider ESG-related factors. Then, based on funds' own categorizations, the Proposal creates a tiered system of disclosure obligations. EDF supports this approach and believes that this improved information about ESG-related funds would support investor interest and need.

The Proposal is designed to operate narrowly, specific only to instances where funds and advisers have opted to self-identify as considering ESG factors or engaging in ESG strategies. In this way, the Proposal operates as a "truth in advertising" rule that can reduce risks of investors being misled by specious claims. This is an important step forward.

In accordance with this truth in advertising principle, the Proposal bases the level and nature of disclosure required from a fund on the level and nature of the fund's claimed use of ESG factors. EDF supports such a tiered approach, which sensibly avoids requiring information that could be confusing or unnecessary for investors and reduces compliance costs, while ensuring that investors receive the information important to assessing each fund.

EDF recommends that the SEC consider whether the rigid delineation between "Integration," "ESG-Focused," and "Impact" funds is necessary and whether it could create unintended consequences. For example, while these distinctions appear reasonable in theory, some funds may be difficult to categorize in practice. Additionally, rigid tiers may lead to suboptimal outcomes, such as discouraging advisers and funds from considering ESG factors or engaging in ESG strategies to avoid the heightened disclosures and liabilities that attach. If not carefully designed, the definitions of such categories could create unnecessary complexity and opportunities for abuse. These risks may be exacerbated by significant variations in obligations between different classifications.

Any regulatory design has advantages and disadvantages, and the SEC has discretion so long as it considers reasonable alternatives and explains its chosen approach. As one alternative, the SEC could consider whether it would be feasible and desirable to directly establish tiered reporting obligations based on the same underlying standards set forth in the Proposal but without rigidly categorizing funds as "ESG-Focused" or "Impact." In other words, the types of claims or representations that a fund makes would trigger the relevant disclosure requirements to enable investors to assess those claims or representations. For example, if a fund makes claims regarding use of ESG factors in its investment selection process, that would trigger a requirement to make the proposed disclosures regarding investment selection methodology; if a fund claims that its strategy involves engagement, that would trigger a requirement to make the proposed disclosures regarding engagement; and so on. Regardless of the approach the SEC ultimately selects, the SEC should acknowledge any important advantages and disadvantages of its chosen approach in its

release of a final rule.

The Proposal sometimes centers its characterizations of how ESG factors are used by funds to the "fund's investment selection process."[23] While ESG factors are important to this process for many funds, they are likewise relevant and important across other investment decisions – not just the "selection process." These other decisions may include valuation processes, voting considerations, engagement practices, and more. The SEC should ensure it considers where and how funds should provide descriptions of what ESG factors they use and how they use them (or not) in their investment decisions and practices broadly, not just in the investment selection process.

B. Use of ESG-Related Indexes and Other Methodology

The Proposal notes the important role that index providers currently play in fund investing, including in many ESG funds.[24] Index providers may, for example, play a role in including, excluding, or weighting different investments based on various selective criteria or measures.

To give investors better insight into funds' investment decision-making, an ESG-Focused Fund would be required to disclose on its registration statement "how the Fund incorporates ESG factors into its investment process, including" information on any relevant "index methodology, "internal methodology," "scoring or ratings system of any third-party data provider," "inclusionary or exclusionary screen," or "third-party ESG frameworks."[25] These methodology-related disclosures are crucial to enable investors to meaningfully distinguish between different ESG funds, and each should be adopted.

The SEC should consider whether to provide further explanation on how funds that use indexes or other third-party data should satisfy methodology disclosure requirements. An adviser that offers a fund tracking a third-party ESG-related index may not necessarily possess the specific details necessary to make complete and accurate disclosures pursuant to this section. The SEC could provide further clarity on what steps, if any, the fund or its adviser would be required to take to obtain the information required to be disclosed pursuant to Item 9 of Form N-1A.

As the SEC has separately recognized in a recent request for information, some index providers and other information providers do not currently disclose important details regarding their methodologies, conflicts of interest, or other factors.[26] Further, these indexes are generally not currently directly or indirectly regulated by the SEC.

If a fund adviser chooses to retain the services of an index provider to assist in investment decisions (such as by licensing an index), the fund should be responsible for ensuring the governance,

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[23] *See, e.g.*, *id.* at 36,660.
[24] *See, e.g.*, *id.* at 36,657.
[25] *Id.* at 36,749.
[26] Sec. & Exch. Comm'n, Request for Comment on Certain Information Providers Acting as Investment Advisers, 87 Fed. Reg. 37,254 (June 22, 2022).

quality, methodology, and accountability of the index.[27] In the ESG-related fund context, this should mean that, at a minimum, the fund is required to obtain sufficient details from the index provider to fulfill this obligation. This due diligence is especially essential given the variation in approaches of ESG-related indexes; some appear to largely track broader market (non-ESG) indexes, which may not align with investor expectations, so clear disclosure is crucial.[28]

C. Portfolio Companies' GHG Emissions

The Proposal would require environmentally-focused funds to disclose their portfolio companies' GHG emissions, unless they declare that they do not consider GHG emissions. This information is valuable to prospective investors for assessing climate-related transition risk, as well as for some investors' impact objectives. The Proposal's identified metrics and methodologies for calculating the portfolio companies' GHG emissions are reasonable, as the Partnership for Carbon Accounting Financials (PCAF)'s Global GHG Accounting and Reporting Standard is a commonly understood and readily implementable approach, already widely used in the marketplace.

The Proposal would not require funds "to estimate the Scope 3 emissions of their portfolio companies" because of "concerns related to the possibility of double counting emissions when adding Scope 3 emissions to a fund's financed Scope 1 and 2 emissions" and concerns that it is "more difficult for a fund to estimate the Scope 3 emissions associated with its portfolio companies as compared to Scope 1 and 2 emissions" because "Scope 3 emissions typically result from the activities of third parties in a portfolio company's value chain."[29] EDF takes no specific position on the Proposal's conclusions here, but notes in general that concerns associated with double counting are less relevant when the purpose of emissions disclosure is to give investors information on investment characteristics including transition risk, as it is here, versus in contexts where the purpose is to create a comprehensive emissions inventory.[30] Furthermore, information on portfolio companies' Scope 3 emissions is likely to become increasingly available and reliable following the finalization of the SEC's climate risk disclosure standards and similar efforts currently underway in other jurisdictions.[31]

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[27] *See* HEALTHY MKTS. ASS'N, BENCHMARK-LINKED INVESTMENTS (2019), https://healthymarkets.wpengine.com/product/benchmark-linked-investments.
[28] James Mackintosh, *ESG Funds Mostly Track the Market*, WALL ST. J. (Feb. 23, 2020), https://www.wsj.com/articles/esg-funds-mostly-track-the-market-11582462980.
[29] Proposal, *supra* note 1, at 36,682.
[30] *See* Alexandra Thornton, *Why Companies Should Be Required to Disclose Their Scope 3 Emissions*, CTR. FOR AM. PROGRESS (Dec. 13, 2021), https://www.americanprogress.org/article/why-companies-should-be-required-to-disclose-their-scope-3-emissions/ ("Inevitably, some companies will claim that Scope 3 emissions reporting will result in double counting, but this is not a serious problem. The goal of disclosure of Scope 3 emissions—as with Scopes 1 and 2—is not to create a national inventory, but rather to help investors understand which companies are connected to emissions and therefore exposed to increased risk.").
[31] *See* Sec. & Exch. Comm'n, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334 (Apr. 11, 2022).

D. Engagement, Voting, and Impact Disclosures

For funds that say that engagement is important to their strategies, the Proposal would "require disclosure of the number or percentage of issuers with whom the fund held ESG engagement meetings during the reporting period related to one or more ESG issues and total number of ESG engagement meetings."[32] The Proposal then defines "ESG Engagement Meeting" to mean "a substantive discussion with management of an issuer advocating for one or more specific ESG goals to be accomplished over a given time period, where progress that is made toward meeting such goal is measurable, that is part of an ongoing dialogue with management regarding this goal," and *not* a "meeting[] or interaction[] for which advocacy on ESG issues is not a focus, or from aspects of a fund's ESG engagement strategy that are not directed to a particular company, such as letters to all issuers in a fund's portfolio or policy statements describing a fund's ESG priorities."[33]

Disclosures regarding all engagements should be disclosed by funds, and those involving ESG factors should be separately delineated. These simple disclosures add an essential accountability factor for funds, as they provide information for investors to qualitatively and quantitatively assess claims that funds meaningfully engage with target companies.

In practice, funds may not always dedicate meetings exclusively to ESG factors. When firms engage with senior leaders of companies, for example, they may seek to cover many topics. Five minutes out of a one hour meeting with a CEO may be more impactful than weekly one hour meetings with "investor relations" staff. Given that funds and advisers could meaningfully engage with companies in multi-purpose discussions, the SEC could consider how to account for multi-purpose meetings, particularly where ESG-related engagement was a significant focus of the meeting.

The Proposal requires a fund that indicates that it uses proxy voting as a significant means of implementing its ESG strategy to disclose the percentage of voting matters. The fund would have discretion to limit this disclosure to voting matters involving the ESG factors the fund incorporates into its investment decisions. The SEC should consider how disclosure of voting decisions can be communicated in not only qualitative but quantitative terms. Further, all funds should be required to provide hyperlinks to their full voting records, as the SEC has proposed, so that investors can assess whether the fund's voting practices align with the investor's objectives.

The Proposal would require Impact Funds to discuss their progress towards achieving their stated and tracked ESG impacts. Today, some funds that would likely be categorized as Impact Funds disclose – in qualitative and/or quantitative terms – the methods they are using, their measurements for progress, and their progress; however, the content and reliability of these disclosures varies

[32] Proposal, *supra* note 1, at 36,674.
[33] *Id.*

considerably. The SEC should consider how to effectively standardize these disclosures where possible to promote comparability and consistency.

E. Placement of Disclosures

The Proposal would require funds to provide the impact, engagement, and GHG emissions disclosures in their annual reports. EDF agrees with this approach. While some information may be moderately timelier and more useful if provided on a more frequent than annual basis (e.g., quarterly), we understand that the SEC has carefully weighed benefits and costs associated with this reporting cadence. Additionally, while information can be included in other sources investors consult, such as the fund's website,[34] website-based disclosures are a complement to, and not a substitute for, mandatory disclosures that are part of SEC filings.

IV. Conclusion

In line with longstanding principles of truth in marketing and fraud prevention, the Proposal would ensure that the growing number of funds and advisers using ESG-related claims in their marketing provide investors with the information they need to vet these claims. The Proposal would address key investor protection needs and should be swiftly finalized pursuant to the SEC's clear and express authority granted by Congress in the Investment Company Act, Investment Advisers Act, Securities Act, and Exchange Act.

* * *

Respectfully Submitted,

/s/ Stephanie Jones
Stephanie Jones
Michael Panfil
Environmental Defense Fund

/s/ Jake Hiller
Jake Hiller
EDF + Business

[34] *Id.* at 36,672.