August 16, 2022

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

Re: *File No. S7-17-22*
Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices

Dear Ms. Countryman:

My name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to comment on the Securities and Exchange Commission's proposed amendments to rules and forms under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 "to require registered investment advisers, certain advisers that are exempt from registration, registered investment companies, and business development companies, to provide additional information regarding their environmental, social, and governance ('ESG') investment practices."[1] The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary financial regulatory systems. The opinions I express here are my own.

The Commission states that these proposed amendments "are designed to create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry."[2] While additional disclosure from investment companies and investment advisers that are pursing ESG strategies may provide

[1] Notice of Proposed Rule ("Notice"), "Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices," SEC Release Nos. 33-11068; 34-94985; IC-34594; File No. S7-17-22, at 1, https://www.sec.gov/rules/proposed/2022/33-11068.pdf.
[2] Notice at 1.

useful information to investors, I share the concerns stated by Commissioner Hester Peirce in her statement regarding this proposal.[3] I write specifically to highlight how this expansive and prescriptive proposed disclosure framework will impose unnecessary costs on investors, potentially limit investment choice, and not result in consistent, comparable, and decision-useful disclosures.

First, the proposed disclosure framework offers little to enhance the Commission's exercise of its existing authority under existing rules but imposes costs on investors whose funds and advisers would expend resources to comply with the framework. A central concern of the Commission in proposing these amendments is combatting "greenwashing."[4] While greenwashing has no "universally accepted definition," it is generally understood to be when an investment is presented as more environmentally friendly or socially responsible than it actually is.[5] Pinpointing when an investment is greenwashed is difficult—if not impossible—due to the many different understandings of what it means for an investment to be considered green or sustainable. Indeed, in many respects, whether an investment is environmentally friendly or socially responsible is in the eye of the beholder.[6] Indeed, the Commission rightly recognizes this by acknowledging that the proposed amendments do not "define 'ESG' or similar terms."[7]

This inherent subjectivity and lack of consensus calls into question whether combatting greenwashing is a realistic goal. Regardless of the specifics of greenwashing, the Commission has long been tasked with ensuring that investors receive the investments that they are promised, and the Commission already has rules to prevent investors from being misled, including anti-fraud rules and rules about how investment funds and their advisers communicate with their investors.[8] The Commission has recently used these tools to address similar issues in the ESG investment context.[9]

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[3] Hester M. Peirce, "Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies," May 25, 2022, https://www.sec.gov/news/statement/peirce-statement-esg-052522.
[4] *See* Notice at 8.
[5] *Id.* at 189.
[6] That's not to dispute that greenwashing is a concern to investors (or consumers, more generally). Recent polling points out that strong majorities of adults, and those who identify as frequent investors, agree that "it is hard to prove whether a company is [as] environmentally friendly [as] it claims to be." Amanda Jacobson Snyder, "As SEC Closes In on ESG Rules for Funds, the Bulk of Frequent Investors Say They Value Such Standards, *Morning Consult*, July 12, 2022, https://morningconsult.com/2022/07/12/sec-rules-esg-investments-survey-data/. The problem with regulations aimed at remedying this problem is that there is no accepted definition about what it means to be "environmentally friendly."
[7] Notice at 24.
[8] *See, e.g.,* 15 U.S.C. § 80b-6; 15 U.S.C. § 80a-33; 17 C.F.R. §275.206(4)-8; 17 C.F.R. § 275-206(4)-1; *see also* 15 U.S.C. § 80a-34(d); 17 C.F.R. § 270.35d-1.
[9] *See, e.g., In re BNY Mellon Investment Adviser, Inc.*, Order Instituting Administrative Proceedings and Cease-and-Desist Proceedings, Administrative Proceeding File No. 3-20867, Investment Advisers Act of 1940 Release No. 6032, Investment Company Act of 1940, Release No. 34591 (May 23, 2022), https://www.sec.gov/litigation/admin/2022/ia-6032.pdf.

With this in mind, the benefit to investors is not likely to be justified by the additional costs that they will bear from compliance with this framework. As the Commission recognizes, costs associated with additional disclosure will be passed on to investors.[10] Investors in funds employing an ESG strategy already pay higher fees on average,[11] and this disclosure framework will increase their costs. In addition to compliance costs associated with preparing disclosures, the prescriptive nature of these proposed amendments—including the definitions of how a fund may count its engagement activities—will also raise costs.[12]

Second, the increased costs associated with this proposed disclosure framework may work to limit the choices available to investors. As the Commission recognizes, the proposed framework "may prompt some funds to change their current investment strategies," where, for instance a "fund may determine that the disclosure requirements associated with operating an ESG-Focused Fund under the proposal may be too costly."[13] While idiosyncratic decisions of individual funds may not decrease in investment diversity in the marketplace, the Commission's treatment of ESG "integration" funds as a whole is likely to decrease the availability of funds following those strategies.

The Commission defines an ESG integration strategy to be one that "consider[s] one or more ESG factors alongside other, non-ESG factors in investment decisions," and where the ESG factor is "generally not dispositive compared to other factors."[14] Integration funds would be required, under the proposed framework, to provide specific disclosures about how they incorporate ESG factors into their selection processes.[15] This disclosure, however, must be carefully calculated. As the Commission explains, "requiring a more detailed discussion of ESG factors…could cause an Integration Fund to overemphasize the role ESG factors play…and impede informed investment decisions because ESG factors discussed at length would not play a central role in the fund's strategy."[16]

When considered together with the concurrently proposed amendments to fund naming rules that would prohibit integration funds from referring to ESG factors in the fund's name,[17] this conveys a view from the Commission that integration funds are not worthy of an "ESG" label, wrongfully putting the Commission's thumb on the scale in favor of ESG-focused or ESG-impact

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[10] *See* Notice at 213.
[11] *See, e.g.,* Michael Wursthorn, "Tidal Wave of ESG Funds Brings Profit to Wall Street," *Wall Street Journal*, March 21, 2021, https://www.wsj.com/articles/tidal-wave-of-esg-funds-brings-profit-to-wall-street-11615887004.
[12] *See, e.g.,* Al Barbarino, "SEC's ESG Fund Plan Called 'Very Weird,' Too Prescriptive," *Law360*, June 6, 2022, https://www.law360.com/articles/1499922/sec-s-esg-fund-plan-called-very-weird-too-prescriptive.
[13] Notice at 214.
[14] *Id.* at 14.
[15] *See id.* at 25.
[16] *Id.* at 27.
[17] Notice of Proposed Rule, "Investment Company Names," SEC Release Nos. 33-11067; 34-94981; IC-34593; File No. S7-16-22 at 81, https://www.sec.gov/rules/proposed/2022/33-11067.pdf.

funds. Moreover, when heightened disclosure is combined with the inability to signal an integration strategy in a fund's name, it is far more likely that at least some of these funds will choose to alter their strategies. Whether the choice results in not considering ESG factors or giving more weight to ESG factors, the result is less diverse investment strategy offerings for investors.

Finally, the proposed amendments will not create a consistent, comparable, and decision-useful regulatory framework. This problem is most easily identified with respect to the greenhouse gas emissions disclosures proposed for environmentally focused funds. The same problems with unreliable data and methodologies that plague the Commission's proposal to mandate disclosure of emissions by public companies plague this proposal.[18] The fact that this requirement is limited to funds who consider emissions in their investment strategies does not alter these fundamental issues with respect to the disclosures themselves.[19]

Rather than "providing a quantitative measure" for comparing funds,[20] as the Commission claims, the proposed emissions disclosures are built on towers of assumptions, undermining the reliability of any resulting information. Because those assumptions will not be uniform across funds, the information disclosed will also not be consistent or comparable. As Commissioner Peirce recognized, "formulating these estimates is about picking and choosing among a selection of datapoints and models, which is another way of saying that these estimates will differ from fund to fund."[21]

The Commission acknowledges all these issues, noting that the "methodologies and assumptions" may "impact the consistency of the data" and that the "GHG information produced by companies themselves, rather than estimated by a fund, also many not be fully comparable, due to the differences in assumptions and approaches at each company."[22] The Commission similarly recognizes that "Scope 3 emissions data are not widely available and are less consistent," and "the methodologies to capture Scope 3 emissions are still evolving."[23] But rather than recognizing the inherent unreliability of information gathered in such circumstances, the Commission seeks to solve this problem by requiring funds to disclose Scope 3 emissions separately from Scopes 1 and 2, in order to supposedly isolate the unreliable

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[18] *See* Jennifer J. Schulp, Thomas A. Berry, and William Yeatman, "Public Comment re: The Enhancement and Standardization of Climate-Related Disclosures for Investors," June 17, 2022, https://www.cato.org/public-comments/public-comment-re-enhancement-standardization-climate-related-disclosures-investors.

[19] The proposed disclosures would apply to environmentally focused funds unless they affirmatively state that they do not consider emissions in their investment decisions. Should this disclosure requirement be enacted, it should be limited to investment funds who opt in by affirmatively stating that they do consider emissions as part of their investment strategy. Notice at 222.

[20] *Id.* at 223.

[21] Hester M. Peirce, "Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies," May 25, 2022, https://www.sec.gov/news/statement/peirce-statement-esg-052522.

[22] Notice at 106.

[23] *Id.* at 225.

information.[24] The proposed amendments further compound this problem by requiring funds to use estimates where emissions data is not available.[25]

The proposed disclosures ultimately may say very little about the fund's exposure to greenhouse gas emissions. Reliance on greenhouse gas emissions estimates may lead to a lack of nuanced understanding about risks that are not subject to being quantified.[26] Thus, investors may think they know more about a fund's climate-related risk or exposure to GHG emissions based on these disclosures than they actually do.

While this problem is not unique to mandated disclosures—and may result from any of the voluntary disclosures that are occurring—the fact that mandatory disclosures have been given the Commission's imprimatur is especially problematic.[27] Evolving understandings of climate change and a broad potential audience make it difficult to create a single, reliable, set of disclosures.[28] Yet, the proposal seeks to do just that.

Importantly, the costs of this proposal are not only borne by investment funds and their investors. Companies that are recipients of fund investments—most notably private companies—will be asked to provide, at a minimum, emissions information.[29] The Commission's analysis fails to address these significant costs. Private companies may engage in their own analyses, often requiring third-party expertise, and such requests from investment funds may result in contractual terms that could require indemnification from private companies for misstatements about carbon emissions. Private companies may lose investment from funds that are not satisfied with the private company's emissions reporting capabilities or

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[24] *Id.*

[25] Notice at 105.

[26] Andrea Saltelli and Mario Giampietro, "What is wrong with evidence based policy, and how can it be improved?," *Futures*, August 2017, at 5, http://dx.doi.org/10.1016/j.futures.2016.11.012.

[27] Mandating disclosure signals to investors that they should care about emissions disclosures—a strong signal to be sending when individual investors are less familiar with the concept of climate risk. *See* FINRA Investor Education Foundation and NORC at the University of Chicago, "Investors say they can change the world, if they only knew how: Six things to know about ESG and retail investors," *FINRA Foundation and NORC at U. of Chicago,* March 2022, at 7, https://www.finrafoundation.org/sites/finrafoundation/files/Consumer-Insights-Money-and-Investing.pdf. The Commission recognizes that there "may be costs associated with emphasizing ESG factors beyond other factors. This could distract investors, and could lead to an overemphasis on ESG investing, detracting from capital formation." Notice at 214.

[28] Hans Bonde Christensen, Luzi Hail, and Christian Leuz, "Economic Analysis of Widespread Adoption of CSR and Sustainability Reporting Standards," *SSRN*, January 25, 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3315673. The Commission also acknowledges that its proposal may itself be harmful to innovation in this space by codifying a particular set of disclosures. *See* Notice at 234.

[29] The Commission's analysis generally assumes that public companies will be required to disclose emissions information as proposed. *See* Notice of Proposed Rule, "The Enhancement and Standardization of Climate-Related Disclosures for Investors," SEC Release Nos. 33-11042; 34-94478; File No. S7-10-22, https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

control strategies.[30] These ripple effects could drive private companies who are unable to comply—regardless of their emissions levels—out of business.[31] These ripple effects could also have counterproductive impacts on green technologies, limiting funding for startups and dampening the very innovations necessary to tackle certain environmental issues.[32]

For all of these reasons, the Commission should not proceed with the proposed amendments in their present form. Thank you for the opportunity to comment on these proposed rule amendments, and I am happy to answer any questions or further engage on this topic.

Sincerely,

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[30] *See, e.g.,* Megan Haines, Todd, O. Maiden, Ben H. Patton, and Jennifer A. Smokelin, "The SEC's proposed climate change rule: impact on private companies," *ReedSmith*, March 24, 2022, https://www.ehslawinsights.com/2022/03/the-secs-proposed-climate-change-rule-impact-on-private-companies/; Shawn Panson, "What the SEC proposed climate disclosures may mean for private companies," *GreenBiz*, June 1, 2022, https://www.greenbiz.com/article/what-sec-proposed-climate-disclosures-may-mean-private-companies.

[31] *See, e.g.,* Tyler Olson, "SEC's proposed ESG rule will leave small farms in the lurch, lawmakers from both parties say," *FOXBusiness*, May 26, 2022, https://www.foxbusiness.com/politics/sec-proposed-esg-rule-leave-small-farms-lurch-lawmakers-both-parties.

[32] *See, e.g.*, Charles K. Whitehead, "Is Now the Right Time to Mandate Costly Climate Disclosure?," *The CLS Blue Sky Blog*, March 29, 2022, https://clsbluesky.law.columbia.edu/2022/03/29/is-now-the-right-time-to-mandate-costly-climate-disclosure/ ("The upshot is that the new Climate Rules will impose higher costs on private and public companies that are pursing early-stage low-carbon technologies precisely at a time when we need to be able to efficiently fund and grow those and future businesses.").