**SEC Response**

Please accept for consideration the following recommendations in response to the SEC's Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices, File Number S7-17-22.

Introduction

The unprecedented growth in sustainable investing[1] in the US, starting in 2019[2], including a dramatic expansion in the number and variety of sustainable investing products, and proliferation in the number of firms offering such products, has contributed to confusion and misunderstanding on the part of investors as well as other stakeholders regarding the various types of sustainable investing strategies and their financial and non-financial outcomes. This has led to concerns and exposed stakeholders to challenges, in particular, for investment managers, asset owners, regulators, investors as well as financial intermediaries. The absence of clear definitions, lack of investment product clarity and a disclosure gap have been contributing factors. With some modifications, the proposed fund categories, definitions, and the enhanced layered disclosure approach proposed by the SEC will address some of these core concerns and create a more consistent, comparable, and decision-useful regulatory framework to inform and protect investors. Once adopted, it is recommended that the implementation of the new disclosure framework include investor education through an information campaign and the introduction of tools to help investors understand the framework and what it means.

Recommendations

Proposed Fund Category Names

As proposed, the fund category names are likely to perpetuate a common misunderstanding that conflates ESG integration for the purpose of evaluating investment risks and opportunities with social, responsible ethical, or impact-oriented investing practices. Even as the elements of what constitutes E, S, and G are still being debated, the idea of ESG integration in investment decisions, in line with the CFA Institute's definition, is to take into consideration in a systematic and consistent manner, any relevant and material environmental, social and governance risks or opportunities. The consideration of ESG issues in financial analysis is intended to complement and not substitute for traditional fundamental analysis that might otherwise ignore or overlook such risks or opportunities. On the other hand, ethical or social investing relies primarily on screening out or excluding companies from investment portfolios for a variety of reasons, including ethical, religious, social as well as other strongly held beliefs, such as environmental concerns or involvement on the part of companies in specific business activities. These may include companies involved in the production or manufacturing of tobacco, firearms, alcohol, or even fossil fuel companies, to mention a few. Instead of the terms Integration Funds, ESG-Focused Funds and ESG Impact Funds, it is recommended that the SEC consider a four-part spectrum, consisting of ESG

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[1] As used in this response letter, sustainable investing is an umbrella term covering various sustainable investing approaches, including values-based investing that relies on inclusions and exclusions (also referred to as ethical, religious, social or responsible investing) thematic investing, impact investing, ESG integration, proxy voting and engagement. It is used throughout the response letter to avoid confusion with ESG investing, a more narrowly defined investing approach as explained in the response letter.

[2] Promoting the Continued Growth and Development of Sustainable Investing in US Mutual Funds and ETFs: A Three-pronged Proposal to Address Misunderstanding and Confusion that Have Arisen in the Sector, Michael Cosack and Henry Shilling, May 2020. Copy available upon request.

Integration Funds, Sustainable-Focused Funds, Sustainable Impact Funds, and Sustainable Thematic Funds (see below). Alternative terms conveying similar concepts may also be considered. (Note: hereafter, fund category references are to the proposed SEC category names).

Integration Funds: Definition and Disclosures

According to the Global Sustainable Investment Review 2020, the most widely reported sustainable investment strategy globally is ESG integration, followed by negative exclusionary screening.[3] This is also the case in the US where ESG integration has experienced the most substantial growth in recent years due, in large part, to fund re-brandings via the explicit acknowledgment of this investment approach in the form of prospectus amendments.

While the actual numbers can be debated, sustainable assets under management and the trajectory of growth generally and ESG integration strategies, in particular, have been unmistaken and not entirely surprising. Active investment managers and credit analysts generally acknowledge that their evaluation and/or selection of securities usually involves the fundamental analysis of individual instruments and issuers. This includes any relevant and material ESG factors that are analyzed for exposure to risks and investment opportunities. However, individual E, S, and G factors may not have been singled out as such. This is because ESG factors may not be deemed or considered central in the evaluation of a company and ESG considerations may not typically be the main driver of valuation or credit outcomes. Rather, broader factors may form a more important part of a company's assessment. For example, even when environmental risks may have material implications, the impacts on valuations may be mitigated by other considerations.

E, S, and G factors are not universally defined. They continue to evolve, and they are not always seen as relevant and material to investment decisions. Also, these considerations can vary by company, sector, security, security type, maturity, etc. How these factors affect decision-making differs from one investment firm to another. Fund firms that wish to call out their funds' ESG integration practices by classifying their funds as Integration Funds should be required, as proposed, to describe how ESG factors are incorporated into their investment selection process and how they incorporate ESG factors in their investment strategies. It is recommended, however, that the SEC consider expanding the definition of Integration Funds to incorporate the concept of ESG relevance and materiality.

At the same time, singling out GHG emissions for more detailed disclosure by Integration Funds seems out of step with the nature of these funds and the idea also advanced by the SEC that "ESG factors are generally no more significant than other factors in the investment selection process…" Requiring disclosure of GHG emissions, even as emissions are likely to be considered, would place excessive emphasis on this factor when, in fact, other, relevant, and perhaps non-E, S and G related factors, may be even more important in the overall evaluation of a security. For this reason, the mandatory requirement to disclose how GHG emissions in particular are evaluated or to disclose quantitative information or other GHG metrics, should be reconsidered.

ESG-Focused Funds and ESG Impact Funds Additional Disclosure Requirements

The SEC's proposed additional disclosure requirements for ESG-Focused Funds and ESG Impact funds are appropriate. That said, calling out and requiring GHG emissions disclosures in cases where GHG

[3] Source: Global Sustainable Investment Review (GSIA) 2020, reports global sustainable assets under management of $35.3 trillion while the US accounts for $17.1 trillion in sustainable assets under management. Of the various sustainable investing strategies, which are not mutually exclusive, ESG integration assets stood at $25.2 trillion, up from $17.5 trillion in 2018. According to GSIA as used in its report, sustainable investment refers to a broad and inclusive definition of approaches to investment that include environmental, social and governance factors in portfolio selection and management across seven different strategies of sustainable or responsible investment, including ESG integration.

emissions or GHG emission reductions are not a stated goal or impact should not be mandated. Rather, funds should be required to identify in reporting the specific set of measures used to evaluate progress consistent with each fund's stated objectives and impacts. These may include various E, S as well as G factors.

Adding a Sustainable Thematic Funds Category

It is recommended that the SEC consider expanding the three categories to include a fourth, a category consisting of Sustainable Thematic Funds. The Sustainable Thematic Funds category would include funds whose strategy involves investing in themes or assets contributing to environmental and social solutions, for example, clean water, climate mitigation or renewable energy, and gender equity, to mention just a few. Unlike ESG Impact Funds, however, funds that fall into this category often do not make an explicit commitment to achieve a stated goal or to pursue a particular impact.

One example involves dedicated green bond mutual funds and ETFs. There are currently seven such funds listed in the US, three ETFs and four mutual funds. These funds invest in bonds issued by various entities whose proceeds are earmarked for qualified "green purposes," such as the development of clean, sustainable, or renewable energy sources, commercial and industrial energy efficiency, or conservation of natural resources. But the funds don't make any representations about achieving specific non-financial outcomes. The same can be said for other thematic funds, such as funds focused on water, solar and clean energy more generally. These funds qualify for consideration as a legitimate separate category and from a disclosure perspective, it is recommended that Sustainable Thematic Funds, if fund managers wish to identify them as such, be subject to the broad disclosures in line with Integration Funds, unless one of the other categories applies and with it the more expansive SEC mandated disclosures.

Index Tracking Funds

The proposed rule amendment calls for sustainable index tracking funds to identify the tracking index, and to briefly describe the index and how it utilizes ESG factors to identify eligible constituents. Most index funds already provide such disclosures. The proposal further requires that an ESG-Focused index fund provide expanded disclosures in line with an ESG-Focused Fund. This is appropriate but it is further recommended that the SEC consider applying to index funds the same layered disclosure approach proposed for actively managed funds. As such, index-tracking funds that integrate ESG or seek to achieve an impact should be classified as Integration Funds or ESG Impact Funds and be subject to disclosure requirements corresponding to these actively managed counterparts.

In addition, index tracking sustainable funds should be required to compare their performance results not only to the performance of the underlying tracking index but also to the performance of the broader conventional index from which the ESG index constituents are drawn. For example, the iShares ESG Aware MSCI EAFE ETF (LDEM) seeks to track the performance of the MSCI EAFE Leaders Index. In addition to being compared to the tracking index, it is recommended that the SEC consider requiring the fund to compare its performance to the MSCI EAFE Index or an equivalent conventional benchmark. In this way, the contribution of sustainable factors, on the one hand, and any trade-offs on the other will be explicitly quantified over time for the benefit of investors.

To the extent that sustainable funds in the future elect to compare their performance to ESG-oriented benchmarks, it is also recommended that such funds be required to retain comparisons of their performance to that of a broad-based conventional index along with the ESG-oriented index for comparison purposes.

Performance Comparisons

Many funds, almost entirely mutual funds but also a small number of ETFs, have been rebranded over the last three plus years in particular by formally adopting sustainable investing practices that consider one or more approaches to sustainable investing. While this action is disclosed at the time of occurrence, it seems that unless the event is deemed to be material, few funds include a reference to this occurrence in future annual and semi-annual filings. Yet, this is relevant for investors when performance is evaluated going forward. It is therefore recommended that fund firms reflect the change date in the form of a footnote in the Performance Table, in their annual and semi-annual reports.

Backcasting Performance Data

Many sustainable indices are relatively new, having been launched in more recent years. Also, definitions and methodologies have been undergoing changes. Yet, many resort to backcasting to reflect a longer-term performance track record, relying on assumptions regarding the historical application of sustainable investing practices. In the event sustainable funds rely on back casted index performance results to make a case for a sustainable investing strategy, such funds should be required to disclose this fact and to provide details regarding the assumptions used to arrive at the index results and how such assumptions and practices may have changed over time.

I appreciate the opportunity to submit comments to help inform the Commission's disclosure framework for sustainable funds. Please feel free to reach out to me for any clarifying comments.

Sincerely,

Henry Shilling
Director of Research
Sustainable Research and Analysis LLC