DISCUSSION DRAFT

U.S. Securities and Exchange Commission

Asset Management Advisory Committee

Potential Recommendations of ESG Subcommittee

December 1, 2020

Executive Summary

The Asset Management Advisory Committee (AMAC) established a subcommittee generally to review matters concerning Environmental, Social and Governance (ESG) investment products, and make recommendations regarding these products for consideration by the AMAC.

The ESG Subcommittee ("the subcommittee") offers the following potential recommendations for discussion and to solicit feedback from the AMAC. The purpose is to arrive at final recommendations to the SEC, at the next subsequent AMAC meeting, to improve the data and disclosure used for ESG investing, in order to create better transparency for investors, and better verifiability of investment products' ESG strategies and practices. In the case of Issuer Disclosure, requirements are already in place requiring issuers to disclose material risks, and we do not recommend changes to those rules, but rather the adoption of standards to guide those disclosures. In the case of Investment Product disclosure, we seek support of best practices, aligned to a more uniform taxonomy.

Recommendations Regarding Issuer Disclosure of ESG Risks:

- *The SEC should require the adoption of standards by which corporate issuers disclose material ESG risks*

- *The SEC should utilize standard setters' frameworks*[1] *to require disclosure of material ESG risks*

- *The SEC should require that material ESG risks be disclosed in a manner consistent with the presentation of other financial disclosures*

Recommendations Regarding ESG Investment Product Disclosure:

- *The SEC should suggest best practices to enhance ESG investment product disclosure, including alignment with the taxonomy developed by the ICI ESG Working Group*[2]*, and clear description of each product's strategy and investment priorities, including description of non-financial objectives such as environmental impact or adherence to religious requirements*

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[1] For example, see document posted on SEC AMAC website for materials related to the December 1, 2020 AMAC meeting, "10152020 SASB SEC AMAC ESG Subcommittee FINAL.pdf"

[2] "Funds' Use of ESG Integration and Sustainable Investing Strategies: An Introduction," Investment Company Institute, July, 2020

- *The SEC should suggest best practices for investment products to describe each product's planned approach to share ownership activities in the Statement of Additional Information, and any notable recent ownership activities outside proxy voting, which is reported in Form N-PX, in shareholder reporting*

Background

The subcommittee was formed in the first quarter of 2020. The subcommittee's purpose is to look into ESG practices of investment products, and to explore, within the areas of the SEC's mandate, whether any recommendations were warranted to improve practices. Of particular interest to the subcommittee was the extent to which ESG investment products differed from other types of investment products, and whether any intervention was needed to address these differences.

- **Definitions and Scope**

  The types of risks and investment styles we describe with the broad term "ESG" in this document include: environmental, social and governance practices; sustainability; impact investing; responsible investing, and other similar terms.

- **Subcommittee's Process**

  The subcommittee explored available literature, interviewed practitioners including asset managers, industry groups and service providers, and held two panel sessions for members of the subcommittee, the first to gather information from experts on Issuer Disclosure of ESG risks, and the second regarding Investment Product Disclosure considerations for ESG. Subcommittee members also studied the recent recommendations in this area by the SEC's Investor Committee,[3] an ESG primer created by the Investment Company Institute (see footnote 2), work by the CFA Institute[4], documents from the Investment Adviser Association[5], and the ESG content in the SEC request for commentary on the Names Rule[6].

Key Questions Discussed by the Subcommittee

ESG investing has grown significantly in recent years; according to the ICI, "socially conscious" registered investment products grew from 376 products/$254 billion in assets under management at the end of 2017 to 1,102 products/$1.682 trillion in AUM by the end of June,

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[3] Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure, May 14, 2020

[4] "Consultation Paper on the Development of the CFA Institute ESG Disclosure Standards for Investment Products," August, 2020

[5] "Sustainable Investing is an Active Process," Investment Adviser Association, 2020

[6] Request for Comment, File No. S7-04-20, SEC, March, 2020

2020[7]. Areas of concern that we identified through our review of literature on the topic and feedback from AMAC members included:

- How should ESG investment products be treated under the Names Rule?
- How can we avoid "greenwashing," that is, investment products bearing the name ESG but not actually engaging in meaningful ESG investment?
- Does ESG, or any substyle of ESG investment, contribute to performance, or are performance claims being made without basis in data?
- Should there be special requirements for ESG investment products in the way they vote proxies?
- Should particular ESG ratings providers or benchmarks be used as part of the requirements for including "ESG" in an investment product's name?
- What guidance should be given to U.S. securities issuers with respect to ESG risks?

The majority of these were questions about what should be required of ESG investment products; but what should be required in issuer disclosure also featured prominently.

The subcommittee divided its work into five separate workstreams, of which three led to the recommendations included in this document. The five workstreams were:

1. Is ESG About Value or Values?
2. Assessing Performance of ESG Strategies
3. Proxy Voting in ESG Strategies
4. Issuer Disclosure of ESG Data
5. What Role Should ESG Rating Systems and Benchmarks Play?

After looking into these individual topics, we merged workstreams 1, 3 and 5 to create the recommendations here presented regarding investment product disclosure. Workstream 4 contributes the recommendations for issuer disclosure, and workstream 2 provides the observations below with respect to ESG performance measurement.

The subcommittee finds that ESG investment products are not significantly different than other types of products, with the following exceptions:

- There is less available public data to support measurement and validation of ESG risk factors than exists for many traditional products;
- ESG products have risk/return objectives that could reflect a longer time horizon than traditional products; and
- ESG products may have objectives that fall outside risk/return objectives alone.

In its work, the subcommittee considered a range of potential recommendations, from taking no action, to mandating particular actions. In most but not all cases, we found that some kind of actions to support best practices would improve transparency for investors, but that more prescriptive actions were counter-productive given the early state of the evolution of ESG

[7] ICI Webinar materials, "New Common Terminology for ESG Fund Investing Strategies," August 11, 2020

investing; strong rulesets might, at this point, freeze development of investment and measurement approaches in this investing style. Therefore, our recommendations to improve investment product disclosure are to provide best practice guidance rather than mandate specific approaches.

The one case where we recommend mandating specific actions, however, is issuer disclosure. We found that, if standardized, consistent issuer disclosure were available, this would allow investors and their third party service providers to verify whether investment products met their objectives, and would make performance attribution to ESG factors more consistent and reliable. Our recommendation is limited in scope: significant disclosure requirements for material risks already exist and we **do not see the need to change the disclosure laws** to improve the quality and comparability of ESG for investors. What we do recommend is the **adoption of standards** for those disclosures; we propose that mandatory, rather than voluntary, standards be established, as the current, unguided approach has not resulted in consistent, comparable, complete and meaningful disclosure. The impact of the current approach could be poor transparency with the potential to mislead investors in investment products, as well as poor disclosure of material risks to investors in issuers' securities. We do not recommend the highly prescriptive approach that is used, for example, in Europe, as that may result in the production of metrics that are not needed to assess an issuer's material risks, and unnecessary cost. Instead, we see a parsimonious approach being sufficient to meet the needs of investor transparency, with a focus on a limited number of material metrics, tailored by industry, overseen by an independent standard setting entity such as SASB, or other similar approaches so long as they are limited to material metrics by industry.

We acknowledge that mandating standards for these disclosures would be a lengthy and complex process. It would not make sense to undertake these actions if no specific investor harm was posed by current practices. The potential harm we as a subcommittee perceive is little ability to verify truth in labelling for investment products that use ESG branding, which could result in misleading investors. In addition, it appears that shareholders in individual securities do not consistently receive this material risk information. With the types of issuer disclosure standards we recommend, independent verification of investment product styles and claims could be more reliably undertaken. It is worth noting that issuer data concerning Governance practices is most reliable and consistent across issuers; this allows verification of the "G" elements of ESG strategies, and allows more accurate performance measurement. Having more reliable "E" and "S" data would help further strengthen verification and measurement.

Given that issuer data regarding material ESG is not yet reliable, consistent and available, it does not make sense to have prescriptive additional requirements for ESG investment product disclosure or performance measurement and attribution practices. We do recommend as a suggested best practice that ESG investment products describe their objectives, how they prioritize these objectives (e.g., are the risk/return objectives a higher or lower priority than any non-risk/return objectives, such as religious rule adherence or social benefits). We recommend that a suggested best practice be the adoption of the language developed by the cross-industry group that served in the Investment Companies Institute (ICI) ESG Working Group (see footnote 2).

Recommendations Regarding Issuer Disclosure

- ***The SEC should require the adoption of standards by which corporate issuers disclose material ESG risks***

  Existing disclosure rules are already very clear that material risks must be disclosed by issuers. What is lacking is consistent standards by which to make these disclosures.

  Those standards should meet these criteria:

  - Be authoritative and binding, akin to generally accepted accounting principles (GAAP);
  - Apply to disclosure of material ESG risks and guide issuers in determining whether an ESG risk is material, or could become so in the future
    - Standards should be material, limited by industry, and provide clear guidance on relevant metrics; SASB's work currently meets these requirements (see footnote 1), and other bodies may also do so in the future; and
  - Ensure ESG disclosure comprehensively addresses all material ESG risks, meaningfully conveys the issuer's exposure to each material ESG risk, and allows uniform comparison of material ESG risks across industries and specific comparison within industries.

- ***The SEC should utilize standard setters' frameworks to require disclosure of material ESG risks***

  Those frameworks should meet these objectives:

  - Clearly articulate the principles by which an issuer determines the backward-looking quantitative and forward-looking qualitative metrics and disclosures it should present on material ESG risks;
  - Prioritize disclosure of material ESG risks applicable to most issuers, such as climate risk, while also requiring disclosure of specific material ESG risks pertinent to the issuer's business and industry; and
  - Mandate disclosure of all material ESG risks by all issuers, with appropriate exceptions considered for issuers that the SEC determines might suffer undue burdens in meeting the requirements, such as smaller issuers.

To ensure adoption by issuers, the AMAC recommends that the SEC, following appropriate study and deliberation, designate those third-party ESG disclosure frameworks as authoritative and binding, putting them at parity with standards promulgated under GAAP. In doing so, the SEC should encourage third-party standard setters to prioritize further development of:

- Forward-looking disclosures, and backward-looking measures, of material ESG risks; analysis of various climate-change scenarios; discussion of efforts being undertaken to mitigate those material risks; and

- Industry-specific disclosures on material climate-change risks, supported by refined industry classifications that promote comparability.

- ***The SEC should require that material ESG risks be disclosed in a manner consistent with the presentation of other financial disclosures***

Currently, disclosures that are made appear in a variety of types of documents and do not always clearly align with other issuer metrics. Material ESG risks should be presented in a manner consistent with the presentation of other financial disclosures, including temporally aligning data with financial metrics, integrating ESG disclosure into required SEC filings and reports, and making the presentation machine-readable in a standard format and taxonomy.

Recommendations Regarding Investment Product Disclosure

- ***The SEC should suggest best practices to enhance ESG investment product disclosure, including alignment with the taxonomy developed by the ICI ESG Working Group, clear description of each product's strategy and investment priorities, including description of non-financial objectives such as environmental impact or adherence to religious requirements***

Existing rules for investment product disclosure and advertising are sufficient and adequate—but disclosures would be improved by elements of consistency. For this reason, the SEC should recommend to the industry best practices for ESG disclosure to foster comparability. This should not be a costly burden, would benefit investors attempting to compare products, and may have benefits to the investment product managers: arguably, products that give consumable, comparable disclosure will be more attractive to investors and professionals who provide research concerning investment products.

We believe this consistency could be achieved by suggesting a taxonomy such as that developed by the ICI ESG Working Group (see footnote 2), which found strategies could be classified in one or more of the following categories:

- Inclusionary;
- Exclusionary; and
- Impact.

Best practices for disclosure would be to describe clearly how the product carries out its strategy, such as whether it uses internal or external research or some combination, how it selects investments in line with its strategy, what its objectives are, and which objectives mainly seek return relative to risk minimization, as opposed to objectives which are not straightforward risk/return characteristics. Best practices would be to indicate any specific priorities in these objectives—whether risk/return objectives come above or below social

objectives, or are equal priorities, for example. For risk/return objectives, it would be helpful to identify the time horizon over which those objectives are designed to be accomplished; the time horizons for some products may be a year, 10 years, a market cycle, or much longer time

In shareholder commentary, we suggest a best practice would be to explain how the product achieved its top objectives, and, ideally, how these are estimated to have contributed to return.

- ***The SEC should suggest best practices for investment products to describe each product's planned approach to share ownership activities in the Statement of Additional Information, and any notable recent ownership activities outside proxy voting, which is reported in Form N-PX, in shareholder reporting***

Experts consulted by the subcommittee, such as the CFA Institute, noted that ESG investment products engage in share ownership activities as a more deliberate piece of their strategy than many, but not all, other investment products. These ownership responsibilities include:

- how they vote proxies
- whether they engage management individually, and/or participate in collective engagement of management
- whether they lead shareholder motions

Investors in these ESG products, and other products, would benefit from clear, consistent statement regarding how ownership responsibilities are carried out by the product. While the reporting of proxy voting is already well regulated, other ownership responsibilities, if significant to the product's strategy, should be noted. An investment manager's intention to use these tools could be indicated in the Statement of Additional Information, and any notable ownership activities could be described in shareholder reporting.

Observations Regarding Performance Measurement

The subcommittee found that there is a wide range of research and assessments concerning how ESG factors affect performance, and that a clear picture of the impact of ESG on performance does not currently emerge.

The subcommittee explored whether it should take any action with respect to performance reporting for ESG products. The SEC already requires a number of elements in fund performance disclosure. We did not find that ESG should be treated any differently than other fund objectives or strategies with respect to disclosing performance. While performance standards might emerge if issuer ESG data improves, at this early state of evolution of ESG investing we did not find that particular standards for metrics and attribution were achievable or desirable.

A key component of the existing rules concerning performance disclosure is the requirement to benchmark against a broad market index, and to allow funds to determine whether it is appropriate to use a secondary, more tailored index. We believe for a number of ESG products, a secondary, ESG-themed benchmark could give investors important information and would be desirable.

As issuer data improves and the ESG investing practices develop further, performance measurement and other analyses may evolve and become even more valuable for investors, as they have for other investment strategies.