Statement

Statement on Environmental, Social, and Governance Disclosures for Investment Advisers and Investment Companies

Commissioner Hester M. Peirce

May 25, 2022

Thank you, Mr. Chair. A key impetus for today's rulemaking[1] is a legitimate concern about the practice of greenwashing by investment advisers and investment companies. This concern is real because advisers can mint money by calling their products and services "green" without doing anything special to justify that label. Only days ago, we settled an enforcement proceeding in which we alleged that an adviser said one thing about ESG and did another.[2] Yet while enforcement proceedings of this sort illustrate the problem, they also show that we already have a solution: when we see advisers that do not accurately characterize their ESG practices, we can enforce the laws and rules that already apply.[3] A *new* rule to address greenwashing, therefore, should not be a high priority.

In any event, this proposed rule misses the mark.

I could have supported a proposal to require advisers and funds to answer three questions about their ESG products and services:

1. If you offer products or services you label as some formulation of "E," "S," or "G," what does the label mean with respect to each such product or service?
2. What do you do to make your product or service line up with E,

S, or G, as you have defined it for that product or service?

3. For each such product or service, what—if any—is the cost to investors, including in terms of forgone financial returns of pursuing E, S, or G objectives alongside of or instead of financial objectives?

This proposal touches on some of these questions,[4] but embodies a fundamentally different approach. It avoids explicitly defining E, S, and G, yet *implicitly* uses disclosure requirements to induce substantive changes in funds' and advisers' ESG practices. Investors will pick up the tab for our latest ESG exploits without seeing much benefit.

The Commission seems to have assumed that today's investor is driven by concern for environmental, social, and governance matters, not an anachronistic desire to earn returns on her hard-earned money. So the SEC comes to the aid of the ESG-minded investor with a purportedly "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."[5] Regardless of what one generally thinks of the SEC mandating hyper-specific ESG disclosures, the proposals we are voting on today will fail of their purpose because they are not so much built on sand as they float on a cloud of smoke, false promises, and internal contradiction.

E, S, and G cannot be adequately defined, nor will they be, should the proposal eventually find its way into the Code of Federal Regulations. All you will learn from the proposed definitions is that "E" stands for environmental, "S" stands for social, and "G" for governance, but I suspect that you already knew that. The cool kids already have moved on to "*E*ESG"—*Employees*, Environmental, Social, and Governance. We better amend that proposal before it goes out the door lest a fund or adviser that prioritizes human capital issues despairs of being able legally to offer an ESG fund. Our refusal to define ESG is, of course, wholly understandable. Can you imagine an issue that would *not* fit within the ambit of at least one of those letters, based on someone's reading? Take, for example, the recent suggestion by some analysts that investments in defense stocks be added to the European Union's Social Taxonomy.[6] Imagine trying to conjure up a definition that not only met the universe of current understanding, but was flexible enough to grow to meet the hour-by-hour expansion of just what makes up E, S, and G.

From a regulatory perspective, the implications of this nod to reality make today's proposals incapable of enforcement on a practical level. How precisely do we envision determining whether a fund has incorporated "ESG factors" into its investment selection process when we have not defined just what those factors are? "I'll know it when I see it" is not a

practice currently recognized in administrative law. The application of the rules to advisers is also awkwardly ambiguous. The proposal would require, for example, “an adviser to provide a description of the ESG factor or factors it considers for each significant investment strategy or method of analysis for which the adviser considers any ESG factors.”[7] The broad sweep of this requirement will affect even advisers who do not consider themselves ESG advisers. Given the ambiguity and breadth of the proposed requirements, the planned one-year compliance date[8] for funds and advisers to get their Es, Ss, and Gs in order is laughably short.

In an attempt to generate comparable metrics, the proposal does get specific in some places. The specificity of these metrics is as problematic as the ambiguity around ESG. The proposed amendments, for example, generally would require that environmentally-focused funds disclose two separate greenhouse gas (“GHG”) emission metrics: one describing a fund portfolio’s carbon footprint, and the other the extent to which the fund is exposed to carbon-intensive companies.[9] The latter is the fund’s weighted average carbon intensity, also known—I say without comment —as “WACI.”

This attempt to provide verifiable data that will allow investors to compare greenhouse gas exposure across funds does not survive close inspection. For some companies, the data will be available, albeit not reliable, if we adopt the climate rule for public companies.[10] If portfolio companies do not provide disclosures, the proposal would require the fund to cobble data together as best it can. The fund would be required to make a good faith effort to estimate each portfolio company’s Scope 1 and Scope 2 emissions, along with providing data sources and a brief explanation as to how it reached its conclusions.[11] Formulating these estimates is about picking and choosing among a selection of data points and models, which is another way of saying that these estimates will differ from fund to fund. Rather than get a uniform range of emission statistics, investors concerned with greenhouse gas numbers will have to do a separate assessment of each fund’s process for making up those numbers. So much for consistency and comparability.

We also are proposing to impose a prescriptive “nag rule” on ESG-Focused funds. The proposal defines an ESG-Focused Fund as a fund that “focuses on one or more ESG factors by using them as a significant or main consideration (1) in selecting investments ***or*** (2) in its engagement strategy with the companies in which it invests.”[12] Conducting a few earnest meetings during which ESG issues are raised will not do; to count for purposes of the rule, such engagements must be “part of an ongoing dialogue with the issuer regarding this goal.”[13] More to the point, an ESG-Focused fund that implements its investment strategy via “ESG engagement meetings,” not only must advocate “for

one or more specific ESG goals to be accomplished over a given time period," the progress toward achieving those goals must be "measurable."[14]

Rather than allow funds to determine what constitutes meaningful interaction with issuers, we are proposing a system that is prescriptive almost to the point of parody. One substantive meeting might be better than five short interactions, but the rule values quantity over quality because the former can be reduced to numbers. If you think I am exaggerating, here is language directly from the release meant to clarify expectations:

[F]unds may hold meetings with certain issuers on an infrequent or ad hoc basis rather than as a significant part of their strategy, and may incorrectly believe that such infrequent or ad hoc engagement would be sufficient for them to claim that engagement is a part of their strategy.[15]

Funds are admonished to:

include[] in their compliance policies and procedures a requirement that employees memorialize the discussion of ESG issues, for example by creating and preserving meeting agendas and contemporaneous notes of engagements relating to ESG issues to assure accurate reporting on the number of engagements, as we propose to define it.[16]

I will be interested to see what commenters say on the matter. Among other things, would such a rule set a precedent for SEC micromanagement of asset management?

Why do we feel compelled to propose such sweeping and prescriptive new rules when we can and do use existing rules to hold funds and advisers to account? Part of the answer seems to be yet another instance of a troubling trend of not-so-subtle coercion through disclosure mandates. Recent proposals, including this one, introduce new pressure points that activists—or stakeholders as some prefer to call them—can use to strong-arm uncooperative companies into instituting policies more conducive to the activists' agendas or punish companies that fail to fall in line.

I pointed out this coercive trend in my opposition to last September's proposed Form N-PX amendments governing disclosure of fund votes. [17] This proposal would intensify the pressure on funds to vote and to do so in a particular way. For example, it would require a fund to disclose "the percentage of ESG-related voting matters during the reporting period for which the Fund voted in furtherance of the initiative."[18] Consider the following deforestation-focused fund example:

During the reporting period, the fund was eligible to vote on 100 voting

matters that would have limited deforestation. If the fund voted in favor of 75 of those matters, then the fund would report that it voted in furtherance of limiting deforestation 75% of the time during the reporting period.[19]

This type of requirement pressures funds to vote for ESG matters even if the fund has real concerns about the particulars of an initiative. Questioning the wisdom of any initiative labeled ESG is hard enough as it is. This proposal would only make it harder. We may end up with companies implementing policies that are neither good for the environment nor for investors.

The proposal's coercion is not limited to proxy voting. What will the practical implications be for an ESG-Focused fund for which issuer engagement is *not* now a strategy? Under the proposal such a fund would have to declare that it has *no intention* of engaging with portfolio companies on ESG matters. A fund that does engage with portfolio companies would be required to disclose the number or percentage of issuers with whom the fund held such meetings during the reporting period. These proposed requirements are designed to manufacture activism by funds on ESG issues.

The proposal also requires all "ESG-Focused Funds" that indicate that they consider environmental factors to disclose the carbon metrics I mentioned earlier unless they affirmatively state that they do *not* consider issuers' GHG emissions as part of their investment strategy.[20] Environmental funds are not monolithic, and a fund that focuses water quality or biodiversity might not otherwise track greenhouse gas emissions. The proposal suggests that it really should.

Forcing ESG-Focused funds to make good faith estimates of a portfolio company's greenhouse gas emissions, when they cannot get such data from "non-reporting portfolio companies," will in turn play a coercive role. This time the coercion will be on companies to disclose greenhouse gas emissions so that funds will invest in them without the burden of greenhouse gas guessing (and subsequent enforcement second-guessing). If demand for greenhouse gas disclosures is becoming the norm, let the standards and expectations develop organically; let investors shape industry practice through their investing decisions, not through regulatory mandates about what investors *ought* to be considering.

Our markets are dynamic and equipped in ways we can never duplicate when it comes to the efficient dissemination of information. This proposal would displace the market's efficient signaling mechanisms with value-laden regulatory nudges. I have little faith that that change will lead to more efficient capital allocation or greater investor wealth accumulation.

The proposal reflects countless hours of careful work to translate the Commission's policy objectives into regulatory text and to craft a robust set of questions to accompany it. That task was not easy. So I will end my remarks by thanking the hardworking men and women of the Divisions of Investment Management and Economic and Risk Analysis, the Offices of the Chief Accountant, and General Counsel, and others at the Commission for rising to the challenge. I will also thank in advance the many commenters who will take the time to provide us with their thoughts and insights, which will inform how I vote should there be an adopting release.

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[1] *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (May 25, 2022), [_____________] [hereinafter Proposal].

[2] *See* Press Release, SEC, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations (May 23, 2022) https://www.sec.gov/news/press-release/2022-86 (announcing settled charges against an adviser for "misstatements and omissions about Environmental, Social, and Governance (ESG) considerations in making investment decisions for certain mutual funds that it managed").

[3] *See, e.g.*, Proposal, *supra* note 1, at 166-68 ("reaffirm[ing] existing obligations under the compliance rules when adviser and funds incorporate ESG factors" and discussing "current regulations seek to prevent false or misleading advertisements by advisers").

[4] Proposal, *supra* note 1, at 35 (The proposal, for example, would require funds and advisers to explain "the relationship between the impact the fund is seeking to achieve and financial returns" and to disclose, if true, that financial returns are secondary to achieving the stated impact or that achieving the fund's stated impact is intended to enhance financial returns. *See* proposed Item 7 of Form N-1A [17 CFR 274.11A]).

[5] *See* Proposal, *supra* note 1, at 1.

[6] *See, e.g.*, Julien Ponthus, *When defence stocks become an unlikely ESG play*, Reuters (Mar. 2, 2022), https://www.reuters.com/markets/stocks/live-markets-when-defence-stocks-become-an-unlikely-esg-play-2022-03-02/ (quoting analysts "We believe defence is likely to be increasingly seen as a necessity that facilitates ESG as an enterprise, as well as maintaining peace, stability and other social goods . . . . Recent events in Europe, we think, will

significantly increase the likelihood of defense's inclusion in the EU's Social Taxonomy'.");Brooke Sutherland, *Defense Stocks Search for Their Place in the ESG Universe*, Bloomberg (Mar. 25, 2022), https://www.bloomberg.com/opinion/articles/2022-03-25/industrial-strength-defense-stocks-search-for-their-place-in-the-esg-universe-l16s9bcq.

[7] *See* Proposal, *supra* note 1, at 129.

[8] *See* Proposal, *supra* note 1, at 168.

[9] *See* Proposal, *supra* note 1, at 88.

[10] For my comments on that proposal, *see* Hester M. Peirce, Commissioner, SEC, We are Not the Securities and Environment Commission - At Least Not Yet (Mar. 21, 2022), https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321.

[11] *See* Proposal, *supra* note 1, at 106.

[12] *See* Proposal, *supra* note 1, at 33 (emphasis added).

[13] *See* Proposal, *supra* note 1, at 84.

[14] *See* Proposal, *supra* note 1, at 81.

[15] *See* Proposal, *supra* note 1, at 62.

[16] *See* Proposal, *supra* note 1, at 82.

[17] *See* Hester M. Peirce, Commissioner, SEC, Statement on Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers (Sep. 29, 2021), https://www.sec.gov/news/public-statement/peirce-open-meeting-2021-09-29#_ftnref2.

[18] *See* Proposal, *supra* note 1, at 77-78.

[19] *See* Proposal, *supra* note 1, at 78 n.109.

[20] *See* Proposal, *supra* note 1, at 88.