Update on progress in ESG Subcommittee

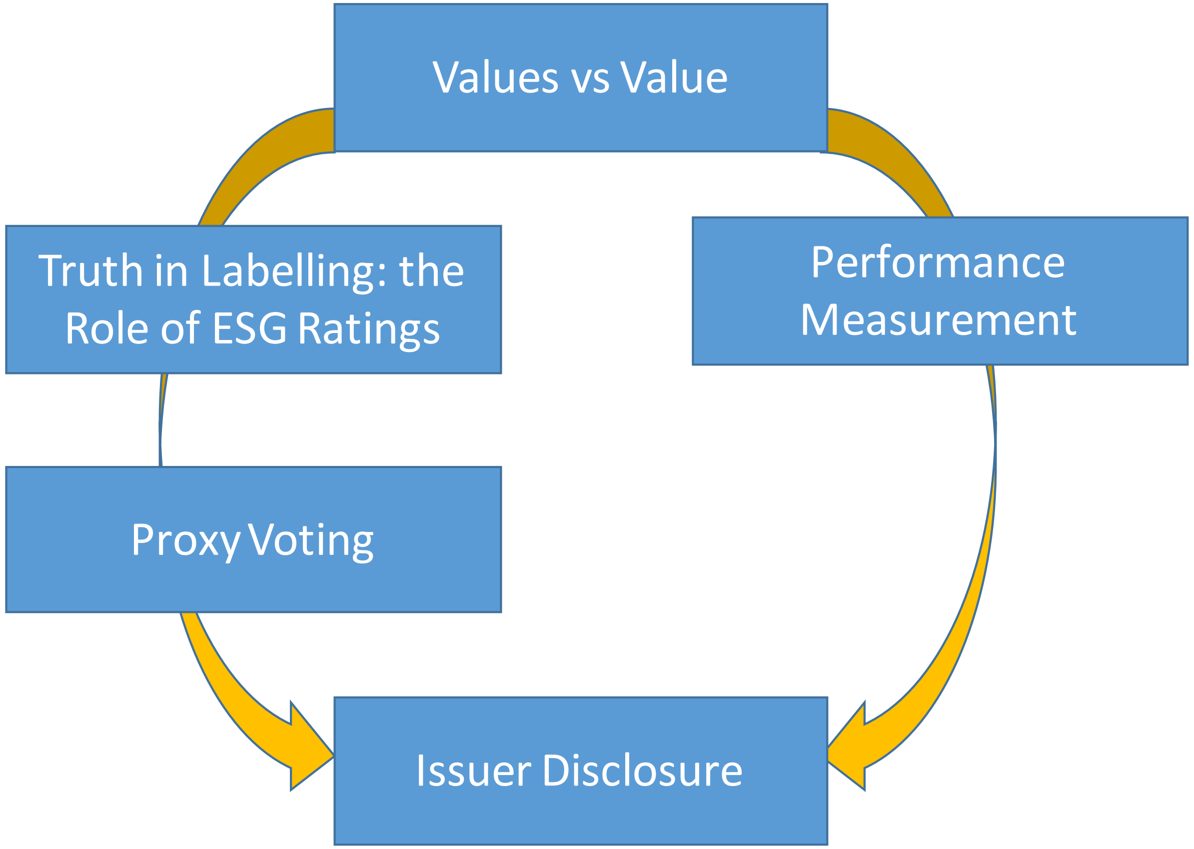
SEC Asset Management Advisory Committee

September 16, 2020

Overview

- Progress report since last meeting for our workstreams
  - Value vs Values
  - Performance Measurement
  - Proxy Voting
  - The role of ESG rating systems and benchmarks
  - Issuer disclosure
- We explore a range of potential actions for three of the workstreams

Understanding how the workstreams work together



For three of the workstreams, we explore a spectrum of potential recommendations

Do nothing | Moderate intervention | Strong intervention

- None of the alternatives explored in this presentation should be taken as recommended or preferred
- They are included here in many cases as “strawmen” to illustrate the spectrum of possibilities, and the costs and benefits of each, to stimulate discussion with the AMAC and gather feedback
- Once we have a better sense of pros and cons for each area, we plan to come back to the AMAC in December with true recommendations

Values vs. Value Workstream

Are ESG funds expressing their investors' values, or creating value for the investor?

- This workstream explores the following questions:
  1. How should ESG be treated within the context of the Names Rule? Is it fundamental? Or is it a strategy?
  2. If ESG is about values, that is an investor choice. How should that impact disclosure?
  3. If ESG is about value, it is about financial metrics. How should that impact disclosure?

ESG in the Context of the Names Rule

Key Features of the Rule

- Rule 35d-1 or the "Names Rule" established and modified over the years to:
  - Recognize that a fund's name may influence an investor's decision to invest in a fund
  - Prohibit materially deceptive or misleading fund names
  - Ensure consistency between what is "marketed" by virtue of a name and the underlying assets owned by a fund
  - Currently requires 80% of assets by value to be consistent with certain attributes included in a fund's name
- Requires 80% of assets by value to align with names that include:
  - Type of investment (e.g., stock, bond, commodity)
  - Industry of investment (e.g., utilities, health care)
  - Geography (e.g., Europe, Asia)
  - Country (e.g., US, Mexico)
- Does not require 80% of assets to align with names that reflect:
  - Investment Objective (e.g., capital appreciation, low volatility)
  - Strategy (e.g., growth, value, ESG)
  - Policy
  - However, the Names Rule still prohibits funds from using materially deceptive or misleading names

1. How should ESG be treated under the Names Rule

- Currently "ESG" is considered a strategy under the Names Rule
  - 80% holdings requirement does not apply
  - Investors continue to receive protections against materially deceptive or misleading names
- Could be changed if SEC determines Names Rule should apply to strategies
  - March 2020 SEC Request for Comments on Fund Names specifically asks for industry input on this point
- Is ESG a strategy or fundamental?
  - It can be either or both, depending on the context in which they are used
  - E, S & G can vary broadly in how they are defined and what they imply in an investment context
  - A strategy could be easier to articulate – e.g., renewable energy, low carbon
  - A fundamental use of ESG would be to treat these as risk factors and attempt to quantify their potential impact on the overall prospects for an investment

- How should ESG be treated under the Names Rule in the future?
  - If ESG is considered a strategy, it should be treated consistently with any Names Rule changes made to the requirements for strategies
  - If the fundamental application is to determine "inclusion" or "exclusion" of certain assets, this is effectively proscribing an asset type or industry which are items already covered by the Names Rule. As such, a holdings requirement should apply.

2. If ESG is about values, that is an investor choice. How should that impact disclosure?

- Certain retail and institutional investors may, for a variety of reasons, seek to invest in assets that reflect their beliefs about a wide array of issues including environmental, social or governance and consider these to be of equal or greater concern than the investment return received from the asset
- Since this is a matter of choice, an investor should remain obligated to conduct reasonable due diligence to ensure that a fund's assets align with their values, regardless of a fund's name
- However, that does not imply that funds should be able to use names that are materially deceptive or misleading to entice investors
- "Trust but verify" should apply. A fund claiming ESG in its name should provide adequate disclosure to allow prospective investors to confirm certain relevant details such as:
  - The elements of E, S, or G that are being included in the fund's strategy
  - How the fund manager specifically interprets these elements in the context of a fund (e.g., if a fund has a "social" focus, is that applied to enhance diversity, avoid child labor, foster fair trade, etc.)
  - How these factors are utilized to select the securities a fund will or will not own (e.g., are these determinations made by the manager exclusively, is an independent ESG rating model used to screen assets, etc.)
  - Whether the use these factors may allow for non-economic outcomes to override the potential for investment returns
  - If and the extent to which any exceptions are allowed within the fund context at individual asset level and at the aggregate fund level (e.g, can a "renewable energy" fund own a traditional power generation company that produces 20% of its energy from renewable sources, what percent of total assets can be invested in non-renewable companies)
  - How any changes to the fund's investment approach will be communicated to and approved by the investors.
- Ultimately, a values-based decision rests on the shoulders of the investor. If they are unable to satisfactorily confirm alignment between a fund's assets, its stated strategy and the values they seek to support, they should pass on the investment opportunity

3. If ESG is about value, it is about financial metrics. How should that impact disclosure?

- We will be covering some of the current research in ESG performance in the next section; there is certainly debate that ESG factors have a sustained, persistent, measurable and material impact on the value of an asset
- Some practitioners believe that ESG factors will lead to superior financial returns in the long-term resulting from:
  - Current ESG-related risks are inadequately reflected in the price of certain assets
  - Capital flows will reallocate to ESG companies and impact multiples / valuation
- As a result, ESG factors or attributes are being used in the asset selection process by:
  - Including assets that meet certain criteria (e.g., nothing allowed unless certain parameters are met or exceeded)
  - Excluding assets that meet certain criteria (e.g., everything allowed except when certain parameters are met or exceeded)
  - Considering ESG factors as a supplemental element in a broader, multi-factor framework employed for asset evaluation
- Disclosure Considerations:
  - Inclusion / Exclusion approaches can materially limit an investable universe and shape a portfolio's construction in ways that create meaningful risks / rewards relative to the broader market. An investor should be provided the information necessary to assess this risk including the metrics or models employed and the relevant thresholds for inclusion / exclusion should be thoroughly described and discussed. Any allowance for exceptions to these limits should be described in detail.
  - Managers using ESG factors as a component in a broader investment process should provide equal disclosure regarding all parts of their process. Added disclosure about ESG elements should be voluntary, but not distort their impact on the total investment process.
  - Managers should be able to create competitive advantage and have proprietary elements to their security selection process

How should we think about how ESG strategies contribute to performance?

- This workstream's objective is to provide recommendations for understanding drivers behind risk and returns of ESG funds, as well as ways to measure alignment of financial outcomes with fund's objectives
- Since the AMAC meeting in May, we have been focusing on recent research measuring the impact of ESG strategies on performance. In particular, we looked at the
    - Performance of ESG Strategies during Covid-19 crisis
    - Impact of E, S, and G individually and collectively on portfolio returns and risk

What does research show about ESG performance during the COVID-19 crisis?

According to recent academic research:

- During the COVID-19 selloff, the performance of ESG funds was better than the broad market index. As such, there were claims that companies with high ESG scores were immunized against the pandemic
- The specific research findings are:
  - After controlling for a number of variables such as industry, liquidity, accounting measures, intangible assets etc., ESG was not significantly associated with market returns during Q1 2020
  - COVID-19 crisis returns are positively associated with intangible assets (R&D, IT, etc.)
  - Innovation-related assets rather than social capital investments offer greater immunity to unexpected COVID-19 related market drawdowns

Source: Demers, Hendriske, Joos, Lev. "ESG Didn't Immunize Stocks Against the Covid-19 Market Crash". Sep 2020

Does bundling E,S, and G together affect performance?

Research by MSCI:

- How do ESG considerations impact performance?
  - E, S, and G issues impact company financial performance differently
  - If they do, should they be combined differently (weighting)?
  - Is the sum of the parts greater than the whole? Or vice versa?

$$E + S + G \neq ESG$$

- Do Companies with High ESG scores and High E, S, G scores outperform those with lower scores?
  - High ESG ranked portfolio outperformed the Lowest ranked portfolio over time
  - High E, S, G ranked portfolios outperformed the lowest ranked portfolios over time
  - High ESG ranked > High G ranked > High S ranked > High E ranked
  - **The whole > Sum of the Parts**

Source: MSCI, "Deconstructing E,S,G Rating Performance. Risk and Return for E, S, and G by Time Horizon, Sector and Weighting". June 2020

Should ESG Funds require additional performance disclosures?

- Traditional investment styles such as growth/value can use commercially available 3rd party returns based and holdings-based performance attribution systems to easily decompose sources of returns and see what bets the fund is taking – from security selection to allocation decisions.

- ESG currently does not have such attribution systems.

- According to a survey by Moody's, 71% of portfolio managers are unable to view performance attribution of ESG factors – only 15% have visibility of ESG factors, while additional 15% said they can view ESG factors but on limited basis.

- In order for end investors to clearly understand the investment outcomes from ESG investing, a performance attribution mechanism is needed – for example, do returns come from E, S, and/or G?

Using the existing performance disclosure requirements as the baseline

- Form N1-A
- Risk/Return Summary: Investment Objectives & Goals
- Risk/Return Summary: Investments, Risks, and Performance
    - Principle Investment Strategies of the Fund – how the fund intends to achieve its investment objectives
    - Principle Risks of Investing in the Fund
        1) Narrative Risk Disclosure
        2) Risk/Return Bar Chart & Table
        3) Required to Benchmark Against Broad Market Index

Spectrum of potential recommendations we have explored in this area

	Do Nothing	Moderate intervention I	Moderate intervention II	Strong intervention
Description:	• Little or no change to existing disclosure requirements for ESG performance reporting	• Best practice guidelines or mandate description of ESG performance objective and fund performance relative to that objective	• Best practice guidelines or mandate use of secondary style-adjusted benchmark	• Mandate performance attribution of E, S, and G as well as ESG factors
Pros:	• Low cost for managers • Allows innovation in the space to continue • ESG is treated the same as other investment strategies.	• Potential for greater transparency re value vs. values performance objectives	• Potential for greater transparency re value vs. values performance objectives. • Greater accountability and comparability of performance objective.	• Greater transparency re value vs. values performance objectives. • Greater comparability. • More information about ESG factor performance.
Cons:	• Difficult for investors to assess performance impact of strategy compared to relevant benchmark • Does not address value vs. values spectrum.	• Unless mandated, compliance is voluntary. • Lack of comparability • Increased burden placed only ESG funds.	• Unless mandated, compliance is voluntary. • Secondary benchmark burden • Lack of ESG standardization creates benchmark selection challenges. • Increased burden placed only ESG funds.	• Methodology, data, and system infrastructure to measure ESG factor performance does not exist. • Significant increased burden placed only on ESG funds • May reduce incentives to develop new strategies

What requirements should govern ESG Funds' proxy voting practices?

- This workstream's objective is to recommend approaches to proxy voting for ESG strategies
- When workstream initiated, the focus was on the range of practice in proxy voting for ESG funds, and whether any action needed to be taken
- In July, 2020, the Commission voted to amend rules concerning proxy solicitations, and provided supplemental guidance
- Benefits of amended rules:
  - Additional conditions to the availability of certain existing exemptions from the information and filing requirements of the Federal proxy rules that are commonly used by proxy voting advice businesses
  - Disclosure of conflicts of interest between proxy adviser and affiliates
  - Clarity that proxy voting advice generally constitutes a solicitation (SEC '34 Act)
  - Failure to disclose certain information my be subject to antifraud provision of the proxy rules
- We believe these actions effectively improved investors ethical outcomes and in combination with rule 13F provide an adequate level of transparency with respect to proxy voting whether a fund is designed to include ESG considerations or not

What role can ESG Rating Systems and Benchmarks play?

- This workstream's objective was initially to provide recommendations for how and whether to suggest or require the use of third party ESG ratings systems and/or benchmarks for those investment portfolios that brand themselves as ESG
- We are broadening this objective to provide recommendations to address "truth in labelling" and concerns about the potential for "greenwashing" in ESG funds, including how and whether to suggest or require the use of third party ESG ratings systems and/or benchmarks for those investment portfolios that brand themselves as ESG
- Since the prior AMAC meeting, we have focused on the best way to achieve this "truth in labelling" objective, examining the potential for voluntary or mandatory enhanced fund disclosure, enhanced issuer disclosure, or the use of ESG ratings or benchmarks
- We set out three of the alternatives we considered on the page that follows; a fourth alternative, enhancing issuer disclosure, will be covered in the final section of the presentation

Spectrum of potential recommendations we have explored in this area

	Do nothing	Moderate intervention	Strong intervention
Description:	• Little or no change to current disclosure requirements for ESG funds	• Provide best practice guidelines for ESG fund disclosure, likely describing investment process, standardizing on ICI-recommended taxonomy	• Require Funds Claiming ESG to have a Higher ESG Score than their benchmark from an "NRSRO" for ESG
Pros:	• Low cost for managers • Allows continuing development in this field to flourish • There are many kinds of fund claims that require no empirical proof; why hold this class to a higher standard	• Relatively low cost for managers • Allows better comparability and consistency • Allows continuing development in this field • Allows for a variety of styles, does not favor one particular style	• Consistent, measurable approach driving a particular kind of consistency and reliability for investors • Quicker to put in place than enhanced issuer disclosure
Cons:	• Potential for misrepresentation • Difficult to distinguish between strategies of varying quality	• Voluntary nature may still result in funds that misrepresent or engage in selective disclosure • Without mandated definitions, comparability might be misleading	• Could drive costs for managers higher • If too few NRSROs, can limit development of the field; if too many, comparability suffers • Rating approaches currently differ markedly

Supporting detail

Fund disclosure taxonomy detail

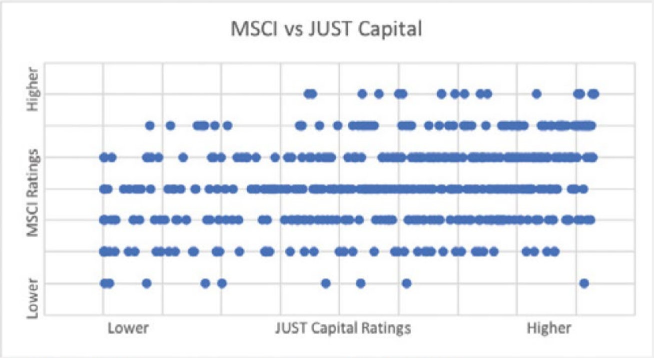
- Enhanced fund disclosure using common language based on the ICI taxonomy[1] would detail how a fund achieves its ESG strategy:
  - Whether the fund excludes securities, includes securities, or uses a combined approach
  - Whether it uses qualitative methods, or quantitative methods such as use of proprietary or third party scoring systems, or a combination of both
- Having a fund board approve the disclosure might add an extra quality control
- A recommended practice might to have performance attribution that demonstrates how these practices affected returns

Comparability of ESG ratings

- As shown in the Investment Adviser Association research brief, "Sustainable Investing is an Active Process," 2020

A SNAPSHOT OF SUSTAINABILITY RATINGS DIVERGENCE

Sustainability ratings from different providers can seem to have little connection with each other, as this scatter diagram illustrates. It plots the MSCI ESG ratings of 518 companies against ratings for the same companies from JUST Capital.



Data: MSCI and JUST Capital ratings available online on May 28-29, 2020.

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

Opportunities to improve the quality of ESG disclosure by issuers

- This workstream's objective is to make recommendations to the SEC concerning guidance it should give corporate issuers (or regulation it should enact) for how those issuers disclose and present ESG data and related information
- Materiality
  - Because ESG issues are material, investors should be able to obtain this information from issuers and that information should be:
    - Comprehensive
    - Meaningful
    - Comparable

Opportunities to improve the quality of ESG disclosure

Dimension	**Standard**
Comprehensive	• Required disclosures and metrics cover <u>all material</u> ESG issues
Meaningful	• Required disclosures and metrics convey issuer's exposure to <u>each material</u> ESG issue • Disclosure standards acknowledge dynamic nature of materiality
Comparable	• Required disclosures and metrics balance standardization (to promote comparison *across* industries) with specificity (to enhance comparability *within* industries)

Opportunities to improve the quality of ESG disclosure

Dimension	Issues
Comprehensive	• < 30% of public cos. disclose ESG risks; even less for private cos. • Fixed-inc. disclosure poor; issuer- or lender-focused, but not both
Meaningful	• Backward- vs. forward-looking • Voluminous metrics makes analysis challenging • Lack of “positive impact” data (vs. mitigating “negative impact”) • Cherry-picking by issuers
Comparable	• Multiple standard-setters (GRI, SASB, TCFD, etc.), stakeholders

Gaps in Disclosure and Role Regulation Can Play

- Standard-setting: Establishing materiality and its meaning across industries
- Disclosure framework: Metrics based on materiality; issuer commentary
- Standardization: Achievable through existing frameworks (i.e., SASB)
- Presentation: Data and issuer commentary

Standard-setting

- Embrace third-party standard-setting organizations’ ESG reporting metrics
  - Emphasize disclosure of material issues (backward- and forward-looking)
- Make third-party standard setters’ recommendations authoritative, binding
  - Similar to GAAP
- Hold 3rd-party standard setters accountable for harmonizing existing standards
  - i.e., GRI, TCFD, SASB, etc.
- Encourage collaboration among standard-setters (i.e., SASB + GRI)

Disclosure framework

- Require principles-based disclosures that focuses on material issues
- Establish balanced approach to required disclosure
  - i.e., focused list of mandatory disclosures applicable to most issuers; supplement w/specific disclosures for business/industry concerned
- Expand reporting requirements from largest firms to nearly all companies
  - Formalize requirements for “green bonds” based on use of proceeds
  - Adopt multi-tier approach that is well adapted to smaller issuers

Standardization

- Standardize…
  - Industry-specific disclosures on env. impact, starting w/climate change
    - Supported by highly refined industry classifications that enhance comparability
    - Disclosures *across* issuers, when material
  - Forward-looking disclosures; backward-looking metrics; discussion of risk management; climate scenario analysis
    - Commentary on change across key dimensions of material ESG risk
  - Baseline ESG disclosures
    - Critical indicators across sectors (climate, safety, etc.)
    - Key information on board diversity; workforce demographic data
    - Policies on bribery and corruption, whistle-blowing, codes of ethics
    - Policy commitments and programs designed to meet commitments
      - At least 3 years of performance data on programs' success

Presentation

- Make ESG disclosures look like other financial disclosures
  - Data should be temporally aligned with financial disclosures
  - Encourage “integrated” reporting (a single, encompassing report, i.e., annual report)
  - Machine-readable in standard format w/standard taxonomy

Spectrum of potential recommendations we have explored in this area

	Do nothing	Moderate intervention	Strong intervention
Description:	• Make minimal change to current issuer disclosure requirements	• Encourage and then mandate disclosure per principles developed by third-party standard-setters; tier by materiality and issuer size	• Codify comprehensive set of disclosure rules through regulation, irrespective of materiality, issuer size
Pros:	• Low cost/burden for issuers • Facilitates "market-driven" response, i.e., investors reward issuers who uphold best disclosure practices, encouraging others to follow	• Gives issuers time to prepare for/adapt to emerging disclosure frameworks • Taps a successful model (i.e., GAAP, etc.) • Promotes common disclosure standard without being overly prescriptive • Differentiates per materiality, issuer size	• Enshrines clear, comprehensive standard for disclosing ESG matters • Boasts authoritativeness, consistency • Obviates need for patchwork approach that takes time to implement, courts risk of confusion
Cons:	• Doesn't uphold best practices for comprehensive, meaningful, comparable disclosure • Impedes development of common disclosure standard and framework, resulting in continued inefficiency	• Industry, regulators haven't coalesced around a third-party framework yet • Gradual, patchwork approach might not promote standardization, comparability	• Fails to acknowledge diffs. in ESG issue materiality, issuer size/readiness • Puts potentially heavy burden on issuers to implement disclosure • Rules-based approach could detract from disclosure meaningfulness

Next steps

- We welcome feedback from AMAC members, and reactions to the range of actions we described for Performance Measurement, ESG Ratings/Truth in Labeling approaches, and Issuer Disclosure
- We plan to meet with investors and issuers in the next quarter to better understand the uses of issuer disclosure, and the costs to produce it
- We plan to return to the AMAC meeting in December to make our recommendations

Appendix

Additional ESG-related questions from the request for comment on Fund Names

- Should we amend the Names Rule to apply specifically to investment strategies?
  - It does not seem unreasonable to require strategies to comply with the Names Rule
  - A manager should be able to describe a fund's strategy, articulate the general parameters as to how that strategy is applied and ultimately demonstrate how selected assets meet these parameters
  - In this way, an investor can be assured that a fund's actual investments reflect what is marketed in its Name
  - Should the Names Rule apply to terms such as "ESG" or "sustainable" that reflect certain qualitative characteristics of an investment?
  - Yes, with flexibility for an asset manager to describe its interpretation of these terms and how they are used to construct a portfolio

- Are investors relying on these terms as indications of the types of assets in which a fund invests or does not invest (e.g., in companies that are carbon-neutral)?
- Are investors relying on these terms as indications of a strategy (e.g., investing with the objective of encouraging enhanced governance)?
- Are investors relying on these terms as indications of a fund's non-economic objectives?
  - For the three questions above the same answer applies
  - Yes, some investors may rely on terms to indicate the type of assets a fund will own, the strategy it employs to select assets and any additional objectives of a fund. Sophisticated investors will generally perform adequate diligence to confirm these facts.

- Should there be limits on a fund's ability to characterize its investments as ESG or sustainable?
- Instead of tying terms such as ESG in a fund's name to any particular investments or investment strategies, should we instead require funds using these terms to explain to investors what they mean by the use of these terms?
  - For the two questions above, the following answer applies.
  - At a minimum current protections should continue to apply - a fund should not be able to make materially deceptive or misleading claims. An improved approach would be to recognize that "ESG" has a broad interpretation and, as such, would require accurate descriptions of that interpretation in the context of a particular fund and then require consistent application of this interpretation with respect to the assets owned