524 Broadway, Floor 11
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May 5, 2020

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Request for Comments on Fund Names. File No. S7-04-20; Release Nos. IC–33809; RIN 3235-AM72

Dear Madam Secretary:

We welcome the SEC's Request for Comment on the Names Rule and its suitability for funds labeled "ESG" and "Sustainable".

Should the Names Rule be kept and in what form?

The Names Rule *in its current form* is not suitable to be applied to investment products labeled "ESG" or "Sustainable". These terms generally do not correspond to a type of investment, and therefore cannot be measured according to the Names Rule's asset-based test.

However, the principle of the Names Rule--to prevent funds from using deceptive or misleading names--is a critical support for a credible market in investment products. This is no less true for ESG and sustainable investments. As investor objectives evolve, investment products evolve, and fund names reflect these evolutions, the careful reflection of the Names Rule's principle in the regulation of fund names will contribute to future credibility between market participants. *Therefore, the Names Rule should be adapted such that it can be applied to this sector of the fund market.*

Disclosures do help investors to understand the objectives, strategies, and assets of an investment product. Yet, not least owing to the quickly growing number of available products, a fund's name is the first and dominant representation of its characteristics, and therefore has the greatest potential to mislead. For this reason, the Names Rule should not be repealed, but should be refigured with technical standards other than an

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asset-based test. Incorporating standards on "strategies" will be a constructive step in the direction of market transparency and credibility. In particular, as terms such as "ESG" and "Sustainable" generally refer to investment strategies, new Names Rule standards can help fund managers and investors to harmonize what they mean by these terms.

In our view, the only de facto consensus regarding the meaning of these labels is to imply a degree of consideration of environmental, social, and/or governance data in relation to the underlying investment activity. Even considerations of this data which are de minimis, inconsistent, or indistinguishable from strategies without this label currently meet this minimum standard.

Why is the application of a new Names Rule important for the fund market?

The need for an improved Names Rule is two-tiered.

First, as a matter of legal importance and urgency, fund managers and investors must be aligned on the *purpose* of a fund's incorporation of ESG data ("ends test"). The *fiduciary duties* of trustees of pension funds, charities, and private trusts are implicated in this determination[1].

In particular, there are three central purposes which motivate the incorporation of ESG data in investment. The first is to improve portfolio risk and return ("risk-return ESG"). The second is to limit negative externalities or increase positive externalities of investment activity for considerations such as environmental or social health ("collateral benefits ESG")[2].

Although these first two purposes are sometimes overlapping, they are distinct--most evidently in their relation to fiduciary duty. This distinction is even more pronounced for pension funds subject to ERISA, which is unequivocal in defining a pension trust's beneficiaries' interest in exclusively financial terms, therefore allowing no scope for collateral benefits ESG.

In contrast to the two purposes listed above, which incorporate ESG data to guide investment activity, a third purpose for which a fund manager may use ESG data is to

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[1] Aaron Cantrell, "To ESG or not to ESG? Fiduciary duty is the question." *Record Macroblog* May 4, 2020 https://macroblog.recordcm.com/to-esg-or-not-to-esg-fiduciary-duty-is-the-question/

[2] Max M. Schanzenbach & Robert H. Sitkoff, "Reconciling fiduciary duty and social conscience: the law and economics of ESG investing by a trustee," *Stanford Law Review*, Vol 72. (February 2020).

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disclose certain information to investors. Most usefully, this would entail the disclosure of any significant negative externalities of investment activity. As a point of comparison, according to new legislation in the European Union (also on-boarded by the United Kingdom), fund managers must separately disclose 1) how they consider ESG data in the investment strategy, as well as 2) any ”principal adverse impacts” on sustainability factors such as the environment or society. This is known as the “Dual-Materiality Framework”.

The second tier of the fund market’s need for an improved Names Rules relates to creating separate, substantive technical standards in relation to the three distinct purposes named above (“means test”). This is perhaps less urgent than the need for clarity about a fund’s purpose in incorporating ESG data, yet nonetheless falls within the scope of the SEC’s intention to prevent the use of misleading names. As an example, if a fund passes an “ends test” by clearly identifying its objective (e.g., risk-return or collateral benefits), but exhibits no substantive element of investment strategy consistent with that objective (failing the “means test”), the name, though clearer than before, is inaccurate and misleading.

How and why can the terms “ESG” and “Sustainable” be repurposed for the fund market?

The terms “Sustainability” and “Sustainable” are borrowed from a broad cultural, political, economic, and historical discourse which examines the durability of human society’s cultures and economic processes, its agents, its resources, and its natural environment. This discourse is often inextricable from the affiliated sustainability movement which goes beyond *understanding*, and attempts to improve the durability of human society.

Private investment plays a central, multi-faceted, and indeed conflicted role in this discourse and in the affiliated movement.

In a large segment of this discourse, private investment is seen as a vehicle by which non-financial sustainability objectives can be achieved. An example is the financing of renewable energy technologies, of environmental (e.g., water management or waste management) technologies, or of social initiatives such as community bonds. These investments are often structured along entirely commercial terms, with investors achieving market return or even better, but they are understood to generate positive

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externalities in addition to financial returns. (They are sometimes additionally assessed on that basis).

For a different segment of this discourse, including many financial market participants, the sustainability of our financial system--and of financial returns--is what is meant by "sustainability". The sustainable management of our environment and natural resources, as well as of social health and cultural assets, are encouraged where they aid economic growth, and investment returns in particular. More practically, exposure to environmental or social "boundaries" is understood to generate risk to investment returns.

Within the financial industry, although these views can be distinguished by purpose in the abstract ("Finance for Sustainability" vs. "Sustainability for Finance"), they are not always so easily disentangled in real terms. There is substantial overlap in terms of data used, investment strategy, and the market participants drawn to each. Investors who place value on environmental or social factors are likely to see these factors both as an inherent *cause* of investment performance, as well as an important *effect* of their investment activity. Moreover, there can be overlap in this cause and effect, particularly where policy or reputational feedback loops exist. That is to say, in certain circumstances reducing exposure to negative externalities can be a way of reducing exposure to financial risk generated by environmental or social factors.

However, not always. Indeed, there can be meaningful trade-offs between financial sustainability and broader social and environmental sustainability, and there will be as long as policy and practical limitations allow for negative externalities in business and investment activity. Therefore, the distinction of purpose still matters, not least for its legal implications for trustees, as described above.

We find that the two terms "ESG" and "Sustainable" can be efficiently repurposed to distinguish the two ways in which ESG data is used. This can eliminate redundancy between these terms and add clarity around fund objectives, while minimizing changes to investor perceptions or fund names, as below.

Given the reference to a broader social discourse on "sustainability", we find that this term *should be reserved for the funds and investment strategies which explicitly take into account environmental, social, and governance factors as <u>effect</u> of investment activity--in other words, for those funds which account for and manage the externalities of their investments*. In our view, an expectation of this accounting for externalities may

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be investors' *most common incorrect inference* with respect to the label of a "sustainable" investment fund. Therefore, this definition of "sustainable" with respect to the Names Rule represents the single most efficient change the SEC could implement to improve understanding in this market.

Furthermore, not least because certain trustees should be able to understand as easily as possible whether any fund is consistent with their fiduciary duty of loyalty, we recommend the term ESG to represent a fund which incorporates ESG data to improve risk, return, or both, and not to account for externalities. This has the benefit of largely representing the emergent consensus usage around this term.

In our view, the third purpose for which fund managers may use ESG data--to disclose significant negative externalities without explicitly informing the investment strategy--should also feature in the SEC's taxonomy. The European Union requires this disclosure for all investment funds. In the US, this could represent a viable subsection of the sustainable investment market.

What form of test would be suitable for a revised Names Rule with respect to "ESG" and "Sustainable"?

After applying an "ends test" to assess the presence of non-financial objectives, the incorporation of ESG data to improve risk and return, and/or the disclosure of "principal adverse impacts" (negative externalities) on social and environmental factors, each of these categories will require a "means test" of substantive technical standards. The question of these standards has no obvious answer. However, we see a constructive role for objective third-party reporting standards--for example, those of the Sustainability Accounting Standards Board (for "ESG" in our definition as above) or of the Global Reporting Initiative (for "Sustainable"). Technical standards could be built on the basis of underlying investments' absolute or relative (to manager baseline or to passive benchmark) performance with respect to these standards.

Additionally, where funds identify non-financial objectives which may not be judged from the portfolio itself ("Impact" objectives), although there are few practicable options today for objective verification of these funds' achievements, the SEC can keep its sights set on standards for these attributes as well. In particular, it may constructively reference the International Finance Corporation's Operating Principles for Impact Management.

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In our view, the technical standards for a revised Names Rule themselves merit an independent Request for Comment from the SEC.

We value the effort of the SEC to build transparency and effectiveness in the fund market as investor and fund objectives evolve in face of 21st century realities.

Sincerely yours,

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Isabel Estevez
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The views expressed herein are the authors' own.