August 16, 2022

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Filings Nos. S7-16-22 and S7-17-22

Dear Ms. Countryman,

My name is Corey Shapiro and I am a student at Columbia Law School who has spent the past year researching and writing a note[1] on the potentially misleading nature of ESG fund names and disclosures. Before law school, I gained exposure to ESG investing opportunities while working at a large asset management firm that offered dozens of ESG products across the investment spectrum. While I saw the promise of ESG investing, I also saw examples in the industry of greenwashing, which I thought had the potential to mislead investors and frustrate the many purposes for investing in ESG products. For my note, I examined the names and disclosures of the largest ESG funds to better understand these funds' investment criteria, if those criteria aligned with the funds' names, and whether a retail investor could reasonably understand a fund's investable universe based on the information provided to them and, in turn, determine if a fund aligned with their specific objectives.

I felt this was an important topic to research because it is widely reported that ESG funds do not always invest in a manner investors might expect based on the funds' names.[2] And if this is true, investors ought to know,[3] and regulation ought to prevent it from happening. I tried putting myself in the shoes of a retail investor who is interested in ESG products, cares about ESG causes, and believes they are helping achieve positive ESG outcomes by investing in ESG funds. As an example, how would this ESG-interested investor feel if they found out, as reported in 2021, that BlackRock's iShares ESG Aware MSCI USA Index Fund—the largest ESG ETF—

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[1] My note is scheduled to be published in Columbia's Journal of Environmental later this fall. I am in the process of revamping my note in response to the Commission's proposed rules. The most recent version is attached at the bottom of this letter.

[2] The Commission itself has observed instances of "potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks" in addition to "a lack of policies and procedures related to ESG investing … documentation of ESG-related investment decisions that was weak or unclear … and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials." SEC Staff, DIVISION OF EXAMINATIONS' REVIEW OF ESG INVESTING 2 (Apr. 9, 2021).

[3] This is especially true as we remain in a market period where ESG funds are underperforming the general market. *See, e.g.,* Katherine Lynch, *2022's Top Sustainable Funds Weather a Tough Market*, MORNINGSTAR (June 9, 2022), https://www.morningstar.com/articles/1097780/2022s-top-sustainable-funds-weather-a-tough-market.

was *more heavily* invested in twelve fossil fuel stocks than the actual S&P 500?[4] I sought to determine if a retail investor could recognize from a fund's disclosures that something like this was even a possibility, and more broadly, whether they could identify and understand how different funds' seemingly similar investing strategies could lead to dramatically different ESG outcomes. I focused on retail investors because ESG funds are popular with retail investors, who, as the Commission knows, are an investing base which generally struggles to comprehend financial information, let alone information in a sector with a lack of standardized definitions and norms.[5] As retail investors (especially environmentally-conscious millennials) continue to invest in ESG funds at record levels,[6] it is important that funds' disclosures position all investors to make informed decisions.

In my research, I analyzed the summary prospectuses of twenty ESG funds: ten ETFs and ten mutual funds. The twenty funds selected were the ten largest ESG funds by assets under management in their respective categories.[7] From this set, I developed a set of several quantitative and qualitative takeaways and ultimately concluded that the ESG fund industry was failing to clearly name funds and disclose key information—which I labeled "the ESG fund labeling problem." Further, I considered the regulatory regime currently in place, led by the Names Rule, and concluded that it was not equipped to reign in ESG funds and the unique challenges they raise. In the original version of my note, I called on the SEC to introduce regulations to address the ESG fund labeling problem, with a particular focus on revising the Names Rule, as well as increasing ESG fund disclosures to limit the potential for investor confusion surrounding misleading fund names and unclear disclosures.

The proposed regulations take great measures toward resolving the ESG fund labeling problem. I think that, overall, the proposed rules will help investors' understanding of ESG products, reduce information asymmetry and, in turn, lead to a fairer market. In particular, I believe the classification of ESG funds into different categories will provide investors with a useful point of comparison about how a particular fund balances achieving ESG outcomes and financial returns. However, there are a few components of the proposed rules that I urge the Commission to reconsider before finalizing the rules:

[4] Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUSINESSWEEK (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

[5] For instance, the CEO of the MSCI conceded that "ordinary investors piling into [ESG] funds have no idea" how his company's ratings methodology worked in that they do not focus on the risk the company presents to the world, but in reality, the other way around." *Id*.

[6] Allison Herren Lee, SEC Commissioner, Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation, Keynote Remarks at PLI's 52nd Annual Institute on Securities Regulation (Nov. 5, 2020) ("There is really no historical precedent for the magnitude of the shift in investor focus that we've witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making.").

[7] The sample set was not intended to be holistic, but to provide perspective on a retail investor's experience researching the largest ESG funds, which in theory, are consulted and relied on the most often.

**(1) That ESG funds, or under the proposed taxonomy, ESG-Focus and Impact Funds, should be subject to the Names Rule's 80% threshold requirement the way other funds are.** I will first explain why the 80% requirement on its own does not fit ESG funds before proposing a reasonable alternative. I discuss both of the Commission's related proposals together because the problem raised in one requires a solution in the other.

The 80% requirement does not fit ESG funds because they are fundamentally different than all other types of investment opportunities. Why? Because many investors choose to put their money in ESG funds for both financial and non-financial returns, something unique to this category of investing. In other words, profit-maximization is not the only goal of many ESG investors, nor is it the sole objective of many ESG funds, which often claim to simultaneously achieve market returns and positive ESG outcomes. In fact, millennials' interest in achieving ESG objectives goes so far that an overwhelming majority—70%—would be willing to sacrifice some yield to achieve sustainable outcomes.[8] Part of the willingness to sacrifice yield for positive ESG outcomes is likely driven by "emotional drivers"[9], i.e., the belief that sustainable investment opportunities can move the needle on ESG issues. For instance, 85% of millennials believe their investment decisions could influence climate change, 44% of whom believed this strongly.[10] The combination of investing for financial and non-financial reasons demonstrates the unique nature of ESG investing. It also explains why a rule created to regulate traditional profit-only funds does not work as well for ESG funds, which market themselves as achieving both market and "extra-market" returns.[11] Sections I.A.3 and I.B of my note, included below, explore these ideas in depth and help show why rules created with a profit-maximization focus are inapposite for ESG funds.

An example makes this even clearer. Put yourself in the shoes of the hypothetical ESG-interested investor mentioned above, who is part of the 85% of millennials who believe their investments can influence climate change and the 70% who would be willing to sacrifice some financial returns for a better environmental outcome; would they feel misled if the "ABC Fossil Fuel Free

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[8] Maintane Sardon, *A Guarded Generation: How Millennials View Money and Investing,* WALL ST. J., (Mar. 13, 2020), https://www.wsj.com/articles/the-recession-left-millennials-loaded-with-debtand-cynical-11583956727.

[9] Sally Hickey, *Advisers need to tap into ESG emotional drivers, says Aviva,* FIN. TIMES (May 24, 2021), https://www.ftadviser.com/investments/2021/05/24/advisers-need-to-tap-into-esg-emotional-drivers-says-aviva/.

[10] Additionally, on the "S" front, 80% of respondents believed it was possible for their investments to create economic growth to lift people out of poverty. MORGAN STANLEY INSTITUTE FOR SUSTAINABLE INVESTING, MORGAN STANLEY, SUSTAINABLE SIGNALS: INDIVIDUAL INVESTOR INTEREST DRIVEN BY IMPACT, CONVICTION AND CHOICE 4 (2019); *see also* Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 WM. & MARY BUS. L. REV. 7 (forthcoming 2022) (arguing that ESG ETFs have become an increasingly popular product fueled by investor desire for meaningful social change and a belief that investments can have a significant impact on a corporation's decision-making).

[11] Others have provided support for the idea that ESG investing has a "dramatically different" objective than other types of investing. *See* Eric C. Chaffee, *Index Funds and ESG Hypocrisy*, 75 CASE W. RSRV. L. REV. 1295, 1304 (2021) (noting the goal of ESG investing is "dramatically different" than traditional index funds because the former is a form of principle-based investing, whereas the latter is profit-based).

Fund"—which they chose to invest in, both to seek market returns and to avoid environmentally-harmful companies—was just fossil-fuel free for 80% of the fund? And in the 20% of the fund not subject to the Names Rule, ABC's fund managers invested in the Carbon Majors[12] the investor was specifically trying to avoid? In reality, this is not a fossil-fuel free fund, and it is difficult to see how its name is not misleading.[13]

In sum, the 80% investment allocation requirement does not work for ESG funds, and in particular, ESG-Focus and Impact Funds, given the dual and often conflicting objectives many investors have for investing in these funds. While such a threshold is appropriate for traditional, profit-maximization funds, it would be antithetical to many ESG investors' "extra-market" expectations[14] if an ESG fund left a sizable portion of the fund that was not adhering to its investment criteria, or even worse, directly working against investors' intentions and motivations for investing in the fund in the first place.

With respect to a solution, it is unrealistic for most funds to achieve 100% compliance with the fund's investing strategy. But funds that market themselves (and profit from doing so) as vehicles to achieve ESG outcomes should not be able to substantially invest in companies that work against the objectives their names purport to achieve. <u>Therefore, a 90% and 95% requirement would be more appropriate for ESG-Focus and Impact Funds, respectively.</u> These numbers still give fund managers breathing room to manage their funds, while greatly limiting the ability for funds to contradict their names and mislead investors.

**(2) Funds that invest in firms or funds that would not meet the fund's investment criteria ought to make that explicitly clear to investors.** A regulatory regime that only proscribes how funds disclose their criteria for selecting investments that make it into the fund's majority (i.e., 80%) strategy leaves investors unclear how a sizable portion of a given fund is invested. Under both the current and proposed regimes, investors could be put in a position where they do not know how 20% of a fund is managed. Put simply, it should be clear to investors when funds are investing in ways that are counter to their names and stated objectives. This will help both the profit-driven ESG investor[15] and the investor that is willing to sacrifice yield for positive ESG outcomes identify which funds best align with their wide-ranging investing objectives.

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[12] *See e.g.*, Press Release, Climate Accountability Inst., Carbon Majors: Update of Top Twenty Companies 1965-2017, (Oct. 9, 2019) https://climateaccountability.org/pdf/CAI%20PressRelease%20Top20%20Oct19.pdf ("We find that the Top Twenty [largest oil, gas, and coal companies] companies have collectively contributed 480 billion tonnes of carbon dioxide and methane, chiefly from the combustion of their products, equivalent to 35% of all fossil fuel and cement emissions worldwide since 1965.").

[13] There could even be a scenario where a fund, in an effort to earn competitive returns, over-levers into Energy-sector stocks, thus providing investors with disproportionate exposure to a sector they sought to avoid in the first place.

[14] *See* Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 WM. & MARY BUS. L. REV. 11 (forthcoming 2022) (noting that supporters of sustainable investing see it as a way to positively enact social and environmental change).

[15] This returns-focused investor, for instance, might be okay with a fund having significant exposure to companies that would not have been selected for the portfolio's investment criteria. As such, they might choose a fund with significant exposure to Carbon Majors or low Governance firms for the potential profit.

To this end, I propose that all ESG-Focus and Impact Funds should be required to clearly and prominently state on their websites what percent of the fund is invested in securities that do not comply with the investment criteria for the 80% portion of the fund, updated on a monthly basis. This monthly cadence will offer investors a somewhat frequent datapoint to consider when deciding whether to invest (or remain) in a fund and provide fund managers ample time to comply with the furnishing of this information. For example, if ABC's Fossil-Fuel Free Fund actually has 2% of its portfolio in an Energy sector ETF, which is invested in securities that would not qualify for the fund's 80%, they should disclose this to investors as the fund's name is technically no longer an accurate description of the fund.

Moreover, I believe Impact Funds should comply with further requirements given the additional extent they market themselves as focusing on positive ESG outcomes. Specifically: (a) Impact Funds should be required to apply a "Best-in Class"[16] strategy to any investments in the "20% part" of the fund so that exposure to undesired industries is limited to the "best of the worst"; and (b) an Impact Fund's investment in any one non-complying company cannot be one of the fund's 25 largest holdings or comprise more than 2% of the total fund's portfolio.

These requirements provide benefits to both investors and asset managers. Investors are given another data point to compare funds to each other, which should facilitate investors selecting funds that best match their objectives.[17] And from a policy perspective, it will force funds to disclose a potentially undesirable datapoint, which, could incentivize them to invest in a manner that is more true to their names. For funds that are investing according to their investment criteria for more than 80% of the fund, this datapoint gives them an opportunity to easily distinguish themselves from competitors. In many respects, this is how Akerlof's lemons model[18] plays out: as sellers are able to provide more information to the market and information asymmetry is reduced, it becomes easier for investors to spot the lemons (and avoid them). In turn, the best products on the market are bought, and in the funds context, will attract investors' dollars.

Below, I am including a truncated and revised version of my Note. I have removed non-relevant sections, and in particular, think it is worth the Commission considering:

- I.A.3 for a framework for explaining how ESG funds fall on a spectrum from being profit or ESG-outcome oriented. I think this will be helpful for your consideration of why it is so important for regulations to help investors identify where funds land across this wide-ranging spectrum.
- I.B provides research and information on the extent to which a large investor base cares about the non-financial impact of their investments. This data underscores the extent to which so many investors are leveraging investments to achieve non-financial benefits.

[16] Best-in-Class Screening is the "investment in sectors, companies or projects selected for positive ESG performance relative to industry peers." GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, 2018 GLOBAL SUSTAINABLE INVESTMENT REVIEW 7 (2019).
[17] Of note, this rule would help both investors looking to maximize impact as well as investors looking to maximize yield find the funds that best match their specific goals.
[18] Investopedia, Lemons Problem (Nov. 29, 2021) https://www.investopedia.com/terms/l/lemons-problem.asp.

- II.A contains several quantitative and qualitative takeaways that analyze the naming conventions and disclosures of the leading ESG funds using hand-collected data.
- II.B applies these takeaways alongside information on retail investors' general financial knowledge and investing habits.

In conclusion, I believe that the proposed regulations will help make the ESG fund industry an easier space for retail investors to navigate, but could be further developed to better achieve these goals. Investors need the ability to identify which funds best match their investing objectives without the underlying concern they are potentially being misled by confusing disclosures and marketing tactics. I hope the Commission finds these comments helpful, and I thank you in advance for your time and consideration.

Sincerely,

Corey Shapiro

# Green Funds in a Gray Area: An Analysis of the ESG Fund Labeling Problem in Action

Corey Shapiro

August 16, 2022


**Abstract**

*Amid record interest in ESG investing and investment in ESG funds, there has also never been more scrutiny of ESG funds and what they actually accomplish. Several former ESG industry leaders are sounding the alarm on ESG investing, calling it a deadly distraction from the real work needed to achieve ESG outcomes, and in particular, to address the climate crisis. They believe large asset managers are engaged in greenwashing, and investors are seriously being misled. The SEC has also found evidence of misleading fund names and disclosures, and has proposed two rules to combat this issue.*

*To answer whether ESG funds are living up to their purported hype, this Note analyzes proprietary data collected from the twenty largest ESG funds (mutual funds and ETFs), and documents the "ESG fund labeling problem." Namely, that ESG fund names are often vague or misleading, and that funds' disclosures do not clearly describe the funds' ESG investment strategies.*

*This version of the Note, submitted to the SEC, has been revised and shortened in light of the Commission's two recent proposed rules. As such, certain sections are omitted as they are no longer relevant.*

## INTRODUCTION

Imagine the following: after hearing about a revolutionary change taking place within the breakfast industry, you head down to your local supermarket to purchase one of these new, "healthy" cereals everyone is buzzing about. Upon entering the cereal aisle, you are paralyzed by the number of options. The first cereal you see is "Cereal Co.'s Nutritious Cereal." The next is "ABC's Healthy Cereal," and the third is "XYZ's Health-Oriented Cereal." To figure out the difference between these three ostensibly similar cereals—and purchase the one that best matches your dietary goals—you read the back of the boxes.

The first cereal box says the following: "We at Cereal Co. seek to deliver a nutritious product that tastes great too. That's why we created our 'Nutritious Cereal.'" ABC's cereal box says "Our 'Healthy Cereal' excludes artificial ingredients so customers can enjoy what they're eating and lose weight too. At least 80% of the ingredients in our cereal are organic and GMO free, and we have the highest rating possible from the leading organic cereal reviewer." XYZ's cereal box says something equally vague: "XYZ's 'Health-Oriented Cereal' has special health benefits derived from a proprietary cereal-making process that integrates healthy ingredients. In recognition of this approach, the U.S. Breakfast Association gave our cereal five spoons."

Looking lower on the boxes, each cereal states that to learn more about the cereal's nutritional information, you can scan the QR code on each box. The QR code takes you to a PDF called the "Summary of Cereal Information," which is long, challenging to read, and filled with industry jargon. Each cereal uses different terminology and metrics to describe its purported health benefits, making it difficult, if not impossible, to compare them to each other.

After reviewing the cereals to the best of your ability, you select one. It is not clear whether you picked a cereal that aligns with your diet, or even a "healthy" cereal at all.[1]

In many respects, retail investors[2] face similar challenges when researching and investing in environmental, social, and governance (ESG)[3] funds (and in particular, mutual funds[4] and exchange-traded funds (ETFs)).[5] Not only is it challenging for investors to compare funds to each other or easily match their investing goals with a fund's objectives given, among other issues—the lack of standardized industry terminology, wide-ranging ESG investment objectives and strategies, and lengthy and confusing disclosures—it is often unclear what being an ESG fund even means.[6] For instance, in the same way one would expect a "healthy" cereal to be

[1] *Cf.* Gary Gensler, Chairman, SEC, Prepared Remarks Before the Asset Management Advisory Committee (July 7, 2021) (making a similar analogy between ESG terminology and different types of milk).
[2] The SEC defines a "retail investor" as "a natural person … who seeks to receive or receives services primarily for personal, family or household purposes." SEC, Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 34-86032 & IA-5247, https://www.sec.gov/rules/final/2019/34-86032.pdf. Notably, this definition includes both current and prospective investors because the SEC "thought it would be beneficial for all natural persons to receive information to facilitate their account choices." *Id.* at 190. Applying this philosophy in the context of this Note, any ESG-related regulatory action analyzed or proposed should facilitate both current and prospective investors' understanding of investment products.
[3] Throughout this Note, "ESG" will be used a general term to include the many other terms that address similar concepts, such as "socially responsible," "sustainable," "responsible," and "green."
[4] The SEC defines a mutual fund as an "open-end investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments." SEC, MUTUAL FUNDS AND ETFS: A GUIDE FOR INVESTORS, OFFICE OF INVESTOR EDUCATION AND ADVOCACY 4.
[5] ETFs "are SEC-registered investment companies that offer investors a way to pool their money in a fund that makes investments in stocks, bonds, other assets or some combination of these investments and, in return, receive an interest in that investment pool." *Id.* at 6.
[6] "The cumulative breadth of possible ESG considerations is spectacular, and the level of resulting subjectivity this entails for an asset manager or commercial index provider in choosing constituent portfolio companies for an ETF index is tremendous." Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 WM. & MARY BUS. L. REV. 9 (forthcoming 2022).

nutritious, an investor might assume that a fund labeling itself as an ESG fund would invest in companies with stronger climate records; however, this often not the case.[7]

There is mounting evidence that ESG funds are not delivering on their stated ESG objectives,[8] and the asset managers behind these funds are not meaningfully fulfilling their promises to consider stakeholders beyond shareholders.[9] A key reason why ESG funds fail to champion ESG causes is because they are not designed to: not only are 90% of stocks in the S&P 500 eligible for inclusion in leading ESG funds,[10] but fund managers do not create their ESG funds to lead on ESG issues. For example, BlackRock's iShares ESG Aware MSCI USA Index Fund, the largest ESG ETF, is *more heavily* invested in twelve fossil fuel stocks than the actual

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[7] *See* INFLUENCEMAP, CLIMATE FUNDS: ARE THEY PARIS ALIGNED? 2 (2021) (finding that 71% of ESG funds had negative Portfolio Paris Alignment scores, and 55% of climate-themed funds received negative Paris Alignment scores. A negative Portfolio Paris Alignment score indicates that the securities within the fund are misaligned with global climate targets); *see also* Rajna Gibson Brandon et al., *Do Responsible Investors Invest Responsibly?*, EUR. CORP. GOV. INST. June 2021, at 4 (finding that ESG funds in the U.S. that signed the Principles for Responsible Investment pledge exhibited at best similar, if not significantly worse portfolio ESG scores than uncommitted peers); the Principles for Responsible Investment is a global alliance of socially responsible investors created in 2005 by United Nations Secretary-General Kofi Annan. Over 3500 investors have signed the pledge, which allows an organization to "publicly demonstrate its commitment to including environmental, social and governance (ESG) factors in investment decision making and ownership." United Nations Principles for Responsible Investment, Become a Signatory, https://www.unpri.org/signatory-resources/become-a-signatory/5946.article (last accessed March 16, 2022).

[8] *See generally* Jonathan B. Berk & Jules H. van Binsbergen, *The Impact of Impact Investing*, (Working Paper No. 3981) (concluding that divestment strategies have had little impact on corporate behavior and will likely have little impact going forward); *see also* Bernard Sharfman, Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE, art. 3, 2021, at 1 (arguing Engine No. 1's success in getting candidates elected to ExxonMobil's board was ineffective because the hedge fund has not provided specific recommendations on how ExxonMobil can transition to a leader in the clean energy sector).

[9] *See* Lucian A. Bebchuk and Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?* VAND. L. REV. (forthcoming May 2022), https://ssrn.com/abstract=3899421 (concluding the Business Roundtable Statement was made "mostly for show" and that companies joining it did not intend or expect it to manifest any material changes in their treatment of stakeholders).

[10] Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUSINESSWEEK (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

S&P 500; in response to public scrutiny, BlackRock says the fund is not intended to offer investors the top scoring-ESG companies.[11] The mismatch between ESG funds' labels and their investments is why some have concluded the ESG label is "often useless," and describe the effort of determining a fund's approach to ESG investing like navigating the "wild west."[12]

The disconnect between the conception and reality of ESG funds has led former asset management industry leaders to sound the alarm on ESG investing, calling it a "deadly distraction" from the actual work needed to address the climate crisis.[13] In 2021, the SEC Division of Examinations issued a Risk Alert on ESG funds, observing instances of "potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks."[14] These issues with ESG funds are particularly acute because ESG funds are popular with retail investors, who generally struggle to comprehend financial information, let alone information in a sector with a lack of standardized definitions and

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[11] *Id.*

[12] Tim Quinson, *ESG Study Shared With SEC Reveals Fund Labels Are Often Useless*, BLOOMBERG (Jan. 11, 2022), https://www.bloomberg.com/news/articles/2022-01-11/esg-study-shared-with-sec-reveals-fund-labels-are-often-useless.

[13] Tariq Fancy, BlackRock's former Chief Investment Officer of Sustainable Investing, recently wrote: "Sustainable investing boils down to little more than marketing hype, PR spin and disingenuous promises from the investment community. Existing mutual funds are cynically rebranded as 'green' — with no discernible change to the fund itself or its underlying strategies — simply for the sake of appearances and marketing purposes." Tariq Fancy, *Financial World Greenwashing the Public with Deadly Distraction in Sustainable Investing Practices*, USA TODAY (Mar. 16, 2021), https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashing-column/6948923002/; *see also* Patricia Kowsmann and Ken Brown, *Fired Executive Says Deutsche Bank's DWS Overstated Sustainable-Investing Efforts*, WALL ST. J. (Aug. 1, 2021), https://www.wsj.com/articles/fired-executive-says-deutsche-banks-dws-overstated-sustainable-investing-efforts-11627810380 (reporting that DWS's former sustainability chief believes that DWS misrepresented its ESG capabilities in their annual report).

[14] SEC Staff, Division of Examinations' Review of ESG Investing 2 (Apr. 9, 2021). Further, the SEC noted "a lack of policies and procedures related to ESG investing … documentation of ESG-related investment decisions that was weak or unclear … and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials." *Id.*

norms.[15] As retail investors (especially environmentally-conscious millennials) continue to invest in ESG funds at record levels, [16] effective regulation is more essential than ever. The current fund disclosure regime fails to present ESG-related information in a digestible manner, and the primary regulation that controls fund naming conventions—the Names Rule[17]— is not positioned to regulate ESG funds and the unique challenges they pose. And while the two rules proposed in May 2022 take great lengths toward reigning in the ESG industry, this Note argues they do not adequately address the ESG fund industry's failure to clearly name funds and disclose key information—which this Note calls the ESG fund labeling problem.

Part I will provide context on the ESG fund landscape, including the retail investor base's interest in ESG investing, and the different types of ESG investing strategies. Building on this background, Part II will analyze data collected from the summary prospectuses of the top twenty largest ESG mutual funds and ETFs to show the ESG fund labeling problem in action. Then, after providing insights on retail investors' habits and preferences, Part II will show how the SEC's current and proposed regulatory regimes both fall short of meeting investors' needs.

Just as consumers cannot determine which cereal best matches their dietary goals without understanding the nutritional information on the cereal box, investors cannot understand which ESG funds best achieve their investment objectives without more clarity.

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[15] The CEO of the industry's largest ratings agency conceded that "ordinary investors piling into [ESG] funds have no idea" how his company's ratings methodology worked in that they do not focus on the risk the company presents to the world, but in reality, the other way around." *Supra* note 10.
[16] Allison Herren Lee, SEC Commissioner, Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation, Keynote Remarks at PLI's 52nd Annual Institute on Securities Regulation (Nov. 5, 2020) ("There is really no historical precedent for the magnitude of the shift in investor focus that we've witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making.").
[17] 17 CFR 270.35d-1.

## I. ESG Funds, Retail Investors, and the SEC's Regulation of Open-End Funds

Given the rapid growth and popularity of ESG investing, ESG funds have outgrown the regulatory framework in place, leading to a confusing environment where funds are labeling themselves as ESG without providing much clarity on what that means.[18] Section I.B provides demographical information on retail investors and the millennials who are driving retail investor interest in ESG investing. Then, Section I.C describes the SEC's current regulations for open-end fund disclosures and fund names, the proposed modifications to those regulations, and the Names Rule, which the SEC has already hinted will play a role in its forthcoming regulation of ESG funds.

### A. The ESG Fund Landscape

The rapid growth of the ESG industry along with the increasing number of interests that fall under the ESG umbrella has led to the status quo where the ESG label could mean one of several different things, which can confuse investors[19] and hinder ESG causes.

*From SRI to ESG*

*[Section I.A.1 has been omitted.]*

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[18] As a result of the lack of industry clarity, "ETF investors are left with cornucopia of product choice with very little (if any) standardized means of making adequate comparative or evaluative judgments other than performance." Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 Wm. & Mary Bus. L. Rev. 10–11 (forthcoming 2022).

[19] The SEC has also recognized that the lack of standardization in ESG labeling has the potential to confuse investors. SEC Staff, Potential Recommendations of the ESG Subcommittee of the Asset Management Advisory Committee 4 (Dec. 1, 2020) https://www.sec.gov/files/potential-recommendations-of-the-esg-subcommittee-12012020.pdf. ("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.").

*The Current ESG Landscape*

Following the early days of SRI and ESG, and in particular since the Global Financial Crisis,[20] ESG investing has boomed, both with respect to the amount of assets under management[21] as well as the diverse interests that are included under the ESG umbrella.[22]

While it is undisputed that the ESG industry has grown considerably, widely-varying methodologies on which investments classify as "ESG" or "sustainable" make it difficult to pinpoint the industry's exact size.[23] For instance, while the Global Sustainable Investment Alliance (GSIA) estimated that sustainable assets under management in the U.S. were over $17 trillion[24] (a number which some have openly expressed skepticism over),[25] Morningstar, one of the ESG industry's leading data and ratings providers, reported that by the end of 2021, assets in U.S. sustainable funds were $357 billion.[26] Even though this estimate is meaningfully lower than GSIA's, Morningstar noted the $357 billion number was a high watermark for the ESG industry in the U.S. and a represented a four-fold increase in ESG fund assets over the past three years.[27]

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[20] Kosmas Papadopoulos and Rodolfo Araujo, FTI Consulting, *Top 10 ESG Trends for the New Decade*, HARV. L. SCH. F. ON CORP. GOV. (Mar. 2, 2020), https://corpgov.law.harvard.edu/2020/03/02/top-10-esg-trends-for-the-new-decade/ (noting a general embracement of ESG principles following the 2008 global financial crisis).

[21] Alyssa Stankiewicz, Morningstar Manager Research, Sustainable Funds U.S. Landscape Report 2021: Another year of broken records 1 (Jan. 31, 2022).

[22] See Amanda M. Rose, A Response to Calls for SEC-Mandated ESG Disclosure, 98 Wash. U. L. Rev. 1819, 1820 (2021).

[23] These stark differences also point out another instance where the ESG industry could benefit tremendously from standardized methodologies.

[24] Global Sustainable Investment Alliance, Global Sustainable Investment Review 2020 5 (2021).

[25] Saijel Kisha, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, BLOOMBERG GREEN, (Feb. 3, 2022), https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021.

[26] Alyssa Stankiewicz, Morningstar Manager Research, Sustainable Funds U.S. Landscape Report 2021: Another year of broken records 1 (Jan. 31, 2022).

[27] *Id.* Having such broad ranging estimates from reputable sources signals another instance in which the lack of industry standards can undermine ESG causes.

For the most part, the ESG fund industry's explosive growth has occurred in spite of several market headwinds[28] and over a period in which non-ESG funds have experienced less consistent growth. In 2021, sustainable fund flows increased by 35%,[29] but the overall fund market only grew by 4%.[30] In 2020, open-end funds lost a record $370 billion, which doubled the record of $180 million of outflows set in 2019.[31] Over the same two year period, sustainable funds more than doubled their net inflows each year.[32] Figures 1 and 2 in the Appendix provide a visual representation of the rapid growth of the ESG fund industry in the U.S. However, amid fears of recession, inflation, rising interest rates, and a global energy crisis, the U.S. sustainable funds industry lost approximately $1.6 billion during the second quarter of 2022.[33] This marked the first quarter of outflows in more than five years,[34] but occurred alongside softer demand throughout the market.[35]

Confusion over the exact size of the ESG landscape carries over to the global market as well. The GSIA estimated the global ESG market was a $35.3 trillion market as of 2020, which

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[28] The Covid-19 pandemic led to a "shedding" of $240 billion from the U.S. equity fund market in 2020 and exacerbated the general investing trend away from active funds and toward lower-cost, passive funds. *See* Adam Sabban, *U.S. Fund Flows Smashes Records in 2021*, MORNINGSTAR, (Jan. 19, 2022), https://www.morningstar.com/articles/1075161/us-fund-flows-smashed-records-in-2021.
[29] Alyssa Stankiewicz, Morningstar Manager Research, Sustainable Funds U.S. Landscape Report 2021: Another year of broken records 10 (Jan. 31, 2022).
[30] Bloomberg Terminal (March 29, 2022).
[31] Tony Thomas, *U.S. Fund Flow Records Fell in 2020*, MORNINGSTAR (Jan. 20, 2021), https://www.morningstar.com/articles/1017899/us-fund-flow-records-fell-in-2020.
[32] Jon Hale, A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights, MORNINGSTAR (Jan. 28, 2021), https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights.
[33] Alyssa Stankiewicz, U.S. Sustainable Funds See Outflows for the First Time in Five Years, MORNINGSTAR, (Jul. 27, 2022) https://www.morningstar.com/articles/1104758/us-sustainable-funds-see-outflows-for-the-first-time-in-five-years.
[34] *Id.*
[35] Cole Horton, *'Tepid' demand for U.S. sustainable funds in July, report says*, REUTERS, (Aug. 15, 2022) https://www.reuters.com/markets/us/tepid-demand-us-sustainable-funds-july-report-says-2022-08-15/.

accounted for over one-third of all assets under management.[36] Meanwhile, Morningstar estimated that the global ESG industry's 53% growth in 2021 brought the industry's assets under management to $2.7 trillion.[37] Reuters reported that in 2021, investors worldwide poured a record $649 billion into ESG funds, up from the $542 billion and $285 billion that flowed into ESG funds during 2020 and 2019, respectively.[38] According to Reuters, 10% of worldwide fund assets are now in ESG funds,[39] and the most bullish analysts estimate that 60% of mutual fund assets will be managed through a sustainability lens by 2025.[40]

In addition to the record assets under management and inflows into ESG funds, there has been a sizable increase in the number of funds employing ESG strategies and incorporating ESG language into their disclosures. As of 2019, in the U.S., there were 564 funds that made references to ESG factors in their prospectuses,[41] and overall, 718 mutual funds and 94 ETFs with ESG assets.[42] The number of fully ESG funds has grown dramatically as well; specifically, there were 534 sustainable funds (374 of which were open-end funds and ETFs) available in the U.S. in 2021, a 36% increase over the record set in 2020.[43] In 2021 alone, 121 new sustainable funds were launched, breaking the previous record of 71 set in 2020.[44] Through the first half of 2022, over 50 sustainable funds have been launched.[45]

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[36] Global Sustainable Investment Alliance, Global Sustainable Investment Review 2020 5 (2021), http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf.
[37] *Supra* note 25.
[38] Ross Kerver and Simon Jessop, *Analysis: How 2021 became the year of ESG investing*, REUTERS (Dec. 23, 2021). https://www.reuters.com/markets/us/how-2021-became-year-esg-investing-2021-12-23/.
[39] *Id.*
[40] *Id.*
[41] John Hale, Morningstar Sustainable Funds U.S. Landscape Report 2 (2021).
[42] US SIF Foundation, Report on US Sustainable and Impact Investing Trends 2020 1 (2021).
[43] *See supra* note 26 at 1.
[44] *Id.*
[45] See *supra* note 33.

With the rise in number of ESG funds has come an increase in funds that label themselves as ESG. Of these funds, the number that include "ESG" or related terms[46] in their names has skyrocketed, from sixty-five in 2007[47] to 311 by March 2020.[48] What's less clear is how these funds differ themselves, approach ESG investing, or incorporate specific ESG principles and strategies into their respective investment selection processes.

*The Different ESG Investing Strategies*

While older iterations of ESG investing primarily implemented exclusionary approaches to avoid businesses that did not reflect their political, social, religious, or moral values, they often paid the price in the form of lower returns.[49] Since then, a litany of ESG investing approaches[50] have been developed that purportedly enable individuals to invest in accordance with their values and simultaneously achieve risk-adjusted returns.[51] Investors' wide ranging motivations for investing in ESG funds have led to the development of various ESG investing strategies that weigh returns and impact differently; identifying where a particular fund falls on

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[46] SEC, Request for Comment on Fund Names, Release No. IC–33809 (Mar. 2, 2020). The SEC used the following search terms: "ESG", "Clean", "Environmental", "Impact", "Responsible", "Social", and "Sustainable".

[47] *Id.*

[48] Aron Szapiro & Jasmin Sethi, Letter in Response to SEC Request for Comment on Fund Names, MORNINGSTAR (May 5, 2020).

[49] Pieter Jan Trinks & Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 J. BUS. ETHICS 193, 194 (2017) (concluding that excluding controversial stocks generally leads to suboptimal financial performance); *but see* Benjamin R. Auer & Frank Schuhmacher, *Do Socially (Ir)responsible Investments Pay? New Evidence from International ESG Data*, 59 Q. REV. ECON. & FIN. 51, 51 (2016) (finding a difference between U.S. investors who can follow an ESG-based investment style and still obtain a performance similar to the broad market and European investors who tended to pay a price for socially responsible investing).

[50] For more information on the various ESG investment strategies and the ensuing potential for investor confusion, *see* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 404–408 (2021).

[51] *E.g.,* Tensie Whelan et al., ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published Between 2015–2020 2–3, 5 (2021) ("ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches.").

the spectrum between return and impact-maximization is crucial to understanding the fund's priorities and its potential ESG impact (or lack thereof).

At a macro-level, ESG investing strategies can be classified as having one of two objectives: returns or impact. Return-focused ESG funds incorporate ESG factors into their investment selection processes along with other material information with the goal of enhancing their financial performance.[52] In contrast, impact-focused funds "use ESG analysis as a significant part of the investment thesis to respond to investors' objectives and accomplish sustainability-related outcomes while seeking financial returns."[53] Put simply, return-focused ESG funds use ESG data to maximize *profit*, while impact-focused funds use ESG data to maximize *ESG outcomes*.[54]

Having established that ESG funds are either return-focused or impact-focused, the next step to understanding a given fund's capabilities is to consider the various non-exclusive strategies it might employ. Although ESG investing strategies are labeled differently across the industry,[55] this Note adopts the GSIA's framework,[56] which breaks ESG investing into seven

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[52] Investment Company Institute, Funds' Use of ESG Integration and Sustainable Investing Strategies: An Introduction 2-4, (2020).
[53] *Id.*
[54] ESG outcomes can range from investing in business that have lower carbon emissions than their competitors to investing in companies researching carbon capturing technology.
[55] *Compare* Thomas Brigandi, Paul Kovarsky & Paul McCaffrey, *The Seven Asset Owner Approaches to ESG,* ENTERPRISING INV. (Sept. 5, 2019), https://blogs.cfainstitute.org/investor/2019/09/05/the-seven-asset-owner-approaches-to-esg/ (breaking ESG investing into seven approaches: Negative Screening, Climate Change, Diversity & Inclusion, ESG Indexation, Frameworks & Standards, Active Ownership, and Integration) *with* MSCI, *ESG 101: What is Environmental, Social and Governance?*, MSCI, https://www.msci.com/esg-101-what-is-esg (2021) (listing five common ESG investing strategies: Bottom-up ESG Integration, Top-down ESG Integration, Best-in-Class selection, Thematic Investing, and Active Ownership). While these frameworks are just a few of the many in existence, the inconsistencies and overlap between them is emblematic of the ESG industry's larger problem of incomparability.
[56] Global Sustainable Investment Alliance, 2018 Global Sustainable Investment Review 7 (2019).

categories: (1) Negative/Exclusionary Screening;[57] (2) Positive/Best-in-Class Screening;[58] (3) Norms-based Screening;[59] (4) ESG Integration;[60] (5) Sustainability Themed Investing;[61] (6) Impact/Community Investing;[62] and (7) Corporate Engagement and Shareholder Action.[63] Using this framework, Negative/Exclusionary Screening, ESG Integration, and Corporate Engagement and Shareholder Action are the three most commonly used strategies globally[64] (figure 3 in the Appendix illustrates the global growth of sustainable investing strategies).

Placing these strategies on the return-impact spectrum, ESG Integration falls close to the former's end of the spectrum, while all other strategies fall somewhere further toward the latter.[65] This visual demonstrates how significant the difference is between ESG-Integration and ESG-Focus and Impact Funds under the SEC's proposed rules. The remaining six strategies can be divided into two groups: those that seek to have an ESG impact by investing, and those that hope to make their impact by *not* investing. Funds that invest in companies to achieve their ESG

[57] Negative/Exclusionary Screening is "the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria." *Id.*
[58] Positive Screening/Best-in-Class Screening is the "investment in sectors, companies or projects selected for positive ESG performance relative to industry peers." *Id.*
[59] Norms-Based Screening involves the "screening of investments against minimum standards of business practice based on international norms," such as those issued by the United Nations. *Id.*
[60] ESG Integration is "the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis." *Id.*
[61] Sustainability Themed Investing is "investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)." *Id.*
[62] Impact/Community Investing is "targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose." *Id.*
[63] Corporate Engagement and Shareholder Action entails "the use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines." *Id.*
[64] *Id.* at 3. Within the U.S., ESG integration "continues to dominate." *Id.*
[65] If the spectrum were to range from zero (maximizing returns) to ten (maximizing impact), ESG Integration might be a one. The other strategies will score higher, but vary (e.g. a Best-in-Class fund might be a three, while an Impact/Community Investing fund might be an eight).

impact typically employ Positive/Best-in-Class Screening, Sustainability Themed Investing, Impact/Community Investing or Corporate Engagement and Shareholder Action strategies. In contrast, funds that achieve ESG outcomes by not investing utilize Negative/Exclusionary Screening or Norms-based Screening strategies.

Where exactly a given fund will land on the spectrum between return and impact will depend on how they balance the ESG strategies they employ. For example, a fund that combines a Negative/Exclusionary strategy with an ESG Integration strategy might fall closer to the return-maximizing end of the spectrum, whereas a fund that employs a Negative/Exclusionary strategy alongside a Corporate Engagement and Shareholder Action might be more impact-focused. Similarly, two Impact/Community Investing funds might have different ESG impacts depending on the extent to which they are willing to trade-off a positive ESG result for yield. From a regulatory perspective, it is important that investors be able to understand that funds with similar names might actually have very different ESG impacts.

B. Retail Investors, Millennials, and Their ESG Beliefs

Retail investors, and millennials in particular, have a demonstrated interest in ESG investing.[66] And while ESG open-end funds are primarily funded by institutional investors,[67] retail investors' growing market share[68] in the ESG sector speaks to their increasing importance and the greater need to consider their needs when crafting future regulations. This section details

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[66] Morgan Stanley Institute for Sustainable Investing, Morgan Stanley, Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice 4 (2019) (reporting that 95% of millennials and 85% of the general population surveyed expressed a general interest in sustainable investing).

[67] BROADRIDGE, ESG: TRANSFORMING ASSET MANAGEMENT AND FUND DISTRIBUTION 9 (2020) (estimating that approximately 60% of ownership of ESG ETFs and mutual funds is from institutional investors, whereas 30% is from retail investors).

[68] Paul Borges, Launching Sustainable Investment into the Mainstream 11-12 (2017) (MSc Thesis, Copenhagen Business School) (explaining that the gap between institutional and retail investors' share of the ESG fund sector has steadily been closing.)

retail investors' interest in ESG investing, the motivations behind their interest, and why their needs ought to be considered in the regulation of ESG funds.

While ESG investing is popular amongst all generations, millennials' interest is consistently and demonstrably stronger: in one survey where 49% percent of the general population was "very interested" in ESG investing, 95% of millennials were;[69] and where approximately half of the general population adopted at least one sustainable investing activity, two-thirds of millennials already had.[70] In addition to seeking sustainable investments, 84% of the general population wanted impact reports, something 91% of millennials wanted as well.[71] The strength and frequency with which millennials engage in ESG-related activities suggests an investing ethos motivated by both financial and non-financial objectives: "Millennials are markedly different than their predecessors. The literature and market research unanimously concludes that, compared to prior generations, millennials are less interested in investment returns and more interested in their investments reflecting their social values."[72]

Millennial interest in ESG investing further diverges from other generations when it comes to putting their money where their mouth is: one study found that while 57% of millennials will intentionally stop investing or choosing to invest in a company because of the impact the company's products or services have on people's health or well-being, only 42% of Gen Xers and 35% of boomers will do the same.[73] Millennials' interest in achieving ESG

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[69] *Supra* note 66.
[70] *Id.*
[71] *Id.* at 2.
[72] Michal Barzuza, Quinn Curtis & David H. Weber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1250. In fairness, the increased interest in sustainable investing by younger generations could signal their higher risk tolerance compared to older generations, which are closer to retirement, and must be more conservative with their investment decisions.
[73] Allianz, ESG Investor Sentiment Study 4 (2019).

objectives goes so far that an overwhelming majority—70%—would be willing to sacrifice some yield to achieve sustainable outcomes.[74] These findings do not suggest that millennials are "indifferent to investment returns, but that they have a greater tendency to assess and even prioritize the social and real world effects of their investments."[75] It also signals a strong interest in ESG investing strategies that fall closer to the impact end of the spectrum.

Part of the willingness to sacrifice yield for positive ESG outcomes is likely driven by "emotional drivers";[76] in other words, the belief that sustainable investment opportunities can move the needle on ESG issues. For instance, 85% percent of millennials believe their investment decisions could influence climate change, 44% of whom believed this strongly.[77] The combination of investing for financial and non-financial reasons demonstrates the unique nature of ESG investments and why regulations need to acknowledge their fundamental difference.[78]

The rapidly increasing popularity of ESG funds and millennials' voracious appetite for ESG products makes it a lucrative offering for asset managers.[79] The reason millennials' interest in ESG investing is particularly important is because the generation is expected to inherit

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[74] Maintane Sardon, *A Guarded Generation: How Millennials View Money and Investing,* WALL ST. J., (Mar. 13, 2020), https://www.wsj.com/articles/the-recession-left-millennials-loaded-with-debtand-cynical-11583956727.

[75] *Supra* note 72 at 1285.

[76] Sally Hickey, *Advisers need to tap into ESG emotional drivers, says Aviva,* FIN. TIMES (May 24, 2021), https://www.ftadviser.com/investments/2021/05/24/advisers-need-to-tap-into-esg-emotional-drivers-says-aviva/.

[77] Additionally, on the "S" front, 80% of respondents believed it was possible for their investments to create economic growth to lift people out of poverty. *Supra* note 66; *see also* Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 WM. & MARY BUS. L. REV. 7 (forthcoming 2022) (arguing that ESG ETFs have become an increasingly popular product fueled by investor desire for meaningful social change and a belief that investments can have a significant impact on a corporation's decision-making).

[78] *See* Eric C. Chaffee, *Index Funds and ESG Hypocrisy*, 75 CASE W. RSRV. L. REV. 1295, 1304 (2021) (noting the goal of ESG investing is "dramatically different" than traditional index funds because the former is a form of principle-based investing, whereas the latter is profit-based).

[79] Some even argue that the opportunity to attract millennial money over the next few decades is the key driver of large asset managers becoming more active ESG players. *Supra* note 72 at 1250.

trillions[80] over the next few decades in what some are calling the "largest transfer of wealth in history."[81] Because firms typically lose 70% to 80% of assets when transferred between generations,[82] the "asset managers who supply millennials [with] ESG investment options will be strongly positioned to attract new assets to the firm as well as retain beneficiary millennial clients,"[83] providing asset managers with tremendous incentive to offer ESG-labeled funds.

While interest in ESG investing is strong, and appears to be staying that way for the foreseeable future, there is a considerable amount of confusion surrounding ESG fund names and fund disclosures. The following section explores the current regulatory framework in place and details how it has forced investors who hope to enter the ESG fund market or learn more about ESG investment options to overcome significant obstacles.

C. The ESG Fund Regulatory Landscape

*[This section was originally developed along with a summary of the pre-proposed rules regulatory regime. I am keeping part of it in for your consideration because of the analysis on investment types versus objectives, which I know is being addressed in the proposed rules.]*

The Names Rule was promulgated by the SEC pursuant to their authority[84] to enforce section 35(d) of the Investment Company Act of 1940, which prohibits registered investment

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[80] Although estimates differ, the potential inheritance is enormous. *Compare* Leena Dagade et al., Cerulli Associates, Global Retail Investors and ESG: Responsible Investing Converges with Accelerated Environmental and Social Imperatives 4 (2021) (estimating a $61 trillion transfer between generations over the next 25 years) with Dave Nadig, *Evaluating Sustainability ETFs with MSCI, ETF.com*, (June 12, 2017), https://www.etf.com/sections/blog/evaluating-sustainability-etfs-msci?nopaging=1. ("We're in the middle of a $30 trillion intergenerational wealth transfer from baby boomers to their children.").

[81] Larry Fink, *Larry Fink's 2019 Letter to CEOs: Profit & Purpose,* BLACKROCK (2019), https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter.

[82] JULIAN SEELAN, INVESTMENTS & WEALTH MONITOR, SUSTAINABLE INVESTING: THE MILLENNIAL INVESTOR 44 (2019).

[83] *Id.*

[84] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 208, 110 Stat. 3416, 3432 (codified at 15 U.S.C. § 80a-34(d)).

companies (including mutual funds and ETFs) from adopting as part of its name “any word or words that the Commission finds are materially deceptive or misleading.”[85] The Names Rule serves an “investor protection measure designed to help ensure that investors are not misled or deceived by a fund’s name.”[86] After all, a fund’s name is often the first piece of fund information an investor sees, and can have a “significant impact”[87] on their investment choice.

The crux of the Names Rule is that if a fund’s name suggests a particular type of investment (e.g., the ABC Bond Fund), industry (e.g., the ABC Technology Fund), or geographic focus (e.g., the ABC Brazil Fund), the fund must invest at least 80% of its assets in the type of investment, industry, or geographic region suggested by its name.[88] Crucially, the Names Rule’s 80% requirement does not apply to fund names that describe a fund’s investment objective or strategy (e.g., the ABC Growth Fund).[89]

This bifurcation between investment types and objectives puts ESG funds in a gray area. ESG funds are not as clearly a type of investment like a sector fund, or an investment strategy like a growth fund. Even ESG funds are not sure whether their names describe an investment type (subject to the 80% requirement), or an investment strategy (exempt from the 80% requirement).[90] Currently, the SEC treats the ESG label as an investment strategy, which means the 80% rule does not apply;[91] nevertheless, “names describing a fund’s objective, strategy, or

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[85] 15 U.S.C. § 80a-34(d).
[86] SEC, Request for Comments on Fund Names, 85 Fed. Reg. at 13,221.
[87] *Id.*
[88] See rule 35d-1(a).
[89] *Supra* note 86**Error! Bookmark not defined.** at 13,222.
[90] As the SEC staff notes, some funds treat “ESG” as an investment strategy, whereas others treat “ESG” as an investment type. *Supra* note 127 at 13,223.
[91] SEC, Update on progress in ESG Subcommittee from the SEC Asset Management Committee 7 (Sept. 16, 2020), https://www.sec.gov/files/update-from-esg-subcommittee-09162020.pdf.

policies are still subject to the general prohibition on misleading names in Section 35(d), as well as other antifraud provisions of the Federal securities laws."[92]

Although the official position of the SEC is that ESG funds describe an investment objective, it has acknowledged that an ESG fund could be describing either an investment type or objective depending on how a specific fund approaches ESG investing: "[i]f 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."[93] This is particularly relevant for the aforementioned impact-focused strategies, which seek to have their impact by investing or not investing in specific companies. On the other hand, mere consideration of ESG principles conveys more of a strategy than an imposition on the potential investable universe of the fund (which aligns with return-focused strategies (i.e. ESG Integration)). This gray area shows how the Names Rule—and the asset-based test used to determine whether a fund is or is not subject to the 80% requirement—is an inappropriate framework to regulate ESG funds, which blur the line between investment types and strategies.

The SEC has hinted that changes may be coming to the Names Rule to address this problem. In September 2021, the acting deputy director and chief counsel to the SEC Division of Investment Management announced that the SEC is developing a framework that divides ESG funds into two buckets: "integration" and "focus" funds.[94] The former is for funds where ESG "is simply a consideration in the strategy."[95] Importantly, these funds would not be allowed to use

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[92] *Supra* note 86**Error! Bookmark not defined.** at n.17.
[93] *Supra* note 86**Error! Bookmark not defined.**.
[94] David Isenberg, *You Can't Just Call Yourself 'ESG': SEC Director*, IGNITES (Sept. 22, 2021). https://www.ignites.com/c/3331484/422474?referrer_module=searchSubFromIG&highlight=ESG%20funds.
[95] *Id.*

"ESG" or related terms in their names or fund objective statements.[96] On the other hand, "focus" funds fully integrate and "weigh ESG factors more heavily than integration funds … and are permitted to use terms like 'sustainable' or other qualitative ESG descriptors in their name or fund objective."[97] Accordingly, "focus" funds would be subject to the 80% requirement.[98]

Applying labels could help investors more quickly discern whether ESG considerations are central to a fund's investment selection process, or whether the fund is more passively integrating ESG factors. It might also eliminate cases of greenwashing in which a fund uses an ESG label for no other reason than to attract inflows.[99] Nevertheless, this regime will require investors to learn a new taxonomy in an already jargon-loaded space. Furthermore, the proposed labels could lead to increased investor confusion because the system's binary structure eliminates the gradients that exist between funds. For example, all "focus" funds might be viewed as equally "ESG," even if their strategies and ESG impact vary dramatically.[100] Part II will examine how this potential change might impact both funds as well as retail investors, who often struggle to make sense of fund disclosures.

## THE ESG FUND LABELING PROBLEM IN ACTION

To better understand how the current regulatory framework is failing to provide investors with the clarity they need to make informed investment decisions, this Part examines how the leading ESG open-end funds are naming themselves and disclosing key ESG information. Just

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[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] However, the consensus is that such egregious greenwashing is rare. *See* Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs,* 13 WM. & MARY BUS. L. REV. (forthcoming 2022) ("There is little evidence that greenwashing is pervasive in asset management or ETFs.").
[100] For instance, a clean energy fund which solely invests in clean energy companies and a large mutual fund that applies an ESG Integration strategy but has a negative Paris climate score might both be labeled a "focus" fund. This might bolster the latter and dilute the uniqueness of the former.

like how a cereal box ought to help a shopper determine whether a cereal aligns with their dietary objectives, ideally, a fund's name and disclosures should enable an investor to determine whether a fund is a good match for their specific investing goals. Because investors have widely varying ESG objectives, disclosure ought to make clear how a fund approaches ESG investing so individuals can invest with increased knowledge and confidence.

The data presented below is not intended to provide a complete view of the ESG fund landscape. However, because the data comes from the twenty largest open-end funds, it is representative of an investor's experience researching funds and indicative of how industry leaders are disclosing ESG information. Then, II.B examines the findings alongside information on retail investors' research and investing habits to highlight how the problematic presentation and delivery of such crucial ESG information elucidates the need for reform.

A. An Investor's Experience Researching ESG Funds

The data below is derived from twenty ESG open-end funds: ten ETFs and ten mutual funds.[101] The twenty funds selected were the ten largest ESG funds by assets under management[102] in their respective categories.[103] The purpose of using the data is to demonstrate what an investor's experience might be like researching ESG funds and attempting to determine from their disclosures which funds best matched their investing objectives. Therefore, the "Investment Objective"[104] and "Principal Investment Strategies"[105] from the summary prospectuses for each fund were aggregated and analyzed for similarities, differences, notable

[101] See *supra* notes 4 and 5 for definitions of mutual funds and ETFs.
[102] All data on fund assets under management is from Bloomberg, accessed on October 12, 2021.
[103] Although some of the largest mutual funds were the institutional class of shares, the summary prospectuses were the same for all classes, thus being relevant for retail investors as well.
[104] This section provides a brief, one-sentence overview of the fund's main investment goal.
[105] This section goes into significantly more detail than the Investment Objective section and fully explains a fund's investment strategy. It can often be several pages of information.

features, and whether they could be classified as utilizing a specific ESG investing strategy.[106] The research will show that funds are failing to achieve the SEC's aforementioned objectives of conveying important information in a concise and simple manner.[107] Where relevant, the SEC's recently announced framework of "focus" and "integration" funds is also analyzed below to consider whether it would be effective in fixing the ESG fund labeling problem.

Overall, ETFs utilized the ESG moniker and related terms in their names more than mutual funds, and appeared to incorporate ESG considerations more thoroughly than mutual funds. Because most mutual funds primarily utilized passive ESG Integration strategies, under the SEC's proposed framework, there would likely be more "integration" mutual funds, and given their increased incorporation of ESG considerations into their investment selection processes, more "focus" ETFs. Although ETFs more thoroughly incorporated their ESG strategies than mutual funds, their disclosures were longer and more technical, which could potentially create comprehension challenges for retail investors. The below takeaways explore these ideas in more detail.

1. *Summary Prospectuses Are Not So Summary*

While the SEC originally intended for a fund's summary prospectus be about three to four pages in length,[108] only one of the twenty funds analyzed met that goal.[109]

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[106] *See supra* notes 57–62 for a refresher on ESG investing strategies.

[107] *See* SEC, Form N1-A ii-iii ("[T]he prospectus disclosure requirements ... are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters. ... Disclosure in the prospectus should be designed to assist an investor in comparing and contrasting the Fund with other funds.").

[108] SEC, Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28,584, 74 Fed. Reg. 4546, 4548 (Jan. 26, 2009).

[109] ESG Mutual Fund and ETF Note Data (on file with author).

The average length of ETF summary prospectus was significantly longer than those of mutual funds (23.8 pages versus 9.7 pages).[110] Notably, the larger asset managers had significantly longer summary prospectuses; for instance, two of BlackRock's funds had *summary* prospectuses that were forty-six and sixty-eight pages.[111] Despite the significantly longer length of ETF summary prospectuses, the Principal Investing Strategy sections of the two fund categories were relatively similar in length (approximately 790 words for ETFs compared to 607 words for mutual funds).[112]

The majority of the funds sampled—especially ETFs—were front-loaded with legal disclaimers, which made it difficult to find when the key information began. On average, ETFs had thirteen pages of front-loaded disclaimers, whereas mutual funds averaged just 2.6 pages of disclaimers.[113] The added length and front-loading of disclaimers have the potential to confuse investors who might not understand what information they are looking for or where to find it.

*2. ETF and Mutual Fund Naming Conventions*

ETFs and mutual funds differentiated themselves from the get-go. Of the ten ETFs in the sample set, all ten used the term "ESG" in the name of the fund.[114] Of the ten mutual funds, zero used the "ESG" moniker, although five used a related term in the fund's name, such as "social," "impact," and "sustainable."[115] ETFs also used other subjective terms in their names in conjunction with the ESG label (e.g. "ESG Aware" and "ESG Leaders").[116]

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[110] The length of each summary prospectus was calculated by downloading a PDF of each from the fund's site. *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] *Id.*
[116] *Id.*

This distinction between the observed naming conventions of ETFs and mutual funds suggests the two groups have differing perspectives on the role that ESG investing plays in the investment selection process. It also raises concerns about the efficacy of the SEC's proposed regime to label funds as "focus" or "integration" funds. Given the stark difference between how ETFs and mutual funds named themselves, under the new framework, ETFs would more likely be labeled "focus" funds, and mutual funds would be labeled as "integration" funds, because ETFs employed ESG terminology more often in their names.[117] In light of the finding that mutual funds are not always incorporating ESG terminology in their names, the SEC needs to decide if it would mandate a "focus" fund that does not name itself as an ESG fund to *add* a label, or if it would only require an "integration" fund to *remove* a misleading term from its name.

If the purpose of the regulation is to combat potentially misleading names or greenwashing,[118] then it makes little sense to force a fund that is not using "ESG" or a related term in its name to add a label like "focus" or "integration." On the other hand, the absence of a clear indicator that the fund uses ESG investing to maximize impact—especially exclusionary practices that tend to underperform non-ESG benchmarks[119]—is also misleading to an investor who is only interested in ESG investing as a way to maximize profit, and who might not appreciate the extent that ESG factors play into the fund's investment process.

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[117] The idea that mutual funds more passively integrated ESG considerations into the investment selection process than ETFs is supported by the data in Part I.A.1, which highlighted that 718 mutual funds, compared to 94 ETFs, incorporated ESG language into their prospectuses. *Supra* note 21.

[118] Press Release, SEC Requests Comment on Fund Names Rule; Seeks to Eliminate Misleading Fund Names (Mar. 5, 2020), https://www.sec.gov/news/press-release/2020-50.

[119] *See* WHELAN ET AL., ESG AND FINANCIAL PERFORMANCE: UNCOVERING THE RELATIONSHIP BY AGGREGATING EVIDENCE FROM 1,000 PLUS STUDIES PUBLISHED BETWEEN 2015–2020 2–3, 5 (2021) ("ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches.").

Notably, the significant consequence of being labeled an "integration" fund is that the fund cannot use ESG terminology in its name. But as shown above, none of the sampled mutual funds used the ESG label, and just half used related terminology.[120] Therefore, if the SEC only decides to remove misleading fund labels, the proposed regulation stands to have a larger impact on ETF fund names than the mutual fund names.

*3. A Review of the Principal Investment Strategies Sections*

While funds' Principal Investment Strategies sections provided specific ESG-related information, the language used was highly technical and presented in a visually unappealing format, making it difficult to understand or follow. The Principal Investment Strategies section for each fund (except one)[121] described how ESG factors were considered within their overall investment selection process.

Generally, ETFs were more descriptive of their investment criteria than mutual funds, although the criteria appeared to come from third-parties rather than the funds themselves. Of the ten ETFs sampled, seven explicitly tracked an MSCI[122] index, six of which included the term "MSCI" in the name of the fund.[123] The fact the term "index" was used 298 times, "underlying" 172 times, "MSCI" 73 times, and "track" 28 times in the ETF Principal Investment Strategy sections strongly supports the notion that ESG ETFs outsourced the ESG fund investment universe curation to third-parties.[124]

ETFs were also more likely to describe specific ESG criteria that their funds considered. In their Principal Investment Strategy sections, ETFs mentioned "weapons" 24 times, "oil" 18

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[120] *See* ESG Mutual Fund and ETF Note Data (on file with author).
[121] The Pioneer fund included all ESG related information is a separate section called "ESG Considerations." Pioneer Core Equity Fund, Summary Prospectus 1–2 (May 1, 2021).
[122] MSCI is a provider of indexes and climate-related data.
[123] ESG Mutual Fund and ETF Note Data (on file with author).
[124] ESG Mutual Fund and ETF Note Data (on file with author).

times, “controversies” 16 times, “coal” 15 times”, “nuclear” 12 times, and “power”, “gas”, “thermal”, and “tobacco” each 11 times.[125] Meanwhile, mutual funds mentioned “fossil” seven times, “energy”, “gas”, and “oil” five times, “nuclear” four times, and “tobacco” and “coal” each three times.[126] Figures 4 and 5 in the Appendix show key word frequencies from the Principal Investment Strategy sections of the mutual funds and ETFs in the sample set.

Although providing specific ESG criteria helps investors understand a fund’s potential investment universe, this information was generally hedged in complex financial jargon that can confuse investors and undermine the purpose of having requirements for simplified disclosure.[127] For example, BlackRock’s iShares ESG Aware MSCI USA Leaders ETF (SUSL) wrote that it “seeks to track … a free float-adjusted market capitalization weighted equity index.”[128] If an investor were to try to determine which ESG investing strategies the fund employed, they would see that the fund excludes securities “involved in the business of tobacco, alcohol, gambling, nuclear power … thermal coal and unconventional oil and gas … companies involved with conventional and controversial weapons, producers and major retailers of civilian firearms, as well as companies involved in very severe business controversies.” A “controversy” was defined as an “instance or ongoing situation in which company operations and/or products allegedly have

[125] *Id.*
[126] *Id.*
[127] *See* SEC, Proposed Rule: Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, (Aug. 5, 2020). For example, the proposed disclosure framework would feature concise and visually engaging shareholder reports to highlight key information that is particularly important for retail investors while removing the more technical information from the reports that are of less use to retail investors. *Id.* at 1.
[128] BlackRock iShares ESG MSCI USA Leaders ETF, Summary Prospectus 2 (Dec 30, 2020).

a negative environmental, social and/or governance impact."[129] From this, one might be able to determine the fund employs an Exclusionary Investing strategy.

The more challenging part is recognizing the fund also employs a Best-in-Class strategy, and what that means in this specific context. The fund does not use the term "Best-in-Class," but instead, says it is "comprised of companies with the highest ESG ratings from each sector of the Parent Index." Here, "Best-in-Class" appears generous: on a rating scale from "CCC" (lowest) to "AAA" (highest), all companies with an ESG rating of "BB" or higher are eligible. Plus, companies "involved in very severe business controversies" are also eligible as long as the ESG impact of their "very severe business controversy" does not exceed a three out of ten.[130]

While SUSL's summary prospectus provides some information on how ESG factors are incorporated into the investment selection process, it also raises questions and concerns. With respect to the security selection process, no governance factors are explicitly referenced, so it is impossible to know from the disclosures the extent that governance factors are considered. Additionally, any security that receives a "Key Issue" score of three or higher is eligible for inclusion; without more context, it is unclear whether that number is appropriate. Three out of ten may seem low, but there is no way to know unless an investor undertakes significant independent research. What corporate behavior would render a score of three, a nine, or a one?

Crucially, BlackRock discloses that while 90% of the fund will generally invest the underlying index, [131] there is a remaining 10% which may be invested in a variety of other financial products. It is unclear whether that final 10% could be placed in investments that run

[129] *Id.* at 2–3. Not all of BlackRock's funds defined "controversy" in the summary prospectus.
[130] *Id.*
[131] *Id.*

counter to the fund's goals, like a money market fund that owns debt from a company that has previously been excluded from the underlying index for poor environmental practices.[132]

Finally, from a presentation standpoint, this entire section is presented in single spaced paragraphs full of long sentences on a two-column page, without any visual aids or words with emphasis to distinguish important information. The section is loaded with complex financial jargon that warrants further explanation, yet little, if any, is provided.

Overall, the complex technical financial language, lack of explanations surrounding key ESG criteria, and unappealing presentation in the disclosures of both ETFs and mutual funds can confuse and overwhelm investors. This clearly runs counter to the SEC's goal that fund disclosures provide information in a concise and digestible manner.[133]

*4. The ESG Investment Strategies Utilized*

Overall, the ESG investment strategies utilized by funds varied significantly, and were not always clear. ETFs were more descriptive of their ESG investing strategies and were more likely to employ Exclusionary screens alongside an ESG Integration strategy, whereas mutual funds primarily utilized ESG Integration approaches and were less descriptive of specific ESG considerations. Because fund providers used different language to describe similar strategies,[134] it was generally difficult to classify funds as utilizing specific ESG investing strategies. Similarly,

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[132] This would be like a cereal labeling itself as "sugar-free" yet that only being true for 90% of the cereal's contents and the rest of the box being filled with sugary, unhealthy cereal.
[133] *Supra* note 127.
[134] On the whole, ETF ESG investing strategies were easier to discern than mutual funds. This phenomenon might be explained by the fact seven of the ten sampled ETFs were from the same asset manager, whereas the mutual fund sample was more varied. Nevertheless, one report tallied the number of different terms used to describe various forms of sustainable investing at nearly eighty. The report emphasized that even when firms provide explanations, having so many terms "adds a layer of complexity that may be challenging, particularly for retail clients." IIF, IIF SUSTAINABLE FINANCE WORKING GROUP REPORT: THE CASE FOR SIMPLIFYING SUSTAINABLE INVESTMENT TERMINOLOGY 2-3 (2019).

funds did not describe or classify their investing strategies in terms that might trigger recognition of a particular strategy.[135] The lack of standardization makes comparing funds more challenging.

Of the seven ESG investment strategies referenced in I.A.3,[136] the top funds primarily employed just a few. The two most popular were ESG Integration and Negative/Exclusionary Investing.[137] The majority of ETFs (seven of ten) applied Exclusionary and ESG Integration approaches where the exclusions were absolute.[138] While some mutual funds also utilized Exclusionary strategies, the disclosure language made the strategy appear more like a guideline than a mandate.[139] However, the manner in which funds described their specific exclusionary criteria varied significantly depending on the funds' specific objectives and different benchmark indexes, making it difficult to meaningfully compare strategies across funds. The different approaches seen within the Negative/Exclusionary Investing category is another example of why additional regulation is required to help investors distinguish between ostensibly similar funds.

The strategies employed by mutual funds and ETFs suggests the two groups have different philosophies on the role that ESG investing plays in their respective funds. Because mutual funds tended to employ ESG Integration strategies alone, whereas ETFs utilized ESG

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135 For example, the SUSL fund did not disclose it was employing a "Best-in-Class" approach, but rather, that it selected "securities of mid- and large- capitalization companies with the highest ESG ratings from each sector of the Parent Index." *Supra* note 177.
136 *See supra* notes 57–63.
137 ESG Mutual Fund and ETF Note Data (on file with author).
138 I.e. the funds entirely excluded securities in specific industries. Yet, as recently as 2019, eight of the ten biggest U.S. ESG funds were invested in oil-and-gas companies, including the iShares ESG MSCI USA ETF and Vanguard's FTSE Social Index Fund. Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL ST. J. (Nov. 11, 2019), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200.
139 *Compare* the iShares MSCI KLD 400 Social ETF, Summary Prospectus 2 (Sept. 1, 2021) ("[c]ompanies that MSCI determines have significant involvement in the following businesses are not eligible for the Underlying Index.") (emphasis added) *with* the TIAA-CREF Social Choice Equity Fund, Summary Prospectus 4 (Mar. 1, 2021) "[t]he Fund will not generally invest in…" (emphasis added). This further supports the idea that ETFs treated ESG investing as the fund's asset type, whereas mutual funds treated it as the fund's objective.

Integration strategies alongside other strategies, it appears that ESG mutual funds fall closer toward the return bookend of the returns-impact spectrum, and ETFs might fall closer toward the middle of the spectrum. Helping investors understand where exactly a specific ETF will fall on this spectrum will facilitate understanding of the ESG fund universe and enable investors to determine which funds best align with their objectives.

Notably, none of the top funds employed Sustainability Themed Investing, Impact/Community Investing, or Corporate Engagement and Shareholder Action strategies. As mentioned in section I.A.3., this might partly explain why so many investors view ESG investing as primarily as an Exclusionary Investing exercise.

*5. Funds' Treatment of the Names Rule*

Although not mentioned explicitly in the summary prospectus of any fund, the Names Rule's seems to be lingering behind the scenes. The 80% requirement was implicitly addressed in the Principal Investment Strategies sections of both ETFs and mutual funds, but only in ETFs with respect to ESG investing. More specifically, several ETFs explicitly stated their goal of investing at least 80% of its assets in accordance with their parent indexes, while other ETFs alluded to the requirement more generally.[140] Mutual funds that addressed investment allocations did so in reference to the fund's general asset type (e.g., equities, emerging markets, or bonds), not its ESG strategy.

References to the 80% requirement, as well as the analysis in *supra* II.A.2 on the naming conventions of ETFs and mutual funds, suggests that mutual funds tended to view the ESG label

[140] *Compare* DWS Xtrackers MSCI USA ESG Leaders Equity ETF, Summary Prospectus 2 (Dec. 18, 2020) ("[t]he fund will invest at least 80% of its total assets (but typically far more) in component securities of the Underlying Index) *with* Vanguard ESG U.S. Stock ETF, Summary Prospectus 3 (Dec. 22, 2020) ("[t]he Fund attempts to replicate the target index by investing all, or substantially all, of its assets in the stocks that make up the Index, holding each stock in approximately the same proportion as its weighting in the Index.").

as describing the fund's investment strategy, whereas ETFs approached ESG investing as if it were the fund's asset type.[141] Under the SEC's proposed taxonomy, mutual funds viewed ESG factors more from an "integration" perspective, whereas ETFs considered ESG strategies to be the fund's asset type, or "focus."

The challenge for investors is that every asset manager discloses their ESG considerations and investment selection process differently, and often in vague terms.[142] This makes determining whether a fund treats ESG considerations as an investment strategy or an investment type onerous. As Part III will show, the SEC can skirt this predicament by recognizing that ESG funds inherently do not fit the Names Rule's current investment type versus strategy framework, and modifying the rule to more effectively regulate ESG funds.

*6. Where the Funds Land on the Return-Impact Spectrum*

As explained in *supra* I.A.2., all ESG funds fall on the spectrum between the bookends of being fully return-focused or impact-focused. Funds that use ESG Integration strategies tend to fall toward the return-focused end, as ESG Integration funds use ESG data in an effort to maximize risk-adjusted returns. On the other hand, impact-focused funds use ESG data to maximize the impact of their investments, and thus land closer to the impact end of the spectrum.

The disclosures of the sampled ETFs do not explicitly indicate how they balance these two goals, which might confuse investors hoping to gauge the extent to which the funds prioritize ESG objectives. For instance, the Investment Objective section of the largest ETF in the sample set says: "[t]he [fund] seeks to track the investment results of an index composed of U.S. companies that have positive environmental, social and governance characteristics as

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[141] This aligns with *supra* note 91, which argued that because exclusionary strategies define a fund's investable universe, it more closely resembles an investment type than a strategy.
[142] ESG Mutual Fund and ETF Note Data (on file with author).

identified by the index provider while exhibiting risk and return characteristics similar to those of the parent index."[143] This references both return-seeking and impact-seeking strategies, yet does not make it clear how the fund balances those factors. At first glance, the explicit reference to ESG characteristics suggests that the fund might be impact-oriented. However, the fact these ESG characteristics are considered alongside the effort to track the fund's underlying index suggests a focus on maximizing returns.

By combining a return-focused strategy (ESG Integration) with an impact-focused strategy (Negative/Exclusionary Screening), ESG funds, and in particular ESG ETFs, seek to provide the best of both worlds. However, this effort might actually leave everyone worse off. When funds attempt to maximize impact and profit, situations arise where ESG funds have more exposure to oil companies than the traditional S&P 500.[144] This reality likely runs counter to investors' expectation of ESG funds, and without clear disclosure of this possibility, could mislead large swaths of well-intentioned investors who might be surprised that a fund with the "ESG" label provides more exposure to some of the most environmentally-harmful firms.

*7. A Potential Culprit for the ESG Fund Labeling Problem*

Fund managers will point to the lack of mandated and consistent ESG-related disclosures at the issuer level, and argue that this makes it difficult, if not impossible, for ESG funds to employ many ESG investing strategies. For instance, if issuers use different metrics to measure their environmental impact, or, do not disclose this information at all, it would be challenging for fund providers to create a Best-in-Class ESG fund which needs this information. The dearth of ESG specific data on the issuer level might explain the prominence of ESG Integration and

[143] iShares MSCI iShares ESG Aware MSCI USA ETF, Summary Prospectus 14 (Sept. 1, 2021).
[144] Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUSINESSWEEK (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

Negative/Exclusionary funds: integration strategies do not commit funds to any action in particular besides the consideration of ESG information in the investment selection process, and exclusionary funds can screen-out the corporations they do not have reliable and consistent data on. The lack of consistent issuer-level data might also explain why summary prospectuses contain such varied language to describe the same general strategies. As the SEC's Asset Management Advisory Committee's ESG Subcommittee concluded, "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."[145] As demonstrated throughout Part II, the SEC's concern is clearly substantiated: ESG funds are struggling to develop clear, consistent, and transparent disclosures.

While funds and third-party index providers might look to point the finger at issuers, they are to blame as well. Although "G" data is the most reliable,[146] the funds sampled did not disclose any specific "G" criteria in their summary prospectuses.[147] Instead, the funds focused primarily on "E" considerations, and to a lesser extent, "S" factors as well.[148] Not only does this call into question the ability of the funds to fully execute on their stated` criteria, but it also suggests that the ESG issues investors care about most, "E" issues, are the ones we have the least information about.

The SEC's landmark proposal in 2022 to require firms to disclose specific climate-related information will eventually improve the quantity and quality of data available to ratings

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[145] SEC, Potential Recommendations of the ESG Subcommittee of the Asset Management Advisory Committee 4 (Dec. 1, 2020).
[146] *Id.*
[147] ESG Mutual Fund and ETF Note Data (on file with author).
[148] *Id.*

providers and fund managers to better determine a specific company's eligibility for inclusion in their funds. However, that day will not come soon. The SEC's proposed rule is intended to be phased in over a period of several years.[149] Even assuming the extremely unlikely best case scenario at the issuer level (i.e. full compliance and no litigation challenges[150] or reversals), retail investors will still have to fend for themselves for years in determining whether ESG-labeled funds match their personal investing objectives.

*8. Reason for Further Concern*

Between overwhelmingly lengthy documents, pages of legal disclaimers, confusing financial jargon, and varying industry terminology, retail investors face myriad challenges that make it nearly impossible to confidently ascertain whether an ESG fund matches their personal ESG objectives. The above data, on its own, raises several concerns about how funds managing over $160 billion[151] in assets disclose their ESG strategies.

What makes matters even worse is the that fund practices are often inconsistent with their disclosures. In 2021, the SEC staff observed instances where funds did not adhere to global ESG frameworks where firms claimed such adherence, and noted that some funds had holdings predominated by issuers with low ESG scores where such predominance was inconsistent with those firms' stated approaches.[152] The SEC staff also identified "unsubstantiated or otherwise potentially misleading claims regarding ESG investing in a variety of contexts."[153] In other

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[149] SEC, The Enhancement and Standardization of Climate-Related Disclosures for Investors 48, Mar. 21, 2022.

[150] Within one day of the proposal's announcement, potential litigation disputes were already covered in the media. *See e.g.*, Dan Papscun, *SEC's Climate Proposal Tees Up Test of 'Material' Info Standard*, BLOOMBERG L. (Mar. 23, 2022), https://news.bloomberglaw.com/esg/secs-climate-proposal-tees-up-test-of-material-info-standard.

[151] ESG Mutual Fund and ETF Note Data (on file with author).

[152] SEC, The Division of Examinations' Review of ESG Investing 4 (Apr. 9, 2021).

[153] *Id.*

words, not only is it extremely difficult for investors to understand a fund's disclosures, but there is a decent chance the fund does not even adhere to the approach it outlines.

As the next section will show, this alarming truth is even more troubling when the above is reconsidered in light of insights on retail investors' behaviors and financial literacy.

### B. A Perfect Storm: The Misalignment Between Retail Investors and ESG Fund Disclosures

As section I.B discussed at length, retail investors have a strong interest in ESG investing. Unfortunately, they also have a "striking ability to do the wrong thing" when it comes to making investment decisions.[154] In fact, one can construct a portfolio with high returns by doing the opposite of what retail investors do.[155] While this fact in the abstract might convince someone to bet against ESG funds given their popularity with the retail base, investors' confusion can largely be explained by poor disclosure[156] and misheld beliefs.[157]

While the specifics of a fund's investment strategy can be found in its prospectus, summary prospectus, or statement of additional information, investors admittedly do not always read or comprehend such materials; several investors surveyed stated they do not review funds' disclosure materials at all.[158] One study showed that 37% of investors review fund disclosures

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[154] Andrea Frazzini & Owen A. Lamont, Dumb Money: Mutual Fund Flows and the *Cross-Section of Stock Returns*, 88 J. FIN. ECON. 299, 319 (2008).
[155] *Id.*
[156] Daniel Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 Y. J. REG. 625, 656 (2019) ("[I]t borders on tautological to note that investors' knowledge of ESG issues depends on their access to ESG information. Accordingly, making sustainability data more useable and more relevant to mainstream investors will help increase the investor community's exposure to, and understanding of, sustainable investing.").
[157] Notably, one-fourth to one-third of investors that ESG investing is limited to traditional exclusionary screening. This misperception was most prevalent amongst the retail investor community. CFA INSTITUTE & PRINCIPLES FOR RESPONSIBLE INVESTMENT, ESG INTEGRATION IN THE AMERICAS: MARKETS, PRACTICES, AND DATA 59, 69 (2018).
[158] SEC, Proposed Rule: Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, (Aug. 5, 2020).

"some of the time," and 12% "never" do.[159] Retail investors prefer visual aids, like graphs and charts: respondents said they tend to skip over the long verbiage and legalese, such as the type highlighted in SUSL's summary prospectus in *supra* section II.A.[160] Of what investors do read, they mostly focus on the fund's performance and the portfolio's holdings.[161] Neither of these categories addresses the fund's ESG criteria, and the latter is not even required to appear in a summary prospectus. As seen in II.A, funds place information regarding their ESG strategy in the Investment Objective and Principal Investment Strategies sections; however, those are not widely consulted: only 21% of investors "always" review the fund's investment strategy and objective, whereas 34% and 32% review those two respective categories "most of the time."[162]

After reading *supra* II.A, it should not come as a surprise why investors consider fund disclosures difficult to understand.[163] Specifically, 72% of respondents surveyed say regulatory disclosures are "not easy" to understand, and just 4% said they are "very easy" to understand.[164] These findings are supported by other investor surveys, which have consistently found that investors view funds' shareholder reports as too lengthy and complicated, and difficult for the average investor to use to effectively find information of interest.[165]

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[159] Broadridge, Comment Letter on Request for Comment on Fund Retail Investor Experience and Disclosure 3 (Oct. 31, 2018).
[160] As *supra* II.A demonstrated, no funds incorporated the visual aids and charts respondents preferred, and all exclusively included long verbiage and legalese.
[161] *Supra* note 159 at 22 (reporting that 41% of investors surveyed always review fund performance information, and another 34% doing so "most of the time." Additionally, 32% and 35% of surveyed investors review the portfolio holdings information, respectively).
[162] *Id.*
[163] *Supra* note 159 at 2.
[164] *Id.* at 21-22.
[165] *Id.* at 5-6 (reporting the responses from surveyed retail investors who generally found a mutual fund's disclosure documents to be too long and overwhelming, and preferred disclosures that can be read in a few minutes and that focus on essential information).

A key driver of investor confusion was too much technical writing.[166] As *supra* II.A.3 demonstrated, that was one of the main challenges in comprehending funds' Principal Investment Strategy sections, which were full of legalese and financial jargon. Additionally, ESG fund disclosures are often vague and technical with respect to describing their investment strategies, which can vary widely.[167] Because the ESG moniker encompasses such a broad umbrella of objectives, and the terminology surrounding such strategies is not uniform,[168] the subtle nuances that distinguish funds from each other are far from clear.

Without digging through prospectuses, something most retail investors admit they do not do (or cannot easily comprehend), investors' specific ESG questions will remain unanswered. ESG funds impose extra burdens on investors who hope to determine a specific fund's ESG characteristics; ESG investors are forced to figure out whether an "investment's combination of ESG strategy, ESG performance, financial return, and cost is suitable for them."[169] While it is true that an investor needs to determine whether an investment fits their financial needs and risk tolerance when making any investment decision, "the burden … is increased under the ESG mantle" given the lack of industry standardizations: "even the most motivated of investors will struggle to unpack what ESG means for a particular fund in a meaningful way."[170] And yet, "despite investors' seemingly limited competence, regulatory and market developments

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[166] *Id.* at 23.
[167] *See e.g.,* Jon Hale, *4 Things to Keep in Mind About Sustainable Investing in 2022*, MORNINGSTAR (Jan. 10, 2022) https://www.morningstar.ca/ca/news/217966/4-things-to-keep-in-mind-about-sustainable-investing-in-2022.aspx. ("Sustainable investing is not a singular approach but instead represents a range of methods that investors can use to generate competitive investment returns while helping generate positive outcomes for people and planet.").
[168] One industry expert says "the biggest frustration on behalf of investors is there's no standardization within [the ESG] industry." Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL ST. J. (Nov. 11, 2019), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200.
[169] Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1940 (2020).
[170] *Id.*

increasingly require retail investors to navigate the financial markets themselves."[171] Although the data is facially concerning, even more troubling is the very real possibility that those surveyed might be overstating their financial literacy.[172]

Notably, this is not just a problem for retail investors: sophisticated investors also struggle to comprehend complex disclosures: "Disclosures often demand *more* than basic skill in reading texts and numbers. Disclosees must negotiate unfamiliar and complex problems where mistakes are easy, a full and exact command of data is needed, and one misunderstanding can be fatal."[173] Because struggling to understand complex financial information is shown to contribute to poor financial decision making,[174] recondite disclosures are likely to remain a significant headwind for all investors barring regulatory action.

In sum, the current ESG fund disclosure landscape is ineffective for retail investors. As Carl Schneider and Omri Ben-Shahar explain, many investors struggle understanding disclosures "because they are not literate or numerate enough to decipher them without reasonable effort. This is both because levels of literacy and numeracy are surprisingly low and because the reading levels of disclosures are surprisingly high."[175] The fact that investors need to undertake significant efforts to compare funds to each other—including decoding various ratings systems,

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[171] Jill Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 606 (2014).
[172] *See* OSCAR CONTRERAS AND JOSEPH BENDIX, MILKEN INST., FINANCIAL LITERACY IN THE UNITED STATES 15 (2021) (reporting that most US adults also tend to overestimate their financial knowledge and their ability to manage financial products and services, and finding that despite the low levels of financial knowledge reported by the study, more than 70% of respondents gave themselves high scores); *see also* SEC, Study Regarding Financial Literacy Among Investors (Aug. 2012), http://www.investor.gov/publications-research-studies/sec-research.
[173] CARL SCHNEIDER AND OMRI BEN-SHAHAR, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 86 (PRINCETON UNIV. PRESS, 2014).
[174] *See generally* Kristina Rennekamp, Processing Fluency and Investors' Reactions to Disclosure Readability (Feb. 2012) (Ph.D. dissertation, The Univ. of Ill. at Urbana-Champaign).
[175] CARL SCHNEIDER AND OMRI BEN-SHAHAR, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 80 (PRINCETON UNIV. PRESS, 2014).

ESG investing frameworks, and funds' generic and technical language—that they do not when researching other investment opportunities strongly suggests the regulatory regime is not providing investors with sufficient support, nor are ESG funds adequately self-regulating. This is not only true for retail investors, but more sophisticated investors as well.[176]

## CONCLUSION

The ESG fund industry is exploding in popularity but is in dire need of regulation. Fund names often mislead investors, and disclosures do not adequately explain funds' specific ESG criteria and investment philosophies. Because ESG funds are a particularly popular investment option amongst retail investors—an investor base that generally struggles to comprehend complex financial information—future regulation needs to be crafted with them in mind so investors interested in ESG investing can more easily identify which funds best align with their personal investing objectives.

Increased disclosure and regulation of ESG fund names can resolve the ESG fund labeling problem. Ideally, these regulations will facilitate investors researching funds the way food regulations help shoppers compare cereals in the supermarket, and enable investors to have a better sense of what they're buying and whether it aligns with their wide-ranging objectives.

[176] *See e.g.*, Adrian Murdoch, *ESG reporting confusion hits companies' bottom line*, CAPITAL MONITOR (May 4, 2021) (reporting that nearly 83% of institutional investors cite ESG and sustainability data as the obstacle to effective assessment of ESG investments).

Figure 1[177]

**U.S. Sustainable Fund Quarterly Flows (2019-2021)**

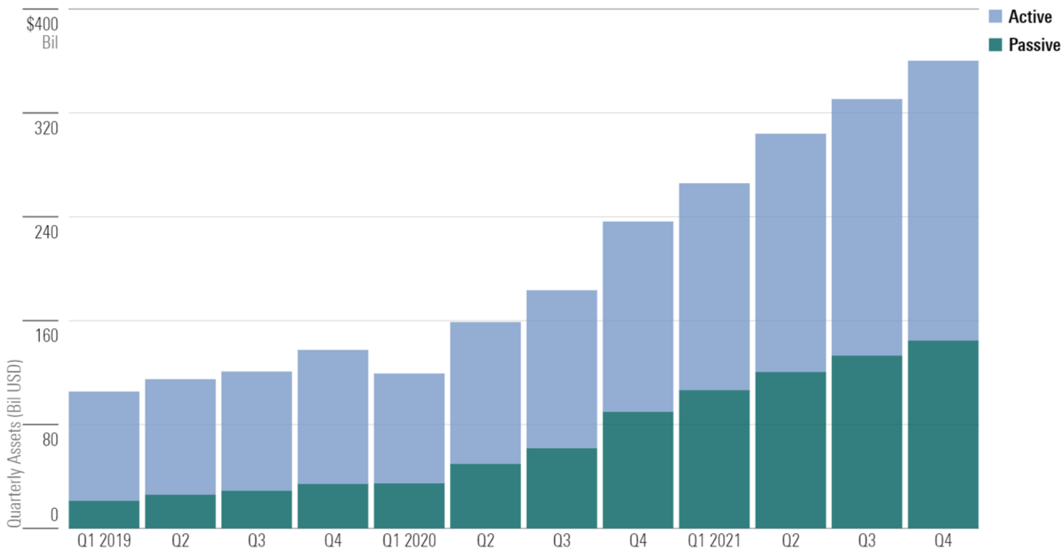
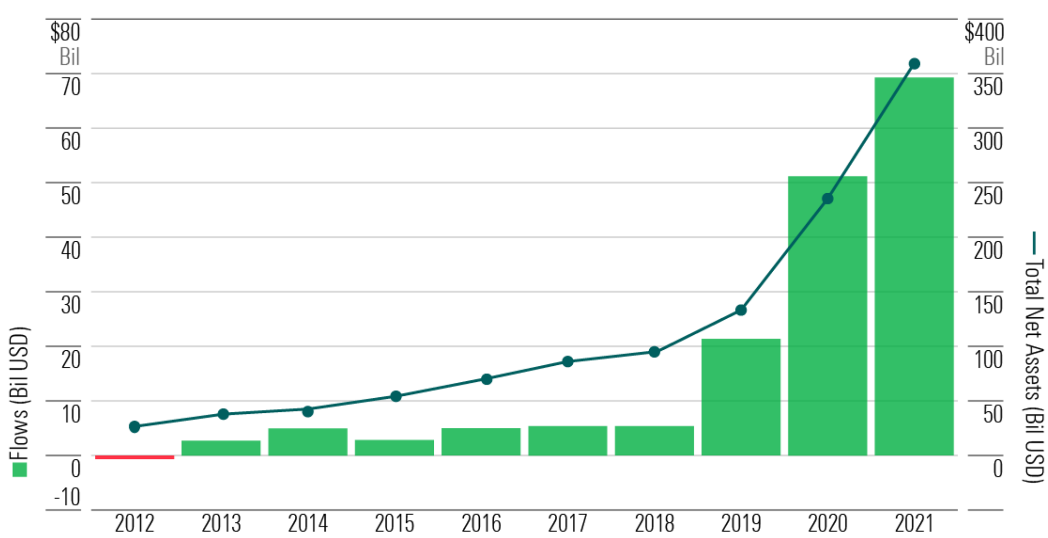



Figure 2[178]

**Growth of U.S. Sustainable Funds and Assets (2012-2021)**




[177] Alyssa Stankiewicz, *Sustainable Funds Dip for the Quarter but Peak for the Year*, MORNINGSTAR (Jan. 31, 2022), https://www.morningstar.com/articles/1076648/sustainable-fund-flows-dip-for-the-quarter-but-peak-for-the-year.

[178] Jon Hale, *Sustainable Funds Landscape - Highlights and Observations*, MORNINGSTAR (Feb. 18, 2022), https://www.morningstar.com/articles/1080300/sustainable-funds-landscape-highlights-and-observations.

Figure 3[179]

**Global Growth of Sustainable Investing Strategies (2016-2020)**

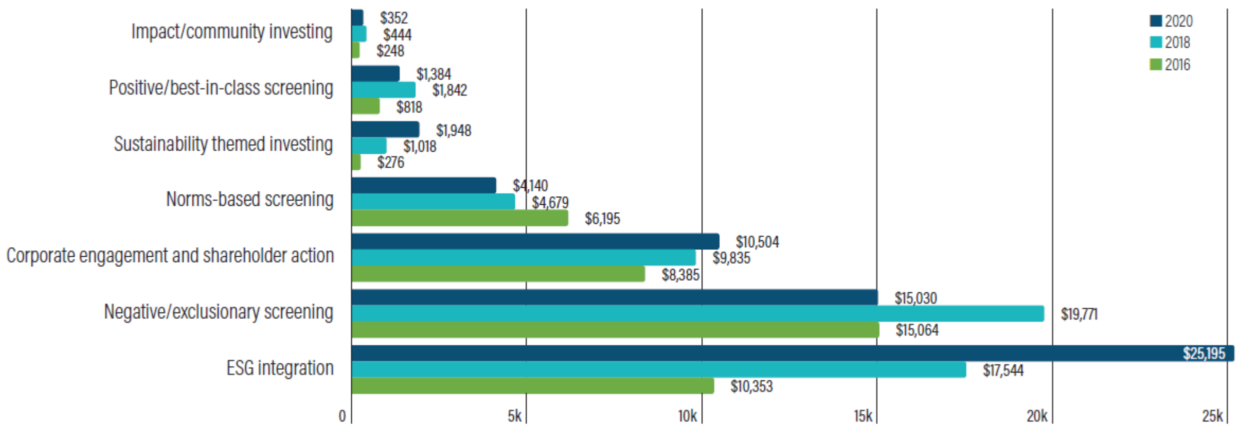
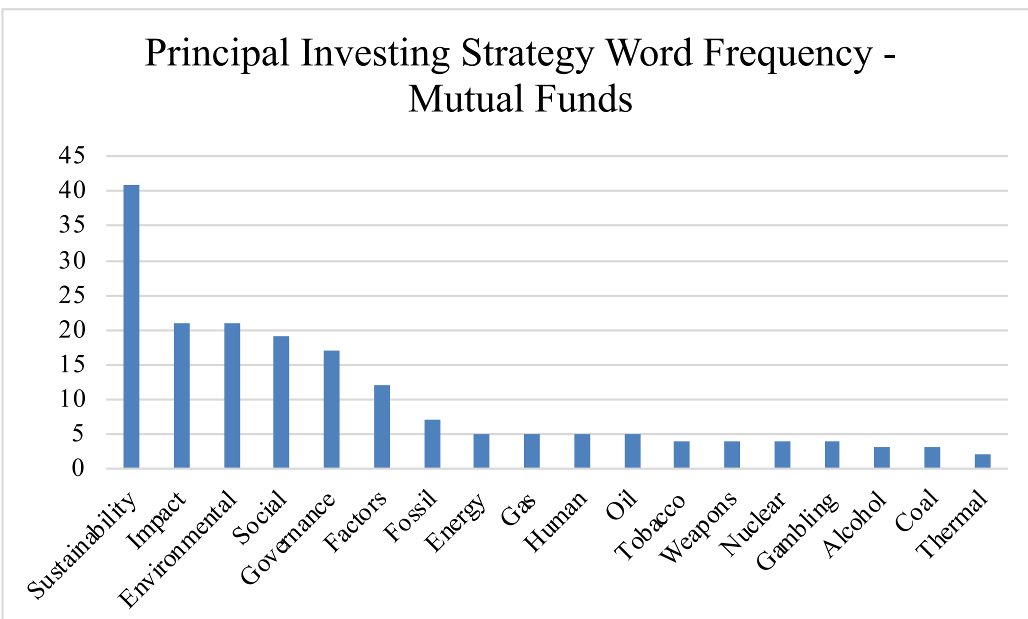


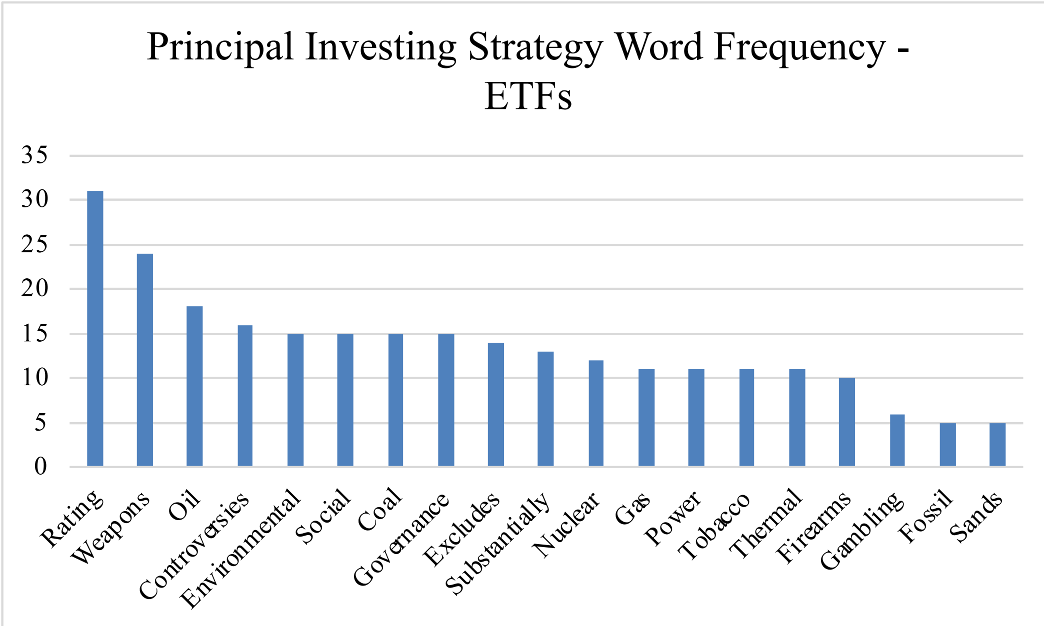

Figure 4[180]




179 GLOBAL SUSTAINABLE INVESTMENT ALLIANCE, GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020 11 (2021).

180 ESG Mutual Fund and ETF Note Data (on file with author).

Figure 5[181]




181 ESG Mutual Fund and ETF Note Data (on file with author).