August 15, 2022

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

Re: Investment Company Names (File No. S7-16-22);
Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (File No: S7-17-22)

Dear Secretary Countryman,

Americans for Financial Reform Education Fund appreciates the opportunity to comment on the proposals of the Securities and Exchange Commission ("the Commission") to bring much-needed standards and disclosures to the vast market of ESG-designated investment products and services. We strongly support both the Investment Company Names proposed rule ("Names Rule") and the Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices proposed rule ("Disclosures Rule"). Below, we discuss the importance and timeliness of the proposed rules, our recommendations for how to make the final rules most effectively accomplish their goals, and suggestions for further rulemaking. Our recommendations for how to strengthen the rules are divided into recommendations related to: the proposed ESG fund categories, materially deceptive and misleading names, general disclosures, proxy voting, greenhouse gas emissions, and derivatives.

<u>The Importance and Timeliness of the Proposed Rules</u>

A massive amount of capital has found its way into ESG funds, with one estimate projecting ESG assets may reach $53 trillion by 2025, which would be a third of global assets under management.[1] While this channeling of capital into ESG funds is indicative of investor interest in ESG investing, the thoroughly unregulated nature of ESG in investment products and services means that investors are in danger of being misled by exaggerated or unfounded ESG-related claims, often referred to as greenwashing in the climate context and ESG-washing more generally.

Greenwashing is a persistent problem. Recent reports show that the twenty largest ESG funds hold investments in seventeen fossil fuel producers on average.[2] More than 70 percent of general ESG funds and over 50 percent of climate-themed funds are misaligned with global climate emissions targets as laid out by the Paris Agreement.[3] BlackRock famously renamed an ESG fund twice in two years—from "Impact US Equity" to "Advantage ESG US Equity" to "Sustainable Advantage Large Cap Core"[4]—even though the fund currently invests in twenty three fossil fuel companies comprising 6.8% of assets and holds a D rating on fossil fuel exposure from Fossil Free Funds.[5]

While some greenwashing and ESG-washing is fraudulent and actionable under current law (made clear by the enforcement actions recently taken by the Commission and other law enforcement agencies), there is a broader need—due to widely varying understandings of what ESG investing is—for investors to have information about what ESG-branded investment products and their managers do and do not do. For example, many investors may be surprised to learn that Amazon tends to be among the largest holdings in ESG funds even though it has come under fire for its harmful labor practices, high greenhouse gas emissions (especially when suppliers and sellers are taken into account), predatory pricing, and other issues.[6] Similarly,

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[1] "ESG assets may hit $53 trillion by 2025, a third of global AUM," Bloomberg Intelligence (Feb. 23, 2021), *available at* https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-thirdof-global-aum/.

[2] "Sustainable finance is rife with greenwash. Time for more disclosure," The Economist, May 22, 2021, *available at* https://www.economist.com/leaders/2021/05/22/sustainable-finance-is-rife-with-greenwash-time-for-more-disclosure.

[3] Amy Gunia, "Thinking of Investing in a Green Fund? Many Don't Live Up to Their Promises, A New Report Claims," Time Magazine, Sept. 20, 2021, *available at* https://time.com/6095472/green-esg-investment-funds-greenwashing/.

[4] Silla Brush, "One Fund, Three Names and Lots of Questions for 'ESG'," Yahoo!, Jul. 25, 2022, *available at* https://www.yahoo.com/now/one-fund-three-names-lots-090019017.html.

[5] "BlackRock Sustainable Advantage Large Cap Core Fund," Fossil Free Funds, Mar. 30, 2022, *available at* https://fossilfreefunds.org/fund/blackrock-sustainable-advantage-large-cap-core-fund/BIRIX/fossil-fuel-investments/FS0000C0EV/F00000W3UB.

[6] *See* Khalil Abdullah,"OPINION: Why ESG investors need to think twice about Amazon," Thomas Reuters Foundation News, Jan. 18, 2022, *available at* https://news.trust.org/item/20220118165222-odl0n/; Tinglong Dai & Christopher S. Tang, "Opinion: Amazon is proof of a major weakness in ESG ratings," MarketWatch, Nov. 10, 2021, *available at* https://www.marketwatch.com/story/amazon-is-proof-of-a-major-weakness-in-esg-ratings-11636553274; Brittany Alston & Cecilia Behgam, "Vanguard's Empty Promises: How Vanguard Funds Harm and Fuels Extractive Industry," 27, Action Center on Race & the Economy (ACRE) & Public Accountability Initiative (PAI), Mar. 2022, *available at* https://acrecampaigns.org/wp-content/uploads/2022/03/ACRE-Report-Vanguard_03.22.pdf.

many investors may be surprised to learn that a private prison company facing a lawsuit alleging forced labor is considered by some important players in the ESG investment industry as a socially responsible investment.[7]

Additionally, beyond ESG-branded funds' underlying investments, investors may be surprised to learn that large asset managers with substantial assets under management in ESG-branded funds often vote against—or abstain from voting on—shareholder proposals and other important issues[8] even though voting proxies in their clients' best interest is a key component of advisers' fiduciary duty.

<u>Two Alternative Recommendations Related to ESG Fund Categories</u>

1. <u>Ensure the integration fund category does not give rise to new opportunities to exaggerate ESG characteristics or mislead investors. Further, ensure that the existence of an "integration" category does not lead fund managers, advisers, and other market participants to the erroneous conclusion that the SEC views the analysis of material ESG risks and opportunities as optional for fiduciaries.</u>

The Commission's proposed definition of integration fund—"a fund that considers one or more ESG factors along with other, non-ESG factors in its investment decisions, but those ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio"—may lead advisers and other market participants to the erroneous conclusion that integrating an analysis of material ESG risks and opportunities into their investment and stewardship decisions is not already required under the advisers' fiduciary duty. In fact, this analysis is not unlike any other assessment of material risks and opportunities.[9] The integration fund category as proposed could also open the door to funds using their Commission-defined status as integration funds to exaggerate their consideration of ESG factors.

To address these two issues, we propose two possible alternatives. One alternative is for the integration fund category to be eliminated, and to require all funds that have policies and procedures for integrating ESG factors into their investment, proxy voting, and engagement

[7] *See* Lee Fang, "Green-Colored Glasses: Private Prisons Are a Socially Responsible Investment, According to Bizarre Wall Street Measures," The Intercept, Jun. 27, 2022, *available at* https://theintercept.com/2022/06/27/esg-funds-corporate-responsibility-dei/; Brittany Alston & Cecilia Behgam, "Vanguard's Empty Promises: How Vanguard Funds Harm and Fuels Extractive Industry," 26, Action Center on Race & the Economy (ACRE) & Public Accountability Initiative (PAI), Mar. 2022, *available at* https://acrecampaigns.org/wp-content/uploads/2022/03/ACRE-Report-Vanguard_03.22.pdf.

[8] Lucian Bebchuk & Scott Hurst, "The Power of the Big Three, And Why It Matters," 24, Feb. 21, 2021, *available at* http://www.law.harvard.edu/faculty/bebchuk/The_Power_of_the_Big_Three_and_Why_It_Matters.pdf.

[9] *See* Principles for Responsible Investment & UNEP Finance Initiative, "Fiduciary Duty in the 21st Century: Final Report," 2019, *available at* https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-final-report/4998.article.

decisions to disclose them in their prospectus. All funds would also be required to disclose if and how they consider greenhouse gas emissions. The other alternative is to preserve the category structure as proposed, but make clear that the Commission's creation of the integration fund category does not reflect a position that consideration of material ESG factors is not already required under advisers' fiduciary duty, but a desire to require basic disclosures of funds that market themselves as ESG integration funds. We make additional recommendations below designed to protect investors from exaggerated ESG- related claims by integration funds.

<u>Recommendations Related to Materially Deceptive and Misleading Names</u>

1. <u>As proposed, names of integration funds that include ESG terms should be considered materially deceptive and misleading.</u>

Because integrating an analysis of material ESG risks and opportunities into investment and stewardship decisions is already required, we support the Commission's proposal to consider integration fund names with ESG terms to be materially deceptive and misleading. The Commission itself, in its economic analysis, points to one commenter's observation that "today virtually all asset managers have incorporated ESG considerations to some degree, or have plans to do so, across their investment strategies." Therefore, the inclusion of "ESG" or ESG terms in the names of integration funds would materially deceive and mislead investors, who would reasonably believe that ESG factors play a more significant role than they do in such funds.

2. <u>While ESG funds should be subject to the same 80% rule as other funds, the Commission should reiterate that abiding by that rule is not a safe harbor for materially deceptive or misleading names.</u>

Question 51 of the Names Rule asks whether some funds should be required to invest a greater percentage of their assets in the investments suggested by the fund's name. We believe that there should not be this type of heightened requirement that only applies to ESG funds or a subset of ESG funds that does not apply to other funds subject to the 80% requirement. However, as recommended below, we do believe investors should know if the ESG funds they are invested in (or are considering investing in) have less than 100% of their portfolio invested in the way the name suggests and why.

Additionally, the Commission should reiterate that abiding by the names rule is not a safe harbor for materially deceptive or misleading names. The Commission provides an example of a fund with "fossil fuel-free" in its name that includes a substantial investment—less than 20%—in an issuer with fossil fuel reserves. The Commission should clarify that fund names will be considered misleading or deceptive if any portion of the fund includes investments that directly contradict the fund name and identified strategy.

3. Fund managers that use fund names that include the name of an index should be required to ensure that the name of the index is not materially deceptive or misleading.

The Commission asks in Question 50 of the Names Rule how to approach a fund name that includes an index name with underlying investments that are "not closely tied" to the type of investments suggested by the index name. Logically, to abide by the legal requirement that a fund name not be materially deceptive or misleading, fund managers need to ensure each of its component parts are not materially deceptive or misleading. That means that before offering a fund that tracks an index, they must ensure that the index name itself is not deceptive or misleading. Not having this requirement, or creating a safe harbor for materially deceptive or misleading names if they are imported from the name of an index the fund is tracking, would go against both the letter and the spirit of the prohibition of materially deceptive or misleading names meant to protect investors.

Recommendations Related to General Disclosures

1. Require integration funds to include the Commission's definition of integration funds and ESG-focused funds in their prospectus and marketing materials.

Since all advisers are required to integrate material ESG factors, the main distinction between integration funds and non-integration funds under the Commission's definition will be how funds choose to self-identify (outside of the context of their names) and market themselves. To ensure investors are not misled as to the significance of ESG factors in funds marketed as integration funds, the Commission should require integration funds include the Commission's definition of both integration and ESG-focused funds in their prospectus and marketing materials. That way, investors can be informed of the role ESG plays in the funds and the fact that there is a category of funds where ESG plays a more central role.

2. Expand the disclosure requirements about whether the ESG strategy applies to less than 100% of the portfolio, proposed for funds utilizing screens, to all ESG funds.

The Commission is proposing that an ESG-focused fund that uses an exclusionary or inclusionary screen disclose if the screen applies to less than 100% of its portfolio, and if so, why. We support this proposal, and recommend the Commission expand this requirement to all ESG funds, including integration funds. Investors have an interest in knowing whether the investment focus articulated by a fund name and accompanying disclosures does not apply to a portion of the fund and therefore a portion of their investment, and why. For example, if only 80% of an ESG-focused fund that uses index tracking as a strategy is invested in the index's underlying investments, investors should know that a fifth of their investment dollars are not tracking the index, and why. Similarly, if an impact fund that seeks to achieve a specific impact is only putting 80% of the fund's investment dollars to work toward that goal, investors should know that fact and why that investment decision is being made.

3. Require disclosure of ESG funds' top three investments in a prominent location.

Question 5 of the Disclosures Rule asks whether the Commission should require additional disclosures for integration funds that would be useful for investors. Question 24 asks the same about ESG-focused funds. We believe the Commission should require an additional disclosure from both integration funds and ESG-focused funds in a prominent location: their top three fund investments. This information would be particularly useful for retail investors, and although useful for all types of ESG funds, it would be particularly useful for investors in the context of integration funds, ESG-focused funds that track an index, and ESG-focused funds that apply an exclusionary screen. For example, a description of the categories of investments an ESG-focused fund that employs an exclusionary screen leaves out—though important—does not tell investors much about what they *are* investing in. The top three investments of the fund—if placed in a prominent location—would give investors and would-be investors a quick, concrete idea of how the fund's ESG investment strategy translates into investment decisions.

Recommendations Related to Proxy Voting

Voting proxies in their clients' best interest is a key component of the fiduciary duty advisers owe their clients, and the final rule the Commission implements should take this fact into account. The Investment Company Act requires advisers to monitor corporate events and vote, and the Investment Advisers Act requires advisers to vote in the best interest of clients. In 2003, the SEC issued a rule that, amongst other requirements, established that advisers who have voting authority over clients' proxies must "adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients."[10] After that, the SEC released a legal bulletin in 2014[11] and guidance in 2019[12] attempting to further clarify advisers' fiduciary duty related to proxy voting. The 2019 guidance states advisers "must have a reasonable understanding of the client's objectives and must make voting determinations that are in the best interest of the client." The guidance contemplates advisers having different voting policies for different funds, "depending on the investment strategy and objectives of each."

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[10] "Final Rule: Proxy Voting by Investment Advisers, Securities and Exchange Commission," Release No. IA-2106; File No. S7-38-02, *available at* https://www.sec.gov/rules/final/ia-2106.htm.

[11] "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," Securities and Exchange Commission, Staff Legal Bulletin No. 20, Jun. 30, 2014, *available at* https://www.sec.gov/investment/slb20-proxy-voting-responsibilities-investment-advisers#_ftnref2.

[12] "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers," Securities and Exchange Commission, Release Nos. IA-5325; IC-33605, *available at* https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

By selecting ESG investing and advisory services, investors are communicating about their objectives with their advisers—that their objectives include a concern for ESG issues (whichever and however they are identified in the fund's name and disclosure materials). The implementation of these objectives cannot begin and end with investment decisions, and advisers cannot ignore these objectives when it comes to proxy voting. Therefore, proxy voting should not be considered relevant in the context of ESG investing and advisory services only if it is identified by an adviser as a "significant" means of implementing a fund's ESG strategy, as proposed by the rule. Instead, voting proxies according to the best interests of asset owners should be an expectation, required under the fiduciary duty investment advisers owe their clients. Below, we make recommendations—within the questions posed in the proposed rule—that would facilitate investors having the information necessary to ensure advisers are complying with their fiduciary duty when it comes time to vote their shares.

1. <u>Require integration funds to summarize how they incorporate ESG factors into their proxy voting policies and procedures.</u>

The Commission proposes minimal disclosures for integration funds—mainly, a summary of how they incorporate ESG factors into their investment selection process. Question 5 of the Disclosures Rule asks, in part, what additional disclosures would be helpful for investors. The Commission should require integration funds that hold voting securities to also include a summary of how they incorporate ESG factors into their proxy voting policies and procedures. This disclosure would help investors ensure advisers are fulfilling their fiduciary duty with respect to proxy voting.

2. <u>Require all ESG-focused funds with voting securities to disclose information about their proxy voting, and eliminate it as a listed, optional strategy.</u>

The Commission proposes ESG-focused funds use a tabular format to provide investors an overview of their ESG strategy. The format includes a checklist of strategies, from which funds would check all that apply. Proxy voting is one of the listed strategies, and the Commission proposes it only be checked if it is "a significant means of implementing [the fund's] ESG strategy." However, voting proxies in their clients' best interest is a key component of the fiduciary duty advisers owe their clients and should not be considered a special ESG strategy. Therefore, we recommend the Commission remove proxy voting from the list of strategies, and require all ESG-focused funds with voting securities disclose information about their proxy voting.

3. <u>For ESG-focused funds that do not vote their shares because they are on loan or for any other reason, require an explanation of why abstaining from a particular vote was in the best interest of the client.</u>

The three largest asset managers—which have substantial assets under management in ESG funds—collectively own about 22% of the average S&P 500 company, up from 13.5 percent in 2008.[13] Researchers found that the votes of these three asset managers could be determinative in a significant number of proxy contests and resolutions related to ESG matters.[14] Meanwhile, these and other large asset managers are active securities lenders, obtaining significant revenues from the securities lending market.[15]

The decision of whether to forego lending fees to vote could present a conflict of interest between advisors and their clients. Some have raised concerns that in some instances, it may be in the best interest of an asset manager to forego recalling shares in order to maximize gains from share lending, while it may be in the best interest of investors to recall shares to exercise voting rights.[16] There is not much public information about how asset managers allocate revenues from securities lending; therefore, it is difficult to know the extent to which individual investors are or are not benefiting from securities lending revenues,[17] and how those benefits would compare to what they could be gaining from proxy voting. However, it has been reported that one asset manager passes under 70% of these revenues to investors and retains the rest, potentially tilting the scale in favor of revenues from securities lending and against recalling shares to vote.[18]

The frequency with which asset managers choose to forego voting rights to obtain lending fees has increased in recent years. A study found that after the Commission issued guidance in 2019 on funds' ability to lend shares rather than vote them in some circumstances, funds made 58% more shares available for lending immediately prior to shareholder meetings, a

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[13] Eric Levitz, "Modern Capitalism Is Weirder Than You Think," New York Magazine, Mar. 15, 2022, *available at* https://nymag.com/intelligencer/2022/03/how-asset-managers-have-upended-how-modern-capitalism-works.html.

[14] Lucian Bebchuk & Scott Hurst, "The Power of the Big Three, And Why It Matters," 4, Feb. 21, 2021, *available at* http://www.law.harvard.edu/faculty/bebchuk/The_Power_of_the_Big_Three_and_Why_It_Matters.pdf.

[15] Joshua Mitts, "The Price of Your Vote: Proxy Choice and Securities Lending," Oct. 11, 2021, *available at* https://clsbluesky.law.columbia.edu/2021/10/11/the-price-of-your-vote-proxy-choice-and-securities-lending/#_edn4.

[16] Edwin Hu, Joshua Mitts, Haley Sylvester, "The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff," 7-8, Columbia Law School Working Paper Series, Dec. 2020, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673531; Joshua Mitts, "The Price of Your Vote: Proxy Choice and Securities Lending," The CLS Blue Sky Blog, Oct. 11, 2021, *available at* https://clsbluesky.law.columbia.edu/2021/10/11/the-price-of-your-vote-proxy-choice-and-securities-lending/#_edn4.

[17] Joshua Mitts, "The Price of Your Vote: Proxy Choice and Securities Lending," The CLS Blue Sky Blog, Oct. 11, 2021, *available at* https://clsbluesky.law.columbia.edu/2021/10/11/the-price-of-your-vote-proxy-choice-and-securities-lending/#_edn4.

[18] Edwin Hu, Joshua Mitts, Haley Sylvester, "The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff," 7, Columbia Law School Working Paper Series, Dec. 2020, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673531.

trend that was particularly pronounced in stocks with high index fund ownership.[19] The 2020 GameStop proxy fight is a notable example of the effects of increased lending ahead of important votes. That year, the ownership of 43.57% of GameStop was concentrated amongst four large asset managers.[20] However, these entities and others decided to forego their voting rights in order to continue obtaining lending fees paid by investors shorting the stock.[21] The result was that two challengers obtained board seats, even though they had previously lost proxy battles.[22]

Although the Commission's 2019 guidance considers that there may be cases in which advisers can forego voting because they determine that the cost to the client would exceed the expected benefit, the Commission explains that "the investment adviser may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfill its fiduciary responsibilities to its clients by merely refraining from voting the proxies;" indeed, before abstaining from voting, "an investment adviser should consider whether it is fulfilling its duty of care to its client in light of the scope of services to which it and the client have agreed."[23]

Through their choice to invest in ESG-focused funds, investors indicate concern for ESG issues. It should be noted that votes on ESG-related shareholder proposals are not the only votes that should be considered ESG-related. Indeed, ESG issues are relevant in all sorts of shareholder votes—director elections, say on pay, and mergers, to name a few. Therefore, the Commission should require advisers of these funds that do not vote any portion of their shares in a particular election to explain why abstaining from that election was in the best interest of the client.

4. <u>Require ESG-focused funds to provide both a narrative explanation and statistics on how they voted on the matters that are the focus of the fund.</u>

Question 79 of the Disclosures Rule asks whether ESG-focused funds should "be required to provide a narrative explanation of how they cast their proxy votes on ESG matters, either instead of or in addition to statistics on ESG matters." The Commission should require ESG-focused funds to provide a narrative explanation on how their ESG focus informed their votes to ensure advisers are fulfilling their fiduciary duty. The explanation should apply not just

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[19] *Id*. at 1.
[20] *Id*. at 16.
[21] Dawn Lim, "How Investing Giants Gave Away Voting Power Ahead of a Shareholder Fight," The Wall Street Journal, Jun. 10, 2020, *available at* https://www.wsj.com/articles/how-investing-giants-gave-away-voting-power-ahead-of-a-shareholder-fight-11591793863.
[22] Edwin Hu, Joshua Mitts, Haley Sylvester, "The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff," 17 n.45, Columbia Law School Working Paper Series, Dec. 2020, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3673531.
[23] "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers," 24, Securities and Exchange Commission, Release Nos. IA-5325; IC-33605, *available at* https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

to shareholder resolutions that are directly related to the fund's focus, but also to other votes that could impact the fund's focus more indirectly—for example, voting no in the election of a director who has been a roadblock to progress on a fund's focus area, or voting against a merger with a company with a bad track record related to the fund's focus area. The Commission should also require ESG-focused funds to release statistics on how they voted on the matters that are the focus of the fund, as proposed.

<u>Recommendations Related to Greenhouse Gas Emissions</u>

As discussed above, greenwashing is a persistent problem among general and climate-themed ESG funds. Recent reports show that the twenty largest ESG funds hold investments in seventeen fossil fuel producers on average.[24] InfluenceMap estimates that 71 percent of general ESG funds and 55 percent of climate-themed funds are misaligned with global climate emissions targets as laid out by the Paris Agreement,[25] while a recent S&P Global analysis suggests that 88 percent of green funds are misaligned with Paris and that "one in three green funds and climate funds are on a trajectory to overshoot even a less ambitious 3°C warming scenario, in which flooding, drought and sea level rise would pose severe risks to human life and society."[26] BlackRock famously renamed an ESG fund twice in two years—from "Impact US Equity" to "Advantage ESG US Equity" to "Sustainable Advantage Large Cap Core"[27]—even though the fund still invests in twenty three fossil fuel companies comprising 6.8% of assets and holds a D rating on fossil fuel exposure from Fossil Free Funds as of March 2022.[28]

The SEC must address the lack of reliability and transparency among green funds so investors are able to compare and find options that meet their needs and stated goals—which for many include Paris alignment. Recent surveys show that 63 percent of ESG retail investors would factor in Scope 3 GHG emissions directly into their investment decisions if that data were

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[24] "Sustainable finance is rife with greenwash. Time for more disclosure," The Economist, May 22, 2021, *available at* https://www.economist.com/leaders/2021/05/22/sustainable-finance-is-rife-with-greenwash-time-for-more-disclosure.

[25] Amy Gunia, "Thinking of Investing in a Green Fund? Many Don't Live Up to Their Promises, A New Report Claims," Time Magazine, Sept. 20, 2021, *available at* https://time.com/6095472/green-esg-investment-funds-greenwashing/.
https://influencemap.org/report/Climate-Funds-Are-They-Paris-Aligned-3eb83347267949847084306dae01c7b0

[26] Matt MacFarland *et al.* "Green funds have a Paris alignment problem," S&P Global, June 7, 2022, *available at* https://www.spglobal.com/esg/insights/green-funds-have-a-paris-alignment-problem

[27] Silla Brush, "One Fund, Three Names and Lots of Questions for 'ESG'," Yahoo!, Jul. 25, 2022, *available at* https://www.yahoo.com/now/one-fund-three-names-lots-090019017.html.

[28] "BlackRock Sustainable Advantage Large Cap Core Fund," Fossil Free Funds, Mar. 30, 2022, *available at* https://fossilfreefunds.org/fund/blackrock-sustainable-advantage-large-cap-core-fund/BIRIX/fossil-fuel-investments/FS0000C0EV/F00000W3UB.

freely available and filed with the SEC[29] and 67 percent of large investors, family offices, and endowments want their investments to "contribute to reaching the Paris climate agreement goal,"[30] even though currently only 12 percent of green funds are Paris-aligned according to S&P Global.[31] The Net Zero Asset Owners Alliance—consisting of 74 institutional investors with $10.6 trillion in aum—has also committed to Paris alignment.

In order for investors of all sizes to be able to make investment decisions that they understand, and that meet their needs, the SEC must rein in deceptive and misleading environmental fund names and require robust disclosures of fund strategies, goals, and progress. This will also allow for investment companies and advisers to be able to offer effective and felicitous products while also being held accountable for the commitments they make to their clients, shareholders, and plan participants.

1. <u>Require all ESG funds (integration, focused, and impact) that *do not* have a policy or strategy regarding issuers' greenhouse gas emissions (GHG) emissions to affirmatively state so in their prospectus</u>.[32]

It is material information for investors whether or not a fund has a strategy regarding GHG emissions.[33] Including an affirmative statement in either case will ensure that investors understand the role that GHG emissions play in different types of ESG funds and avoid confusion, given that all of these types of funds will now be categorized by the Commission as "ESG funds."

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[29] Of retail investors that "prefer to invest in companies that disclose ESG criteria and practices," 63% would factor in GHG emissions produced by a corporation's products and supply chain, 60% would factor in GHG emissions produced by a corporation's day-to-day operations, and 55% would factor in GHG emissions produced by activities funded by banks' and financial institutions' investments and loans. *Source*: AFREF and Public Citizen. "Results of a Nationwide Survey: Retail Investors' Support for the SEC Mandating Climate-Related Financial Disclosures from Public Companies." April 28, 2022, updated August 15, 2022, *available at* https://ourfinancialsecurity.org/wp-content/uploads/2022/08/Updated-Report_Climate-Disclosure-Survey-Results_AFR-PC-2.pdf.

[30] Abby Schultz, "Future Returns: Wealthy See a Role in Investing to Tackle Climate Change," Barron's Penta, Sept. 21, 2021, *available at* https://www.barrons.com/articles/future-returns-wealthy-see-a-role-in-investing-to-tackle-climate-change-01632255522

[31] Matt MacFarland *et al.* "Green funds have a Paris alignment problem," S&P Global, June 7, 2022, *available at* https://www.spglobal.com/esg/insights/green-funds-have-a-paris-alignment-problem

[32] This addresses Question 6 in the Commission's Disclosures Rule proposal.

[33] Americans for Financial Reform Education Fund (AFREF) and Public Citizen, "Results of a Nationwide Survey: Retail Investors' Support for the SEC Mandating Climate-Related Financial Disclosures from Public Companies," Apr. 28, 2022, *available at* https://ourfinancialsecurity.org/wp-content/uploads/2022/04/FINAL-Report_Climate-Disclosure-Survey-Results_AFR-PC-2.pdf.

A typical investor in an "ESG integration fund" or an "ESG focused fund" will likely expect that fund to consider GHG emissions in some way[34] and therefore it's important to clearly indicate when that is not the case, to avoid the inclusion of "ESG" in the category names from being misleading. Many ESG-focused funds use generic names like "sustainable" or "ESG" or "socially responsible" and a typical investor in such a fund would expect to be able to find information about GHG emissions (affirmative or negative) in the funds prospectus and strategy. Allowing ESG funds to omit all mention of GHG emissions (affirmative or negative) would be misleading.

2. ESG integration funds that *do* have a policy or strategy for integrating GHG emissions should include a description of their methodology and ESG-focused funds that *do* consider GHG emissions should provide that description of methodology and their GHG emission figures, as proposed.[35]

GHG emissions are a prime, comparable indicator of transition risk at the portfolio company level and at the fund level that investors increasingly integrate into their investment practices. This information will help investors select a fund that is appropriate for them and prevent greenwashing by funds that claim to be "low-carbon" without disclosing their actual carbon emissions levels.

At the portfolio company level, direct emissions (Scope 1) and emissions from purchased electricity and heat (Scope 2) provide context for certain important financial estimates and assumptions, particularly related to the value of long-lived assets and the sustainability of certain operating costs. Disclosure of emissions from value chain (Scope 3) are perhaps even more critical, as they provide information about potential transition risks to a portfolio company's supply chain or revenue base and about opportunities to partner with customers and suppliers on mitigating this risk.

As investors continue to shift capital towards index and exchange traded funds and away from individual securities, the need for fund-level financed emissions disclosure has become critical in order for investors to understand aggregate risk across a portfolio and find investments that actually match their needs and goals. And there is value in analyzing financed emissions for financial entities as well as they undertake managing their own risk and developing

[34] "ESG ratings, which are applied to companies representing around 80% of market capitalisation in 2020, have evolved in recent years to incorporate long-term financial risks and opportunities in investment decision making processes. **At the same time, the environmental 'E' pillar score of ESG rating is being increasingly used as a tool to align investments with a low-carbon transition**, and a range of financial market products and measurement approaches have developed to help investors align portfolios with specific climate-objectives and strategies in line with the Paris Agreement." OECD (2021), *ESG Investing and Climate Transition: Market Practices, Issues and Policy Considerations,* OECD Paris, *available at* https://www.oecd.org/finance/ESG-investing-and-climate-transition-Market-practices-issues-and-policy-considerations.pdf.

[35] This addresses Question 87 in the Commission's Disclosures Rule proposal.

climate-friendly investment products; a 2015 pilot program of Dutch financial institutions found that "by measuring financed emissions, they were able to identify carbon-intensive hotspots and develop innovative low carbon products for their clients and investees…measuring financed emissions is the cornerstone of informed climate actions [and] one of the first steps any financial institutions should take when embarking upon a process to understand climate risks and opportunities and assessing portfolio alignment in the context of the Paris Agreement."[36] For environmentally-focused funds using environmentally-inspired names, measuring and disclosing GHG emissions is a non-negotiable first step required to ensure a fund's name and disclosures are not materially misleading or deceptive.

Additionally, climate and environmentally-focused funds that are focused on investing in carbon capture technology should still be subject to the same GHG emissions reporting requirements[37] because GHG emissions are a core quantitative metric needed by investors. Funds should not be allowed to factor in purported negative emissions produced by carbon dioxide removal projects financed by the fund, as discussed in more detail below.

3. Replace "investment selection process" with "investment decisions" in Item 9(b)(2)1(b).[38]

Question 6 of the Disclosures Rule asks whether or not to require disclosure of how an integration fund considers GHG emissions of its portfolio holdings if the fund "considers the GHG emissions of its portfolio holdings as an ESG factor in its investment selection process." This criteria should be expanded beyond integration into its "investment selection process" to recognize the varying ways that GHG emissions might be used by funds. Integration funds that prioritize engagement with portfolio companies may well consider GHG emissions in their engagement and proxy voting but not have a GHG emissions policy for investment selection.

4. Remove the stipulation that only "publicly provided" Scope 3 emissions from portfolio companies must be disclosed, and use the same standard as for Scopes 1 and 2 emissions: "comprehensive disclosure with reasonable estimates."

Reliance on only "publicly provided" data will yield unacceptable data gaps that will reduce the comparability and completeness of resultant emissions figures.[39] It is currently a standard financial industry practice to calculate financed GHG inventories for Scopes 1, 2, and 3 using a combination of publicly-available data, engagement with portfolio companies, and

[36] Partnership for Carbon Accounting Financials PCAF, "The Global GHG Accounting and Reporting Standard for the Financial Industry," 2020, *available at* https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf.
[37] This addresses Question 88 in the Commission's Disclosures Rule proposal.
[38] FR at 36749.
[39] This addresses Question 101 in the Commission's Disclosures Rule proposal.

commercially available datasets from data aggregators like MSCI or CDP, which often rely on reasonable estimates to fill data gaps.[40] The SEC should look to the data quality hierarchy developed by the Partnership for Carbon Accounting Financials (PCAF)—the leading standard for calculating financed emissions—to establish more detailed guidance on data quality, and the Commission should expand the proposal's data hierarchy to require incorporation of "commercially-available" data as well.[41]

Additionally, the Proposal's definition of "portfolio company" is appropriate and fund's investments in other funds and private funds should be included in the GHG emissions calculations.[42] It is critical that fund-of-fund structures not be allowed to obfuscate GHG emissions risk or bypass reporting.

Funds should use measured data or reasonable estimations of underlying funds to determine their own GHG emissions, and they should disclose their methodology, any significant estimates, assumptions, or uncertainties, and primary and third party data sources they used for their calculation. For parent funds that invest in other covered registered funds, GHG emissions data can be calculated by the share of the funds investment multiplied by the GHG emissions of the investee fund.[43] For funds for which no publicly reported data is available, funds should rely on engagement with investee funds and companies, commercially available data, and should be allowed to make reasonable estimates by using emission factors multiplied by available activity data, or if activity data are unavailable, economic data. To promote data comparability and quality, registrants should be required to use emission factors from the EPA[44] if available, or if not, describe the alternative source used.

5. <u>Require environmentally-focused funds that consider GHG emissions to calculate and disclose emissions without netting out purported negative emissions derived from the purchase or generation of carbon offsets by portfolio companies. Additionally, for such funds that invest in portfolio companies with significant usage of carbon offsets, require them to separately describe any material risk this presents to investors</u>.

There are major integrity problems in the carbon offsets market, and offsets often do not deliver their purported climate benefits despite their near-ubiquitous use in corporate net zero transition plans.[45] Additionally, offset projects without adequate safeguards and free, prior, and

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[40] Partnership for Carbon Accounting Financials PCAF, "The Global GHG Accounting and Reporting Standard for the Financial Industry," 2020, *available at* https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf.
[41] *Id*.
[42] This addresses Question 107 in the Commission's Disclosures Rule proposal.
[43] This addresses Question 108 in the Commission's Disclosures Rule proposal.
[44] Environmental Protection Agency (EPA), "Emission Factors for Greenhouse Gas Inventories," Apr. 1, 2022, *available at* https://www.epa.gov/system/files/documents/2022-04/ghg_emission_factors_hub.pdf.
[45] Bloomberg, "Carbon Offsets Have an Integrity Problem. COP26 May Help Fix It," Nov. 16, 2021, *available at* https://www.bloomberg.com/news/articles/2021-11-17/carbon-offsets-have-an-integrity-problem-cop26-may-help-fi

informed consent from local stakeholders have been found to negatively impact marginalized communities, contributing to environmental, racial, and economic inequality.[46] As such, the Commission should not allow carbon offsets to factor into GHG emissions figures, and funds that invest in portfolio companies with significant usage of carbon offsets should disclose any material regulatory, legal, or reputational risks stemming from failure to deliver purported climate benefits, misleading investors, and environmental justice and community-level impacts of offset projects.

6. Environmentally focused funds that invest in holding companies should include the consolidated emissions of all subsidiaries owned by that holding company as Scope 1, 2, and 3 financed GHG emissions of the fund.

Regardless of business structuring, investors in environmentally focused funds need to know the entire extent of GHG emissions financed through their investments, both because they are financially relevant and because omitting those emissions would be materially deceptive and misleading. As with fund-of-fund structures and private equity firms that don't consolidate portfolio companies, material risk from subsidiaries can be transmitted to the parent entity, and holding companies typically exert some level of financial and/or operational control over subsidiaries and can act to mitigate these risks. Additionally, investors would not expect complicated business structuring to obfuscate the emissions disclosures they are relying upon to select funds that match their needs and goals.

To address this loophole, the SEC should require funds to account for Scope 1, 2, and 3 emissions from subsidiaries within the Scope 1, 2, and 3 GHG emissions of an investee parent holding company using an equity share approach, and incorporate those emissions into the ESG funds' Scope 1, 2, and 3 financed GHG emissions figures. This method is similar to recent

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x-it; New Climate Institute and Carbon Market Watch, "Corporate Climate Responsibility Monitor 2022," Feb. 2022, *available at* https://newclimate.org/sites/default/files/2022/02/CorporateClimateResponsibilityMonitor2022.pdf; Bloomberg, "Green Groups Want Offsets Disclosed as Part of the SEC''s Climate Rule," Feb. 14, 2022, *available at* https://www.bloomberg.com/news/articles/2022-02-14/green-groups-want-offsets-disclosed-as-part-of-sec-s-climate-rule.

[46] Berk, Norah, and Prince Lungungu, "REDD-Minus: The Rhetoric and Reality of the Mai Ndombe REDD+ Programme," London: Rainforest Foundation UK, 2020, *available at* https://www.rainforestfoundationuk.org/media.ashx/redd-minus.pdf; Jennifer Devine, "Counterinsurgency Ecotourism in Guatemala's Maya Biosphere Reserve." *Environment and Planning D: Society and Space* 32, no. 6 (January): 984–1001, 2014, *available at* https://doi.org/10.1068/d13043p; Milne, Sarah, Sango Mahanty, Phuc To, Wolfram Dressler, Peter Kanowski, and Maylee Thavat, "Learning From 'Actually Existing' REDD+: A Synthesis of Ethnographic Findings," *Conservation and Society* 17, no. 1 (2019): 84–95, 2019, *available at* https://www.environmentandsociety.org/mml/learning-actually-existing-redd-synthesis-ethnographic-findings.

guidance[47] published by Initiative Climat International, ERM, UN Principles of Responsible Investment, CDP, and Ceres for private equity firms.

7. Require environmentally focused funds to disclose the Scope 1, 2, and 3 GHG emissions of their portfolio holdings using the carbon footprint and the weighted average carbon intensity (WACI) metrics, consistent with the PCAF Standard and the TCFD.[48]

The SEC should require that funds use the carbon footprint methodology and the WACI metrics for Scope 3 emissions disclosure, the same approach as for Scope 1 and Scope 2 emissions, and Scope 3 should be disaggregated from Scopes 1 and 2.[49]

Thousands of companies and financial institutions already disclose their Scope 3 emissions estimates. A 2021 TCFD survey even found that 62% of climate-disclosure preparers already estimate Scope 3 emissions (54% already estimate and disclose) and 87% of preparers are already or have plans to estimate Scope 3 emissions soon.[50] With company-level full scope emissions disclosure fast becoming the norm, investors expect the same level of disclosure from funds, especially those marketed as "ESG" or "green" funds.

Established accounting methodologies for financed emissions—like PCAF—offer clear guidelines to help funds and other financial institutions incorporate primary data and make reasonable estimates to account for their financed emissions without much difficulty or added cost.[51] Improvements to software efficiency will also continue to decrease costs for funds. For example, a July 2022 report from Persefoni, a software provider for automating carbon accounting and financial disclosures, found that over a three-year period their customers experienced 40% efficiency improvements for carbon accounting and reporting processes and over $900,000 total benefits from resource efficiencies and decreased spending on additional consulting services.[52]

GHG emissions—both economic intensity and carbon intensity-based metrics—are prime, comparable indicators for portfolio transition risk that are used widely by investors and other market participants.[53] Economic emissions intensity helps investors understand how

[47] Initiative Climat International (ICI) and Environmental Resources Management (ERM), "Greenhouse Gas Accounting and Reporting For the Private Equity Sector," May 2022, *available at* https://www.unpri.org/download?ac=16265.
[48] This addresses Questions 93, 95, 102, 104 in the Commission's Disclosures Rule proposal.
[49] This addresses Question 102 in the Commission's Disclosures Rule proposal.
[50] Shannon M. Lloyd, Maida Hadziosmanovic, Kian Rahimi, and Pankaj Bhatia, "Trends Show Companies Are Ready for Scope 3 Reporting with US Climate Disclosure Rule," World Resources Institute, Jun. 24, 2022, *available at* https://www.wri.org/update/trends-show-companies-are-ready-scope-3-reporting-us-climate-disclosure-rule.
[51] This addresses Question 93 in the Commission's Disclosures Rule proposal.
[52] "Report: The Total Economic Impact™ of Persefoni: Cost Savings and Business Benefits Enabled by Persefoni," Jul. 2022, *available at* https://persefoni.com/persefoni-expert-publications/forrester-total-economic-impact-persefoni.
[53] This addresses Question 93 in the Commission's Disclosures Rule proposal.

emissions intensity of different portfolios (or parts of a portfolio) compare to each other per dollar invested, while WACI helps investors understand exposure to carbon-intensive companies.[54] These measures complement each other and should be required for Scopes 1, 2, and 3 from all environmentally-focused funds.

We agree with the SEC's proposal not to require funds to disclose the carbon emissions of the portfolio as a whole, as this information could be confusing and is less decision-useful for investors.[55] If investors are concerned about GHG emissions and related risk, the most decision-useful metric is emissions per dollar invested, rather than the emissions of the entire portfolio which will scale with total assets. For example, for a climate-minded investor a large climate-friendly fund would likely be a better candidate than a small carbon-intensive fund, though the former may have much higher gross emissions due to its scale.

The proposed definitions of CO2e, GWP, GHG, GHG emissions, and Scopes 1, 2 and 3 are appropriate and well-established. Funds should not be allowed to use their own definitions, which could confuse investors and yield incomparable disclosures.[56]

Recommendations Related to Derivatives

The Commission should ensure that investment funds have the flexibility to utilize derivatives, but at the same time the Commission must ensure there is no discrepancy between how the derivative and its underlying asset equivalent exposure are treated under these proposals to avoid regulatory arbitrage. A number of investment funds, for example, have recently been opting to trade the credit default swaps referencing corporate bonds instead of the underlying bonds themselves, given how much more liquidity may be available in the credit default swaps market.[57]

Most derivatives should be taken at net notional value, with certain exceptions. For the purposes of these rules, derivative exposures should be treated as follows:

1. Credit default swaps at net notional amounts
2. Futures at their underlying net notional amounts
3. Interest rate swaps at their 10-year equivalent notional value
4. Options at a delta-adjusted notional value

[54] Partnership for Carbon Accounting Financials PCAF, "The Global GHG Accounting and Reporting Standard for the Financial Industry," 2020, *available at* https://carbonaccountingfinancials.com/files/downloads/PCAF-Global-GHG-Standard.pdf.
[55] This addresses Question 95 in the Commission's Disclosures Rule proposal.
[56] This addresses Question 106 in the Commission's Disclosures Rule proposal.
[57] Eleanor Duncan and Christopher Whitall, "CDS volumes surge as bond trading slumps," Refinitiv IFR, Jul. 16, 2022, *available at* https://www.ifre.com/story/3443407/cds-volumes-surge-as-bond-trading-slumps-bmzyyxlhn2.

We strongly argue against reliance on any market values for derivatives, as in some cases those market values are close to zero and therefore provide little to no informational value on the fund's actual exposure. Interest rate swaps, for example, often have market values close to zero at the time of issuance.[58] The Commission should provide a table for market participants to easily refer to in its final rule.

1. Credit default swaps should be treated at their net notional amounts.

For the purposes of calculating fund exposure, the Commission should treat credit default swaps at their net notional value. For example, if Fund XYZ were to sell $10 million in protection against a corporate borrower defaulting using credit default swaps, it is taking the equivalent exposure as purchasing $10 million of the corporate borrower's bonds.[59] The fund should therefore be able to net (rather than take at gross notional) its exposures between the credit default swaps and underlying corporate bonds that would be considered "deliverable" in case of a default.[60]

2. Futures should be treated at their equivalent underlying net notional amounts.

Similarly, futures contracts allow investment funds to trade physical commodities and standardized, widely traded financial instruments, such as US Treasury bonds, over exchanges. A major benefit of futures contracts, however, is the ability for funds to take on exposure to an asset, while only putting up a fraction of its cost through posting initial margin, representing anywhere between 3% and 12% of the contract's notional value.[61]

For the purposes of the 80% investment rule, similar to credit default swaps, futures contracts should be taken at their net notional value, with cross-netting allowed between futures contracts and the underlying cash financial instruments. For example, in the instance of one long futures contract on 10-year US Treasury futures, even though the fund must only put up $1,800 for a position equivalent to $100,000, for the purposes of the 80% calculation, the Commission should treat the position at its full $100,000 notional value.[62]

Characteristics of certain derivatives call for specific adjustments in their treatment.

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[58] Pacific Investment Management Company, "Understanding Interest Rate Swaps," *available at* https://global.pimco.com/en-gbl/resources/education/understanding-interest-rate-swaps.
[59] "Understanding Credit Default Swaps," Pacific Investment Management Company, *available at* https://global.pimco.com/en-gbl/resources/education/understanding-credit-default-swaps.
[60] "A Plain English Summary of Credit Default Swap Settlement Protocol," Cadwalader, Nov. 18, 2008, *available at* https://www.cadwalader.com/resources/clients-friends-memos/a-plain-english-summary-of-credit-default-swap-settlement-protocol.
[61] "The Power of Leverage," Chicago Mercantile Exchange Group, *available at* https://www.cmegroup.com/education/courses/understanding-the-benefits-of-futures/the-power-of-leverage.html.
[62] "10-Year T-Note," CME Group, *available at* https://www.cmegroup.com/markets/interest-rates/us-treasury/10-year-us-treasury-note.html.

While we generally support the Commission taking derivatives at their net notional values, especially compared to market values, the characteristics of some derivatives require the Commission to consider additional adjustments to properly account for their true exposures.

3. Interest rate swap exposures should be adjusted by their 10-year equivalent.

The treatment of certain short-term interest rate swaps and futures for the purposes of the 80% rule should follow the standardized market practices across the investment management industry where the notional amounts are adjusted for a corresponding 10-year equivalent amount.

A change in interest rates have varying degrees of effect on the price of interest rate derivatives. Much of that is determined by the time to maturity of the interest rate derivative, measured through what is known as duration. Duration is the sensitivity of a bond's price to a 1% change in interest rates. For example, a bond with a duration of 5 means that for every 1% rise in interest rates, the price of the bond would correspondingly decline by 5%.[63]

Given how changes in interest rates affect different maturities of debt differently, with securities with a longer time to maturity more greatly impacted, many market participants like to standardize such various degrees of risk into a 10-year equivalent unit.[64] Therefore, in the case of a $1 million notional Eurodollar contract with a three-month maturity, the three months would be adjusted to a 10-year equivalent by dividing the three months by the monthly equivalent of 10 years (120 months) to get 0.025. Therefore, the 10-year adjusted notional exposure of a 3-month Eurodollar contract would be $1,000,000 * 0.025 = $25,000.[65] Already, the Commission accepts 10-year equivalent adjustments for reporting interest rate derivatives over Form PF.[66]

4. Options should be taken at their delta adjusted notional values.

Options, similar to futures, offer funds an inherent amount of leverage, with one option contract most commonly representing 100 shares of underlying stock or 1 futures contract with a notional value of $100,000.[67] Options, unlike other financial instruments, uniquely allow

[63] "Understanding duration," Nuveen, Jun, 6, 2022, *available at* https://www.nuveen.com/en-us/insights/municipal-bond-investing/understanding-duration.
[64] Robert Litterman and Kurt Winkelmann, "Managing Market Exposure," Goldman Sachs, Jan. 1996, *available at* https://faculty.fuqua.duke.edu/~charvey/Teaching/BA453_2006/GS_Managing_market_exposure.pdf.
[65] Abbey Capital, Re: Proposed Rule on the Use of Derivatives by Investment Companies and Business Development Companies, Mar. 28, 2016, *available at* https://www.sec.gov/comments/s7-24-15/s72415-95.pdf#page=9.
[66] "Form PF Frequently Asked Questions," Securities and Exchange Commission, *available at* https://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml.
[67] "10-Year T-Note Options – Specs," CME Group, *available at* https://www.cmegroup.com/markets/interest-rates/us-treasury/10-year-us-treasury-note.contractSpecs.options.html.

investors to speculate on the underlying asset reaching various prices near and very far from the current price, known as strike prices.

Instead of buying 100 shares of a stock, a fund investor could sell 1 put contract that if exercised, would require them to later purchase 100 shares of stock.[68] However, the likelihood of that short put position getting exercised depends on the strike price relative to the current price of the stock. For example, with a stock trading at $10, a short put with a strike price of $9 is far likelier to get exercised and require a purchase of 100 shares compared to a short put with a further strike price of $5. The delta of an option therefore is an approximation of the likelihood of an option being "in-the-money" or having the price of the underlying asset reaching that strike price.[69]

Therefore, for the purposes of calculating exposures towards the 80% rule, the Commission should not only consider an option's underlying notional value, but adjust it for its delta, to incorporate the probability of the option getting exercised and fund taking on that equivalent notional value.[70]

<u>The Commission must consider appropriateness of investment in derivatives versus cash-market equivalents for funds that focus on ESG positive screening.</u>

As mentioned earlier, there are several legitimate reasons why an investment fund would opt to trade in derivatives over the underlying asset, but in certain cases, investors may expect the fund to be investing in the cash-market instrument rather than the derivative. This is especially pertinent for positive ESG screening funds where purchases of the cash-market debt at the time of offering directly provide financing to the issuer whereas investments in the derivatives are something closer to a "side bet" rather than direct financing support of a set of issuers.[71]

Looking Ahead

[68] Sage Anderson, "Long Stock vs. Short Puts," TastyTrade, May 23, 2018, *available at* https://www.tastytrade.com/news-insights/long-stock-vs-short-puts.
[69] "The power of delta," Fidelity, Jan. 11, 2019, *available at* https://www.fidelity.com/viewpoints/active-investor/power-of-delta.
[70] Convexity Capital Management LP, "Definition of a 'Major Swap Participant,'" Sept. 24, 2010, *available at* https://www.sec.gov/comments/s7-16-10/s71610-78.pdf.
[71] Michael Lewis, "The End of the Wall Street Boom," Nov 26, 2008, *available at* https://delong.typepad.com/egregious_moderation/2008/11/michael-lewis-t.html. "When a fantasy player drafts Peyton Manning, he doesn't create a second Peyton Manning to inflate the league's stats. But when Eisman bought a credit default swap, he enabled Deutsche Bank to create another bond identical in every respect but one to the original. The only difference was that there was no actual homebuyer or borrower. The only assets backing the bonds were the side bets Eisman and others made with firms like Goldman Sachs."

The Commission has been engaged in critical regulatory activity going to the heart of its mission. These two rules about ESG investing and advisory services complement the climate disclosure rule and the anticipated human capital management disclosures rule for issuers, providing guidance for advisers and fund managers on how to describe their strategies within a more meaningful data environment. The issuer rules will make crucial information that is often both material for financial performance and important to investors newly available to investors and fiduciaries alike, and the Commission should consider engaging in further regulatory action to clarify how this soon-to-be newly available information should inform how advisers fulfill their fiduciary duty to their clients—inside and outside the context of ESG-branded investing and advisory services.

Additionally, we note that GHG emissions—while critical to maintain and strengthen in this rulemaking—are not the only quantitative ESG metrics needed by investors to evaluate funds and protect them from misrepresentations and exaggerated ESG claims. In future rulemaking, the Commission should incorporate other aspects of the climate disclosure rule, the upcoming human capital management rule, and other future issuer disclosure rules into the Disclosures Rule as needed to protect investors. We strongly support rulemaking on issuer disclosures of labor issues, human rights, political contributions and lobbying, tax transparency, environmental, racial, and economic justice, and other community impacts to better protect investors from ESG risks. These issuer disclosures could then be used as a basis for further fund disclosures, including quantitative metrics, as needed.

We appreciate the Commission's consideration of our recommendations to make the rule as effective as possible. For further discussion, please contact Natalia Renta at natalia@ourfinancialsecurity.org, Alex Martin at alex@ourfinancialsecurity.org, and Andrew Park at andrew@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform Education Fund