INVESTMENT COMPANY INSTITUTE

MEMO# 34258

August 17, 2022

ICI Comment Letter on SEC ESG Disclosure Proposal

[34258]

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TO: ICI Members
Disclosure Working Group
ESG Advisory Group
ESG Fund Disclosure Working Group
ESG Public Company Disclosure Working Group
ESG Task Force
Proxy Working Group
SEC Rules Committee SUBJECTS: Disclosure
ESG RE: ICI Comment Letter on SEC ESG Disclosure Proposal

On August 16, 2022, ICI submitted a comment letter on the SEC's proposal for new disclosure requirements for investment companies and investment advisers.[1]

The letter expresses ICI's support for the fundamental goals of the Commission's proposal: to mitigate the risk of greenwashing and promote investor understanding of ESG funds. It also states support for certain key aspects of the proposal, such as facilitating the ability of investors and the marketplace to distinguish between "ESG" funds and "non-ESG" funds and promoting the comparability of key information about ESG-related investing strategies.

Despite its endorsement of the Commission's goals, however, ICI states that it cannot support many parts of the proposal, which are overly complex and prescriptive and unnecessarily depart from the SEC's time-honored approach to disclosure requirements. ICI asserts that the some of the new disclosure requirements could unintentionally increase, rather than mitigate, the risk of investor confusion. In addition, the prescriptive requirements would impose costly burdens on funds without appreciable benefit to fund investors.

The letter discusses the concerns raised by the complex and prescriptive nature of the SEC's proposal and recommends modifications to address those concerns. A summary of ICI's letter is provided below.

Complex and Prescriptive Nature of Proposed Disclosure

Requirements

The proposal defines certain categories of funds for the purpose of mandating specific disclosure obligations for each fund category. The proposed definitions, however, are not appropriately tailored to the intended purpose of the mandated disclosures and, thus, can produce unintended consequences.

Integration Funds

The Commission proposes to require a fund that falls within the definition of Integration Fund to include specific ESG-related disclosures in its prospectus. The breadth of the proposed definition combined with the new disclosure requirements means that this new disclosure obligation could be imposed on most, if not all, funds. In addition, by mandating that these funds elevate the role of ESG factors (and possibly GHG emissions) in disclosures relating to their investment analysis, above other factors a fund may consider, the proposed new disclosure requirements could even increase the risk of investor confusion and the appearance of greenwashing.

ESG-Focused Funds

The proposal would require enhanced disclosures by ESG-Focused Funds in prospectuses and specific reporting obligations in annual reports, in certain circumstances. We support aspects of the proposed new requirements that would facilitate the ability of investors and the marketplace to identify those funds that are ESG-Focused Funds and promote comparability of key information about an ESG-Focused Fund's principal ESG strategies. The proposed disclosure requirements, however, include unnecessarily broad and prescriptive provisions that could increase the risk of investor confusion and the burdens and costs to funds. Among other things, the proposal would require an ESG-Focused Fund to include a detailed ESG Strategy Overview table in its summary prospectus, which would be contrary to the goal of a summary prospectus.

Impact Funds

We agree with the intent behind the Commission's proposed enhanced disclosures for Impact Funds - that is, that a fund that seeks to generate a measurable impact should explain that strategy and report on its progress. We disagree with two aspects of the proposal, however. First, the proposal would require funds that fall within a Commission-dictated definition of Impact Funds to include an impact objective in the formal investment objective of the fund, when we believe that the fund, and not the Commission or the staff, is best positioned to articulate its investment objective to promote investor understanding. Second, the proposed disclosure and reporting requirements seem to assume that a fund would measure progress at an aggregated portfolio level when funds generally measure progress of individual investments.

Annual Reports

The Commission proposes requiring certain ESG-Focused Funds to report in their annual reports the percentage of ESG voting matters for which the fund voted in furtherance of the initiative and the number or percentage of issuers with which the fund held ESG engagement meetings and the total number of ESG engagement meetings. The proposed reporting of these metrics could result in confusing and potentially misleading information and would impose unnecessary burdens on funds to identify and track "ESG voting matters" and "engagement meetings."

In addition, any ESG-Focused Fund that considers environmental factors (except if it affirmatively states in the ESG Strategy Overview table that it does not consider the GHG emissions of portfolio companies) would be required to disclose the carbon footprint and weighted average carbon intensity (WACI) of the portfolio for the reporting period. The fund would be required to use a hierarchy of data sources from which to calculate the metrics: regulatory reports, information publicly provided by the portfolio company, and, if such information is unavailable, a "good faith estimate" of the portfolio company's emissions. In addition, if a portfolio company reports its Scope 3 emissions in a regulatory report or provides it publicly, then an ESG-Focused Fund that considers environmental factors also would be required to report separately the carbon footprint metric based on the Scope 3 data.

The scope of funds subject to the GHG emissions reporting obligation is overly broad because it could capture funds that do not have a principal investment strategy that focuses on investments in line with GHG emissions reduction. The proposed reporting requirements also would put funds in the untenable position of having to report metrics in a regulatory report that are dependent on data from portfolio companies when portfolio companies are not obligated to report their own emissions data in a regulatory report.

Adviser Disclosure (Form ADV)

The proposed requirements that an adviser provide extensive and granular information regarding each significant investment strategy could unfortunately lead to increasing, rather than mitigating, the risk of investor confusion. Current brochure disclosure regarding non-ESG investing strategies is less detailed. This imbalance may cause investors to misinterpret ESG-related disclosure as indicating a greater focus on ESG than actually exists, merely because of its outsized length.

Economic Analysis and Compliance Costs and Dates

The Commission's economic analysis for this proposal does not provide compelling evidence of the need for the proposed extensive and prescriptive disclosure and reporting requirements. As we have noted, many of the proposed provisions would not enhance investor understanding but could, instead, increase the risk of investor confusion. Thus, the benefits of many of the proposed requirements have not been demonstrated. Yet the costs would be substantial. The Commission's cost analysis substantially underestimates the costs to each fund and to the fund industry of this proposal, including failing to account for key costs funds would incur.

The Commission proposes the compliance dates of one year for prospectus disclosure requirements and 18 months for annual report requirements. We urge the Commission to extend the compliance period for the new disclosure and reporting requirements to three years.

ICI's Recommended Modifications

We recommend the following modifications to better achieve the goals of the proposal without the negative consequences or unnecessary burdens and costs.

- Revise the definition of ESG-Focused Fund to be more consistent with the current disclosure framework and current practices;
- Require enhanced disclosure only of ESG-Focused Funds, and not Integration Funds;
- Require less-prescriptive prospectus disclosure requirements for ESG-Focused Funds;

- Revise Impact Fund disclosure requirements to better reflect the current disclosure framework and impact investing practices;
- Eliminate annual shareholder report disclosures regarding proxy voting and engagement;
- Right-size the scope of funds subject to aggregated GHG emissions reporting and limit fund reporting to data in portfolio companies' regulatory reports;
- Revise adviser disclosure obligations to eliminate unnecessary details; and
- Extend the compliance period for the new disclosure requirements to three years.

Annette Capretta
Associate General Counsel

Notes

[1] See Letter from Eric J. Pan, President & CEO, and Annette M. Capretta, Associate General Counsel, ICI to Vanessa A. Countryman, Secretary, SEC regarding Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (Aug. 16, 2022), available at https://www.ici.org/system/files/2022-08/22-ici-cl-sec-esg-disclosure-proposal.pdf.

For a summary of the proposal, see ICI Memorandum No. 34170 (Jun. 2, 2022), available at https://www.ici.org/memo34170.