October 19, 2023

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, File No. S7-17-22 ("ESG Disclosure Proposal")

Dear Ms. Countryman:

We are writing on behalf of the Sierra Club and its millions of members (including those who are retail investors) to provide updated information regarding the above-referenced proposed rule. This letter supplements the comments we submitted on August 16, 2022. As we explain below, finalization of a strong ESG disclosure rule for registered investment companies and investment advisers (together, "asset managers") will be critically important to protecting investors from misleading ESG-related marketing, especially misleading marketing relating to asset managers' attention to climate-related financial risks and opportunities.

Prohibiting ESG marketing by funds lacking an ESG focus

The ESG Disclosure Proposal was published in the Federal Register on June 17, 2022, the same day on which the SEC published its proposed Fund Names rule for comment. Last month, the SEC finalized its Fund Names rule, thereby taking an important step in fulfilling its statutory mission of ensuring that investors are protected from misleading information provided by registered investment companies regarding their investments and risks. However, it declined to follow through on its proposal to include in the Fund Names rule a prohibition against ESG marketing by so-called ESG integration funds, indicating that this idea remained under consideration.

We urge the SEC to follow through on its proposal to strictly limit ESG-related marketing of ESG integration funds. As we explained in our August 2022 initial comment letter, the SEC should help investors distinguish between three broad categories of ESG-related funds: (1) funds claiming to consider ESG factors without treating them as the main consideration when making investment and engagement decisions ("ESG integration" funds); (2) funds where ESG is the main consideration in investing and engagement ("ESG-focused" funds); and (3) funds that do not focus exclusively on financial returns in addressing ESG factors ("impact" funds).[1]

Specifically, the SEC should ensure that any marketing of specialized ESG expertise or strategy, explicit or implicit, be limited to ESG-focused and impact funds. Allowing managers of ESG integration funds to reference consideration of ESG factors in the context of a discussion in their prospectus of their fiduciary duty to consider all material risks may be appropriate. However, the SEC should prohibit ESG integration funds from using ESG labels or engaging in any other marketing that suggests the asset manager is providing specialized ESG expertise or services to investors. When undertaken by ESG integration funds, such marketing is fundamentally misleading.

Evidence is abundant that many asset managers are making ESG marketing claims without offering evidence that they are providing ESG-focused investing services. In its 2022 report tallying the assets under management (AUM) of ESG funds, the US SIF Foundation elected for the first time *not* to include the AUM of asset managers claiming they incorporate ESG considerations in their investments and portfolio construction but failing to provide information on any specific ESG criteria used.[2] This enables a rough comparison between the full set of funds engaged in ESG marketing and the subset offering evidence of an ESG investing focus.

According to US SIF, at the beginning of 2022, $8.4 trillion of U.S.-domiciled assets under professional management were funds that disclose an ESG investing methodology.[3] This is roughly half of the $16.6 trillion managed by funds found in US SIF's 2020 report to be using ESG marketing with and without disclosures of an investing methodology.

ESG-related marketing continues despite the large-scale "anti-ESG" campaign recently launched by fossil fuel-industry aligned groups. Morningstar finds in a September 2023 report that the

[1] We also recommended that the SEC avoid the term "significant or main" consideration in defining ESG-focused (as proposed) because the use of "significant" would effectively negate the value of "main."

[2] US SIF counted a fund as an ESG Incorporation fund if (1) the AUM of funds with one or more specific ESG criteria incorporated in investment decision-making and portfolio construction; or (2) the AUM of funds for which asset managers identify ESG or sustainability as integral to their investment decision making and portfolio construction in the fund's prospectus, even without providing specific ESG criteria.

[3] US SIF also found that funds with $3 trillion in AUM at the beginning of 2022 filed or co-filed shareholder resolutions on ESG issues at publicly traded companies from 2020 through 2022.

number of U.S.-domiciled funds with climate-related marketing grew from 200 in 2018 to 1,400 in mid-2023, with 25 more such funds created in Q1 and Q2 of 2023 than were shuttered.

In its year-end 2022 report on global trends, Morningstar finds that the category of ESG funds that it calls "sustainable" funds collected more than $3 billion net inflows in 2022. Assets under management grew by 0.7%, outperforming funds that did not market themselves as focused on sustainability-related risks and opportunities; in fact, the overall universe of funds shrank by 1.3%. The three-year picture is even more striking: in 2020 and 2021, these ESG funds outgrew the broader universe by 31 and 22 percentage points, respectively.

Asset managers clearly recognize that ESG marketing can be used successfully to attract clients. However, these marketing claims are frequently made without providing the reliable and consistent disclosures that investors need to evaluate them.

In a September 2023 report, the CFA Institute examined product disclosures for a sample of 60 investment funds marketed to retail investors as incorporating ESG factors into the investment process, including 30 U.S.-based funds. Noting that investor perception of greenwashing can arise when they "struggle to understand the underlying sustainability characteristics of a fund," the Institute found widespread "inconsistency of disclosures," where "information provided in a given document does not align with the information provided elsewhere." It found confusing and inconsistent information in a host of areas, fund names, screening criteria, fund reporting, ESG terminology, and ESG-related impact claims. According to the Institute, this greenwashing "can damage trust and confidence … leading to ESG fund outflows and undermining investment firms' broader sustainability credentials and objectives" and can result in "investors misallocating assets to products or strategies that do not align with their investment goals." Addressing this problem thus is essential "to maintain fair and efficient capital markets, protect investors, and hold investment firms accountable for their claims."

The ESG Disclosure Proposal should be finalized with clear prohibitions against any ESG marketing that is unaccompanied by detailed, standardized disclosures justifying claims.

Combating Climate-Related Greenwashing is an Urgent Priority

Although the problem of misleading ESG-related fund marketing goes well beyond climate change, the evidence shows that climate-related greenwashing with respect to these risks and opportunities is particularly rampant.

According to US SIF, attention to climate change and fossil fuel divestment is by far the most significant of the ESG claims made by asset managers, addressed in funds with a combined $4.8 trillion in AUM. The next largest ESG categories, military/weapons and tobacco, are addressed in funds with $1.8 trillion and $1.7 trillion in AUM, respectively.

The explosion of funds making assertions about attention to climate change and fossil fuels must be seen in the context of a core economic reality facing asset managers: failure to address climate risk means potentially losing large numbers of valuable clients. As the impacts of climate change and the energy transition on the economy become increasingly visible, growing numbers of investors are concerned about associated risks to their portfolios and overall quality of life.[4] Yet many asset managers have failed to take action on the risks and opportunities arising from climate change or, at a minimum, have failed to explain what actions they are taking.

Meaningfully addressing climate change requires understanding and responding to rapid and dramatic changes underway, including major cost declines in renewable energy, energy storage and energy efficiency, steady increases in regulations and court rulings forcing carbon pollution reductions, and ever-growing physical impacts of climate change. The real estate sector is among the sectors facing the prospects of significant asset strandings due to lack of attention to these transition and physical risks. Asset managers that invest in this and other vulnerable sectors and market themselves as climate-savvy have an obligation to articulate their strategy for addressing these very significant risks.

Regulators are Recognizing the Need for Action on Unsupported ESG Marketing Claims

The failure by many asset managers to back up their climate and other ESG claims is attracting the attention and concern of regulators and other oversight bodies:

- In November 2022, the UN High-Level Expert Group on Net Zero Commitments by Non-State Actors issued a report calling for urgent attention to climate-related greenwashing and providing detailed recommendations for asset managers and other financial institutions, among others.
- In February 2023, the UK's Financial Conduct Authority issued a letter to asset manager CEOs noting its concern that claims about ESG and sustainable investing products may be "misleading or inaccurate" and setting forth detailed instructions regarding disclosures and governance.
- In May 2023, the EU's European Securities and Markets Authority (ESMA) published a report noting rapid growth in ESG-related financial products and markets, finding growing concerns among both institutional and retail investors about greenwashing, and offering recommendations for strengthening the Sustainable Finance Reporting Directive to address these concerns.
- ESMA followed up with an October 2023 report that, using natural language processing to examine more than 100,000 fund documents, finds that the share of investment funds with ESG words in their name has increased from less than 3% in 2013 to 14% in 2023. In addition, "investors consistently prefer funds with ESG words in their name" and

[4] See, e.g., Roboredo, J., et al. Are investors aware of climate-related transition risks? Evidence from mutual fund flows - ScienceDirect (Nov. 2021).

"funds respond to extra demand from investors by changing their names." However, fund managers frequently use general rather than specific words in fund names, and often fail to provide reliable and consistent disclosures. Thus, "funds with ESG words in their name have a particular responsibility to demonstrate the efforts they make to ensure alignment between their portfolios and their name."
- In July 2023, the Australian Securities & Investment Commission launched civil penalty proceedings against Vanguard for false and misleading statements in its ESG fund marketing, including statements about fossil fuel exclusions. Vanguard essentially acquiesced to the Commission's claims, stating that it was cooperating with authorities.

The SEC also has taken an important enforcement action on ESG fund marketing, a September 2023 consent order that it secured against Deutsche Bank's investment advisory subsidiary DWS. However, a more comprehensive and proactive approach to addressing ESG-related greenwashing by investment companies and advisers is needed. The ESG Disclosure Proposal represents an important opportunity to fill this gap in investor protection.

Mandatory Disclosure of Engagement Approaches will be Critical for Enabling Investors to Evaluate Climate-Related Marketing Claims

In finalizing its ESG Disclosure Proposal, the SEC should focus on remedying a significant greenwashing risk: funds that market themselves as oriented toward climate and sustainability risks but nonetheless invest heavily in fossil fuel producers and other carbon-intensive firms with significant transition and physical risk. In its September 2023 report, Morningstar finds that many funds that market themselves as offering "climate solutions" and "clean energy/tech portfolios" invest substantially in carbon-intensive businesses.

As we explained in our August 2022 letter, investments in fossil fuel companies and other carbon-intensive businesses are typically justified by financial firms with claims that they are engaging with portfolio companies on emissions reduction strategies. However, meaningful and consistent disclosures on such engagements are lacking. For example, Morningstar acknowledges in its September 2023 report that "investment stewardship is key to influencing corporate climate strategies and mitigating risks in investment portfolios," but it offers no data on any engagement by the supposed climate-focused funds in its report.

The need for meaningful disclosures about asset managers' engagement approaches is becoming increasingly urgent as large asset managers, apparently in response to political pressure, have begun reducing support for ESG-related resolutions. Investors who believe that they have a right to climate risk disclosures and other information on sustainability risks sought in these resolutions have the right to be kept informed when their asset managers stand in opposition. According to an October 2023 Morningstar report, shareholder support for resolutions on environmental and social matters dropped from an average of 30% in the 2022 proxy year to an average of 20% in 2023 proxy year. Two of the nation's largest asset management firms, BlackRock and Vanguard, "sharply reduced" their support for key resolutions.

In our August 2022 comment letter, we provided recommendations for ensuring that engagement disclosures provide sufficient information to prevent greenwashing and enable investors to discern which funds are truly addressing climate and other sustainability risks as claimed. We encourage the SEC to consider these ideas in finalizing its rule.

Disclosure of Financed Emissions is Essential for Evaluating Climate-Related Marketing Claims

Since the ESG Disclosure Proposal was released in June 2022, the justification for its inclusion of mandatory financed emissions disclosures has only strengthened. Whether financial firms and operating companies are measuring, managing and disclosing GHG emissions is now considered to be a key indicator of seriousness in addressing climate-related financial risks and opportunities. In recognition of the importance of these emissions inventories, increasing numbers of companies are now participating in voluntary initiatives such as CDP, Partnership for Carbon Accounting Financials, and Science-Based Targets Initiative. Policy makers around the globe – including most recently, in California – likewise have identified GHG emissions inventories as essential to risk management and are therefore mandating standardized emissions disclosures to protect investors and other market participants.

This rapid scaling of emissions inventories and disclosures means that data collection and analysis is becoming much easier and much less costly for asset managers, both because portfolio companies' data is becoming much more available and because asset managers themselves are becoming much more accustomed to collecting, analyzing and disclosing inventories. Many asset managers that would be covered by the ESG Disclosure Proposal are already covered by the EU's Sustainable Finance Disclosure Regulation (SFDR) emissions disclosure requirements. S&P Global conservatively estimates that U.S. investment companies with $2.5 trillion AUM are already subject to the SFDR.

We appreciate your consideration of these supplemental comments and would welcome any discussion of our recommendations.

Sincerely,

Ben Cushing, Fossil-Free Finance Campaign Director, Sierra Club

John Kostyack, Sierra Club Consultant