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U.S. Securities and Exchange Commission

Asset Management Advisory Committee

Recommendations for ESG

July 7, 2021

Executive Summary

The Asset Management Advisory Committee (“AMAC”) established a subcommittee generally to review matters concerning Environmental, Social and Governance (“ESG”) issues and make recommendations to AMAC regarding how these matters might pertain to managed investment products¹.

The AMAC offers the following recommendations to the SEC, to improve the data and disclosure used for ESG investing, in order to create better transparency for investors, and better verifiability of investment products’ ESG strategies and practices. In the case of Issuer Disclosure, requirements are already in place requiring issuers to disclose material risks, and the AMAC does not recommend changes to the regulatory framework, but rather the adoption of standards to guide those disclosures. In the case of Investment Product disclosure, the AMAC seeks support of best practices, aligned to a more uniform terminology.

Recommendations Regarding Issuer Disclosure of Material ESG Matters:

- *The AMAC recommends the SEC take steps to foster meaningful, consistent, and comparable disclosure of material environmental, social, and governance (ESG) matters by issuers.*
- *To foster meaningful, consistent, and comparable disclosure, the SEC should encourage issuers to adopt a framework for disclosing material ESG matters and to provide an explanation if no disclosure framework is adopted.*
- *In addition, the AMAC recommends the SEC initiate a study of third-party ESG disclosure frameworks for the disclosure of material ESG matters to assess whether the frameworks could play a more authoritative role in the future.*

Recommendations Regarding ESG Investment Product Disclosure:

- *The SEC should suggest best practices to enhance ESG investment product disclosure, including alignment with the taxonomy developed by the Investment Company Institute (“ICI”) ESG Working Group,² and clear description of each product’s strategy and investment priorities, including description of non-financial objectives such as environmental impact or adherence to religious requirements.*

¹ Examples of managed investment products include mutual funds, exchange traded funds, closed-end funds, unit investment trusts and variable annuities.

² [“Funds’ Use of ESG Integration and Sustainable Investing Strategies: An Introduction,”](#) Investment Company Institute, July 2020.

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- *The SEC should suggest best practices for investment products to describe each product's planned approach to shared ownership activities in the Statement of Additional Information, and any notable recent ownership activities outside proxy voting in Form N-PX (the Annual Report of Proxy Voting Record of Registered Management Investment Company).*

Background

The AMAC formed the ESG subcommittee (“the subcommittee”) in the first quarter of 2020. The main purpose is to look into ESG practices of investment products, and to explore, within the areas of the SEC’s mandate, whether any recommendations were warranted to improve practices. Of particular interest to the AMAC was the extent to which ESG investment products differed from other types of investment products, and whether any intervention was needed to address these differences.

- **Definitions and Scope**

The types of risks and investment styles we describe with the broad term “ESG” in this document include environmental, social, and governance practices; sustainability; impact investing; responsible investing; and other similar terms.

- **Subcommittee’s Process**

The subcommittee explored available literature, and interviewed practitioners including asset managers, industry groups and service providers. In October 2020, the subcommittee held two panel sessions for the subcommittee members at subcommittee meetings. The first session gathered information from experts³ on Issuer Disclosure of ESG risks, and the second⁴ focused on Investment Product Disclosure considerations for ESG. At the March 2021 AMAC meeting, the subcommittee held a panel focusing specifically on issuers and investment managers.

The subcommittee members also studied the recent recommendations in this area by the SEC’s Investor Committee,⁵ an ESG primer created by the ICI (see footnote 2), work by the

³ Panelists from SASB, T. Rowe Price, Nuveen, Sustainalytics and ISS participated.

⁴ Panelists from Investment Company Institute (ICI), the CFA Institute, JP Morgan, Fidelity and BlackRock participated.

⁵ [Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure](#), May 14, 2020.

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CFA Institute,⁶ documents from the Investment Adviser Association,⁷ and the ESG content in the SEC request for commentary on the Names Rule.⁸

Key Questions Discussed by the Subcommittee

ESG investing has grown significantly in recent years; according to the ICI, “socially conscious” registered investment products grew from 376 products/\$254 billion in assets under management (“AUM”) at the end of 2017 to 1,102 products/\$1.682 trillion in AUM by the end of June, 2020.⁹ Areas of concern that the subcommittee identified through its review of literature on the topic and feedback from AMAC members included:

- How should ESG investment products be treated under the Names Rule?
- How can we avoid “greenwashing,” that is, investment products bearing the name ESG but not actually incorporating material ESG matters into investment decisions?
- Does ESG, or any substyle of ESG investment, contribute to performance, or are performance claims being made without basis in data?
- Should there be special requirements for ESG investment products in the way they vote proxies?
- Should particular ESG ratings providers or benchmarks be used as part of the requirements for including “ESG” in the corresponding product name?
- What guidance should be given to U.S. securities issuers with respect to their duty to disclose material ESG matters?

While the majority of these were questions about what should be required of ESG investment products, issuer disclosure standards became a prominent topic. As the subcommittee worked through these questions, it became apparent that issuer disclosure is the starting discussion point for all ESG matters. As such, the subcommittee prioritized and elected to not tackle the “Names Rule” for ESG products.

The subcommittee divided its work into five separate workstreams, of which three led to the recommendations included in this document. The five workstreams were:

1. Is ESG About Value or Values?
2. Assessing Performance of ESG Strategies
3. Proxy Voting in ESG Strategies
4. Issuer Disclosure of ESG Data
5. What Role Should ESG Rating Systems and Benchmarks Play?

After looking into these individual topics, the subcommittee merged workstreams 1, 3 and 5 to create the recommendations here presented regarding investment product disclosure.

⁶ [“Consultation Paper on the Development of the CFA Institute ESG Disclosure Standards for Investment Products,”](#) August, 2020.

⁷ [“Sustainable Investing is an Active Process,”](#) Investment Adviser Association, 2020.

⁸ [Request for Comment, File No. S7-04-20](#), SEC, March, 2020.

⁹ [ICI Webinar materials, “New Common Terminology for ESG Fund Investing Strategies,” August 11, 2020.](#)

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Workstream 4 contributes the recommendations for issuer disclosure, and workstream 2 provides the observations below with respect to ESG performance measurement.

The AMAC Rationale

The AMAC considered the work and record of the subcommittee and finds that “ESG” is not a monolithic category of issues unto itself. Rather, it is a short-hand reference that encompasses environmental, social, and governance factors individually and together.

Indeed, even within each factor—E, S, and G—there are numerous sub-factors whose importance to investors can vary depending on the characteristics of a given business or industry; changing preferences and market conditions; or the perceived materiality of given factors. The measurement of material E, S, and G factors and sub-factors can also vary and in some cases metrics have yet to evolve.

That said, some factors are further along on this journey than others. For instance, governance issues have been actively deliberated for years. While these issues can hardly be said to have been settled, these deliberations have yielded a higher level of understanding and consensus. By contrast, best practices for defining, prioritizing, and measuring material environmental and social matters like climate change and diversity, equity, and inclusion are still being debated and honed.

The AMAC believes that interpretations of “public interest” and “materiality” in the regulatory framework have been applied to specific, relevant facts and circumstances. However, the AMAC also believes that evolving financial markets and investor interests may be useful in influencing these interpretations. Through the decades this has ensured that SEC rules and regulations have been able to adapt to meet the demands of the dynamic capital markets to which they’ve been applied.

Against that backdrop, the AMAC believes the SEC should consider the significance that investors have come to attach to ESG. While this too is debated, the AMAC examined it through a few different lenses that it believes the SEC should consider. The first lens is the relationship between material environment, social, and governance risk and investment performance.

There is spirited debate about this relationship, to which the subcommittee’s December 1, 2020 draft recommendations briefly alluded.¹⁰ Some argue that there’s a link between material ESG risk and investment returns; others contest this, suggesting that other factors could be at play.¹¹

¹⁰ [U.S. Securities and Exchange Commission, Asset Management Advisory Committee, Potential Recommendations of ESG Subcommittee](#) (Dec. 1, 2020).

¹¹ “Have Investors Paid a Performance Price? Examining the Behavior of ESG Equity Funds”, the Journal of Portfolio Management, Feb 2020.

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All told, the debate is still largely unsettled, which is perhaps unsurprising given that the definition and measurement of ESG factors is still emerging.

The second lens is market interest. Here there is less debate: The sheer volume of activity surrounding sustainable investing speaks to the high and growing importance of ESG issues to market participants. Investors are directing prodigious sums towards investments whose mission, objective, or strategy at least consider ESG factors.¹² Notwithstanding the question of whether these investors are acting based on “values” or “value”, the market’s demand for ESG-oriented investments is unmistakable.

A third lens is regulatory activity and emergence of professional standards. In recent years, a range of policy and regulatory initiatives on ESG have been launched in a number of jurisdictions around the globe. The Principles for Responsible Investment (PRI) identified 124 new or revised sustainable finance policy instruments in 2020, up from 92 in 2019.¹³ This is most notably the case in the European Union where complex new regulatory frameworks have been introduced to promote sustainable investment.¹⁴ Separately, at the international level, important initiatives have been launched by the IFRS Foundation and IOSCO to explore the development of a global architecture for sustainability reporting in the form of an International Sustainability Standards Board (ISSB) to establish a global baseline for ESG disclosure. The report “Sustainable Finance and the Role of Securities Regulators and IOSCO” (April 2020) found the rise of “multiple and diverse sustainability frameworks and standards” had created demand among market participants for convergency of standards. Indeed, 65% of market participants IOSCO surveyed cited the need for harmonization of standards, with more than half of those encouraging coordinated regulatory guidance or endorsement/adoption of third-party standards.¹⁵

Viewed through these lenses, the AMAC has observed that market participants, regulators, and standard setters view material ESG matters to play a role in capital formation, capital allocation and risk/return expectations. To these participants, the lack of clear, consistent, and comparable issuer disclosure of material ESG matters may suggest a call to action, not inaction. The AMAC concurs with this view and the initial draft posted in December contained recommendations for mandated adoption of third-party standard setting frameworks.

The March expert panel by issuers and investment managers highlighted additional perspectives. While all the panelists unanimously agreed that consistent and comparable ESG disclosures across industries would be highly desirable, there are challenges to achieving that goal in the near future. First, ESG metrics are still evolving. As such, a rule- based disclosure framework regime may not capture all new information and subsequent developments. Second,

¹² <https://www.reuters.com/business/sustainable-business/sustainable-fund-inflows-hit-record-high-q1-morningstar-2021-04-30/>

¹³ <https://www.unpri.org/policy/regulation-database>

¹⁴ <https://home.kpmg/xx/en/home/insights/2020/05/beginning-of-esg-regulatory-journey.html>

¹⁵ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD652.pdf>

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mandated disclosures also raised questions about the practicality of setting disclosure requirements on certain ESG factors where it can be difficult to demonstrably prove the disclosure is material to the issuer's financial statements.¹⁶ The AMAC believes that this is most pertinent to social (S) matters, where it can be difficult to identify and measure the sub-factors concerned.

After considering above viewpoints, the AMAC concluded it was premature to broadly recommend specific mandated disclosure of material ESG matters through SEC rulemaking or required adoption of third-party standards.

Nevertheless, the AMAC believes there is a pressing need for the SEC to effect a process for enhancing the quality, consistency, and comparability of ESG disclosures that issuers make to investors. This would ensure investors can access relevant information and improve the likelihood such data will be consistent and comparable across issuers in similar lines of business or industries. Consistent and comparable ESG metrics could also help market participants assess the impact of various metrics on risk and return.

As and when those metrics attain widespread market adoption and acceptance, the SEC could revisit whether to provide more specific guidance codified in regulation. Any such regulation should be principles-based, consistent with the approach the SEC has traditionally taken to matters where issuers must exercise considerable discretion in determining whether they would be relevant and important to investors.¹⁷ It also should be founded on the same notions of "materiality" that have been a fundamental underpinning of disclosure practices issuers have followed through the years.

These recommendations do not call for the SEC to set public policy as they relate to the issues discussed. Rather, just as the SEC has continually evaluated specific definitions of issues such as materiality and public interest in the context of changes in market practices and investor needs,¹⁸ the AMAC believes this approach will accelerate the emergence of generally accepted standards and metrics in an area that is evolving rapidly.

The AMAC also finds that ESG investment products are not significantly different than traditional products such as value funds or growth funds: both product types have objectives and investment processes to achieve those objectives. However, there is less publicly available data to support performance measurement and validation of ESG related features than exists for many traditional products. The AMAC finds that ESG products have risk/return objectives that could reflect a longer time horizon and have objectives that extend beyond risk/return goals.

In its work, the AMAC considered a range of potential recommendations, from taking no action, to mandating particular actions. In most but not all cases, the AMAC finds that some kind of actions to support best practices would improve transparency for investors. However, more prescriptive actions can be counter-productive given that ESG investing is still evolving; strong

¹⁶ See March 2021 AMAC meeting transcript

¹⁷ [SEC.gov | SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K](https://www.sec.gov/news/press/2021/20210315sec-rule-amendments-to-modernize-disclosures-of-business-legal-proceedings-and-risk-factors-under-regulation-s-k)

¹⁸ <https://www.sec.gov/news/speech/remarks-economic-club-new-york>

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rulesets might, at this point, freeze development of investment and measurement approaches in this investing style. Therefore, the AMAC's recommendations to improve investment product disclosure are to provide best practice guidance rather than mandate specific approaches.

The AMAC recommends as a suggested best practice that ESG investment products describe their objectives and how they prioritize these objectives (e.g., are the risk/return objectives a higher or lower priority than any non-risk/return objectives, such as religious rule adherence or social benefits). The AMAC recommends that a suggested best practice be the adoption of the terminology developed by the cross-industry group that served in the Investment Companies Institute (ICI) ESG Working Group (see footnote 2).

Recommendations Regarding Issuer Disclosure

- ***The AMAC recommends the SEC take steps to foster meaningful, consistent, and comparable disclosure of material environmental, social, and governance (ESG) matters by issuers.***

This recommendation does not contemplate revising the materiality standard requirement that has guided issuers in determining whether disclosure of a matter is warranted. Rather, this recommendation acknowledges that ESG is a still-developing concept and therefore issuers' determination of materiality and definition of material ESG matters can vary. Moreover, issuers' disclosure of material ESG matters can take various forms, complicating analysis and making comparison harder.

- ***To foster meaningful, consistent, and comparable disclosure, the SEC should encourage issuers to adopt a framework for disclosing material ESG matters and to provide an explanation if no disclosure framework is adopted.***

These frameworks could include 1) those developed by third-party standard-setting organizations, or 2) those developed by an industry group dedicated to ensuring consistent, comparable disclosure of material ESG matters

To foster such action, the SEC should encourage issuers taking one of the following approaches:

The issuer (a) should identify a commonly accepted disclosure framework and fully disclose all material information in accordance with such framework

or

(b) if the issuer elects not to adopt a disclosure framework, then the issuer should disclose an explanation of why it chose not to do so.

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If a framework is adopted by the issuer for disclosure purposes, the framework should clearly articulate the principles by which an issuer determines the backward-looking quantitative and forward-looking qualitative metrics and disclosures it should present on material ESG risks. It also should prioritize disclosure of material ESG risks applicable to most issuers, such as climate risk, while specifying disclosure of specific material ESG risks pertinent to the issuer's business and industry. While this recommendation does not call for changing materiality standards as relates to ESG matters, it still would usher in needed improvements.

In encouraging issuers to adopt frameworks for disclosing material ESG matters, the SEC would underscore the importance of presenting information on material ESG matters in a consistent, comparable way. This signals to issuers that they must coalesce around material ESG matters relevant to their industry/sub-industry, thereby improving the quality and comparability of that information in the process.

This approach would also afford issuers some flexibility to determine and refine an appropriate disclosure framework. The AMAC acknowledges that many third-party frameworks for disclosing material ESG matters and the standards that underpin them continue to evolve. It also recognizes that in some cases industry-developed disclosure frameworks might be a more suitable approach than third-party ESG disclosure frameworks.

- ***In addition, the AMAC recommends the SEC accelerate its study of third-party ESG disclosure frameworks for the disclosure of material ESG matters and acquire relevant subject matter expertise to assess how frameworks could play a more authoritative role in a near future.***

This would not only serve to catalyze the process for further improving these standards, but also demonstrate the SEC's commitment to harmonizing the way in which issuers determine what constitutes a material ESG matter and conveying that information to investors.¹⁹

We believe this action would provide a roadmap for potential establishment of a standard setting body to develop ESG disclosure standards. Consistent applications of those standards by issuers can be enforced by the SEC, like the enforcement of U.S GAAP accounting standards developed by the FASB²⁰.

Recommendations Regarding Investment Product Disclosure

- ***The SEC should suggest best practices to enhance ESG investment product disclosure, including alignment with the terminology developed by the ICI ESG Working Group²¹, clear description of each product's strategy and investment***

¹⁹ [SEC.gov | ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets](https://www.sec.gov/news/speech/2014-spch052014mjjw)

²⁰ <https://www.sec.gov/news/speech/2014-spch052014mjjw>

²¹ https://www.ici.org/news-release/20_news_esgprimer

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priorities, as well as description of non-financial objectives such as environmental impact or adherence to religious requirements.

Existing rules for investment product disclosure and advertising are sufficient and adequate—but disclosures would be improved by elements of comparability. The AMAC finds that integration of ESG factors into investment process by funds varies quite substantially. For this reason, the SEC should recommend to the industry best practices for ESG product disclosure to foster comparability. The AMAC views that adopting those practices should not be a costly burden; it would benefit investors attempting to compare products, and it may have benefits to the investment product managers. Arguably, products that give consumable, comparable disclosure will be more attractive to investors and professionals who provide research concerning investment products.

The AMAC believes this consistency could be achieved by adopting broad terminology that classifies investment strategies, such as the one developed by the ICI ESG Working Group (see footnote 2), into one or more of the following categories:

- Inclusionary;
- Exclusionary; and
- Impact.

Suggested best practices for disclosure would be to describe clearly how the product carries out its strategy (such as whether it uses internal or external research or some combination), how it selects investments in line with its strategy, what its objectives are, and which objectives mainly seek return relative to risk minimization, as opposed to objectives which are not straightforward risk/return characteristics. Suggested best practices would be to indicate any specific priorities in these objectives—for example, whether risk/return objectives come above or below social objectives or are equal priorities. For risk/return objectives, it would be helpful to identify the time horizon over which those objectives are designed to be accomplished; the time horizons for some products may be a year, 10 years, a market cycle, or much longer time. The AMAC believes the adoption of terminology also aligns well with the EU Sustainable Financial Disclosure Regulation (SFDR) proposed by the European Commission.²²

In shareholder commentary, a suggested best practice would be to explain how the product achieved its top objectives, and, ideally, how these are estimated to have contributed to return.

- ***The SEC should suggest best practices for investment products to describe each product's planned approach to share ownership activities in the Statement of Additional Information, and any notable recent ownership activities outside proxy voting, which is reported in Form N-PX, in shareholder reporting.***

²² <https://eur-lex.europa.eu/eli/reg/2019/2088/oj>

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Experts consulted by the subcommittee, such as the CFA Institute, noted that ESG investment products engage in share ownership activities as a more deliberate piece of their strategy than many, but not all, other investment products. These ownership responsibilities include:

- how they vote proxies;
- whether they engage management individually, and/or participate in collective engagement of management; and
- whether they lead shareholder motions.

Investors in these ESG products, and other [investment] products, would benefit from clear, consistent statement regarding how ownership responsibilities are carried out by the product. While the AMAC believes that the reporting of proxy voting is already well regulated, other ownership responsibilities, if significant to the product's strategy, should be noted. An investment manager's intention to use these tools could be indicated in the Statement of Additional Information, and any notable ownership activities could be described in shareholder reporting.

Observations Regarding Performance Measurement

The AMAC finds that there is a wide range of research and assessments concerning how ESG factors affect performance, and that a clear picture of the impact of ESG on performance does not currently emerge.

The AMAC explored whether it should take any action with respect to performance reporting for ESG products. The SEC already requires a number of elements in fund performance disclosure. The AMAC did not find that ESG should be treated any differently than other fund objectives or strategies with respect to disclosing performance. While performance standards might emerge if issuer ESG data improves, at this early state of evolution of ESG investing the AMAC did not find that particular standards for metrics and attribution were achievable or desirable.

A key component of the existing rules concerning performance disclosure is the requirement to benchmark against a broad market index, and to allow funds to determine whether it is appropriate to use a secondary, more tailored index. The AMAC believes, for a number of ESG products, a secondary, ESG-themed benchmark could give investors important information and would be desirable.

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As issuer data improves and the ESG investing practices develop further, performance measurement and other analyses may evolve and become even more valuable for investors, as they have for other investment strategies.