Potential Recommendations from the ESG Subcommittee

SEC Asset Management Advisory Committee

December 1, 2020

Overview

- Activities since prior meeting
- How is ESG different than other products?
- Discussion of potential recommendations regarding issuer disclosure of ESG information
- Discussion of potential recommendations regarding investment product disclosure of ESG information
- Observations regarding ESG performance measurement and attribution
- Next steps, including returning to AMAC with recommendations for vote

Activities since prior meeting

- Since our last update to the AMAC, we:
  - Convened a panel of investors, service providers and other experts to better understand what investors need with respect to issuer disclosure of ESG information
  - Convened a panel of investors and representative from industry groups to better understand best practices in ESG investment product disclosure
  - Began to reach out to issuer groups to understand their perspective on issuer disclosure
    - this work has not yet taken place and may continue to refine our recommendations
- We became aware that the Commission has *not* taken a position on whether ESG represents a "strategy" for purposes of the Names Rule, so these references in our September 16, 2020 presentation should be stricken. We also became aware that comments to funds by the Commission staff are consistent with an interpretation that ESG is an investment type and therefore subject to the Names Rule
  - The ESG subcommittee, however, does believe that ESG is best treated as a strategy under the Names Rule

How is ESG different than other products?

- Including E, S, or G separately, or any combination; and including impact, socially responsible, or sustainable investing
- These products:
  - Have **less available public data** to support measurement and validation of ESG risk factors than exists for many traditional products
  - Have risk/return objectives that could reflect a **longer time horizon** than traditional products
  - May have **objectives that fall outside risk/return** objectives alone
- Is the problem created by the lack of public data important enough to require a solution?

How we approached our recommendations

- Focused on issuer disclosure as improvements in its availability, consistency and meaningfulness would allow better investor transparency, and better performance measurement accuracy
- Did not believe disclosure rules need to change—issuers already have to disclose material risks—but that standards needed to be mandated as the state of data is poor without them
- Sought to minimize burden and create clarity/simplicity for issuers:
  - Minimum number of material metrics
  - Tailored by industry
  - Appropriate to the SEC's mandate—not trying to emulate the E.U.'s approach
- Sought the encouragement of best practices in investment product disclosure, aligned to a more standard taxonomy for comparability
  - Including a broader focus on how managers undertake share ownership responsibilities

Potential recommendations regarding issuer disclosure of ESG risks

The SEC should:

- Require the adoption of standards by which corporate issuers disclose material ESG risks
- Utilize standard setters' frameworks to require disclosure of material ESG risks
- Require that material ESG risks be disclosed in a manner consistent with the presentation of other financial disclosures

Adoption of standards

Standards should meet these criteria:

- Be authoritative and binding, akin to generally accepted accounting principles (GAAP)
- Apply to disclosure of material ESG risks and guide issuers in determining whether an ESG risk is material, or could become so in the future
  - Standards should be material, limited by industry, and provide clear guidance on relevant metrics
- Ensure ESG disclosure comprehensively addresses all material ESG risks, meaningfully conveys the issuer’s exposure to each material ESG risk, and allows uniform comparison of material ESG risks across industries and specific comparison within industries

Adopt standard setters' frameworks

Those frameworks should meet these objectives:

- 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.
- Prioritize disclosure of material ESG risks applicable to most issuers, such as climate risk, while also requiring disclosure of specific material ESG risks pertinent to the issuer's business and industry
- Mandate disclosure of all material ESG risks by all issuers, with appropriate exceptions considered for issuers that the SEC determines might suffer undue burdens in meeting the requirements, such as smaller issuers

Examples of Material ESG Disclosures with Poor Disclosure Rates By Industry

Real Estate

Value of properties in identified flood zones

Percent of properties that are LEED certified (49%)*

Scope 3 greenhouse gas emissions (property usage)

Food Products

Water use (52%)

Percent of suppliers subject to external certifications (45%)

Scope 3 emissions (logistics and fleet)

Pharmaceuticals

Number and percent of suppliers located outside the U.S. (by country)

Payments to healthcare professionals in key markets outside the U.S. (e.g. China)

Description of sales incentive structure (55%)

Chemicals

Number of hazardous chemicals produced (according to SIN List, EU REACH List, etc)

Description of activities to reduce or phase out hazardous substances from product portfolio (50%)

Percent of operations in identified flood zones

** disclosure rates are the percentage of companies that have any disclosures on the topic. Disclosure best practice or even good practice would be a much smaller subset of those that do disclose.*

Source: Sustainalytics, a Morningstar company

Potential 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 ICI ESG Working Group, and clear description of each product’s strategy and investment priorities, including description of non-financial objectives such as environmental impact and adherence to religious objectives
- 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

ICI ESG Working Group taxonomy

- Classifying strategies in one or more of the following categories:
  - Inclusionary
  - Exclusionary
  - Impact
- Describe how product carries out its strategy and objectives
- Prioritize objectives – do risk/return objectives have a higher or lower priority than social objectives, for example

Ownership activities

- Useful for all products:
  - How they expect to vote proxies
  - Whether they engage management individually, and/or participate in collective engagement of management
  - Whether they expect to lead shareholder motions
  - Any other ownership activities of note
- As part of the Statement of Additional Information
- With periodic reporting of any notable ownership activities in shareholder reporting
  - Proxy reporting would continue in its existing fashion

Observations regarding ESG performance measurement and attribution

- Does ESG add alpha?
  - A clear, consistent picture does not emerge
  - There are multiple conflicting studies
- Given the state of public data and the early evolution of practices, the subcommittee did not feel it should recommend specific approaches to ESG performance measurement
- We do believe that, for certain funds, adopting a secondary, ESG-themed benchmark would add information for investors

Next steps

- We welcome your suggestions and feedback
- We expect to consult groups representing issuers to understand their point of view
- We plan to return to the next quarterly AMAC meeting with final recommendations for a vote