

# Green Funds in a Gray Area: The ESG Fund Labeling Problem and How the SEC Can Fix It

Corey B. Shapiro\*

*Environmental, Social, and Governance (ESG) funds face tremendous skepticism regarding their impact relative to investor perceptions. In fact, several figures, including media commentators and asset management leaders, have sounded the alarm on ESG investing. They believe investors, especially retail investors, are being misled by funds' names and largely unhelpful disclosures, and that some fund managers are exaggerating their ESG practices in the name of attracting investors' money. The Securities and Exchange Commission (SEC) has documented evidence of misleading statements regarding ESG investing processes and has brought enforcement actions against companies for making false claims in their disclosures. In an effort to address the lack of standardization and clarity in the ESG fund industry, the SEC proposed two rules in May 2022 that would change the naming and disclosure requirements for ESG funds.*

*To examine how ESG funds are naming themselves and disclosing key ESG information, this Note aggregates data collected from the twenty largest ESG mutual funds and exchange-traded funds (ETFs). Based on an analysis of this data—which simulates an investor's experience attempting to identify which ESG funds best align with their objectives—this Note derives quantitative and qualitative takeaways. The main conclusion is that ESG fund names are often vague and misleading, and neither their names nor their accompanying disclosures describe the funds' investment strategies in a manner retail investors can meaningfully understand and use to make fully informed*

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*investment decisions. This Note calls this phenomenon the “ESG fund labeling problem.”*

*In addition to analyzing the ESG fund labeling problem and its impact on retail investors, this Note considers whether the SEC’s two proposed rules from May 2022 will be successful in abating the ESG fund labeling problem. Ultimately, this Note concludes that the proposed rules fall short of meeting investors’ needs in key areas and proposes modifications the SEC can employ to further resolve the ESG fund labeling problem and reduce investor confusion.*

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## I. INTRODUCTION

Selecting an environmental, social, and governance (ESG)<sup>1</sup> fund is a lot like choosing a “healthy” cereal at the supermarket.<sup>2</sup> At the beginning of the process, there are a paralyzing number of ostensibly similar options that supposedly let you have the best of both worlds. Imagine the first cereal you see is “Cereal Co.’s Sugar-Optimized Cereal,” the next is “ABC’s Nutritious Cereal,” and the third is “XYZ’s Health-Oriented Cereal.” ESG funds also have fairly similar, and non-informative names, and the differences between them can be as stark as regular versus sugar-free cereal. For example, while the “iShares ESG Aware MSCI USA ETF” held eleven oil and gas companies including ExxonMobil and Chevron, the “the iShares MSCI USA SRI ETF” held just two.<sup>3</sup>

When both cereal and fund names fail to convey much of substance, the next place to turn are their descriptions. Imagine Cereal Co.’s box said the following: “We at Cereal Co. seek to deliver a nutritious product that tastes just like our classic recipe. That’s why we created our ‘Sugar-Optimized Cereal.’” ABC’s cereal box says “Our ‘Nutritious Cereal’ avoids unhealthy ingredients so customers can enjoy what they’re eating and feel good too. At least 80% of the cereal in this box meets our industry-leading health criteria.” XYZ’s cereal box says something equally vague: “XYZ’s ‘Health-Oriented Cereal’ has special health benefits derived from a proprietary cereal-making process that integrates nutrient-rich ingredients.”

In many respects, retail investors<sup>4</sup> face similar challenges when researching and investing in ESG funds (an industry primarily

1. Throughout this Note, “ESG” will be used as a general term to include the many other terms that address similar concepts, such as “socially responsible,” “sustainable,” “responsible,” and “green.”

2. *Cf.* Gary Gensler, Chairman, SEC, Prepared Remarks Before the Asset Management Advisory Committee (July 7, 2021) (making a similar analogy between ESG terminology and different types of milk).

3. RUMI MAHMOOD, MSCI ESG RESEARCH LLC, THE TOP 20 LARGEST ESG FUNDS – UNDER THE HOOD 11 (2021). The report noted that the former fund has 2.15% of its assets allocated to energy, whereas the latter had 0.72%. *Id.*

4. The SEC defines a “retail investor” as “a natural person . . . who seeks to receive or receives services primarily for personal, family or household purposes.” Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492 (July 12, 2019) (to be codified at 17 C.F.R. pts. 200, 240, 249, 275, and 279). Notably, this definition includes both current and prospective investors because the SEC “thought it would be beneficial for all natural persons to receive information to facilitate their account choices.” *Id.* at 33,542. Applying this philosophy in the context of this Note, any ESG-related regulatory action analyzed or proposed should facilitate both current and prospective investors’ understanding of investment products.

composed of mutual funds<sup>5</sup> and exchange-traded funds (ETFs).<sup>6</sup> Not only is it challenging for investors to compare funds to each other or easily match their investing goals with a fund's objectives—given, among other issues, the lack of standardized industry terminology, wide-ranging ESG investment objectives and strategies,<sup>7</sup> and lengthy and confusing disclosures. Moreover, ESG funds are also significantly costlier than traditional alternatives (typically 40% more expensive), meaning investors are often subjecting themselves to higher fees for ESG funds that “often closely mirror ‘vanilla’ funds.”<sup>8</sup>

Based on these unclear names and descriptions, investors are left to make a difficult decision. Often, it is unclear whether the fund they chose fits their investing objectives, or if they ended up paying more for a better-looking box of “cereal.”<sup>9</sup>

On a more basic level, there is no general consensus on what being an “ESG fund” even means.<sup>10</sup> For instance, in the same way one would expect a “healthy” cereal to be good for you, an investor might assume that a fund labeling itself as an ESG fund would invest in companies

5. The SEC defines a mutual fund as an “open-end investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments.” SEC, SEC PUB. 182 (12/16), MUTUAL FUNDS AND ETFs: A GUIDE FOR INVESTORS 4 (2019).

6. ETFs “are SEC-registered investment companies that offer investors a way to pool their money in a fund that makes investments in stocks, bonds, other assets or some combination of these investments and, in return, receive an interest in that investment pool.” *Id.* at 6.

7. The SEC referenced this issue explicitly as a reason it provided a new classification system in its May 2022 proposed rules. See Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654, 36,657 (proposed June 17, 2022) (“ESG is an expansive term that incorporates three broad categories of interest for investors . . . which can pose challenges for investors choosing among investment products and services.”).

8. Kenneth P. Pucker & Andrew King, *ESG Investing Isn't Designed to Save the Planet*, HARV. BUS. REV. ONLINE (Aug. 1, 2022), <https://hbr.org/2022/08/esg-investing-isnt-designed-to-save-the-planet> [<https://perma.cc/ER5U-NFYU>]. In this context, a “vanilla” fund refers to a traditional, less expensive counterpart, like an index fund.

9. For example, in December 2021, the “overlap between the holdings in Vanguard’s FTSE Social Index Fund . . . and the holdings in Vanguard’s Mega Cap Index Fund . . . was 84 percent.” Malcom Baker et al., *How Do Investors Value ESG?* 1 (2022). Despite this overlap, the former’s expense ratio was twice the latter’s (0.12% and 0.06% respectively). *VFTNX: Vanguard FTSE Social Index Fund Institutional Shares*, VANGUARD, <https://investor.vanguard.com/investment-products/mutual-funds/profile/vftnx> (last visited Apr. 14, 2023) [<https://perma.cc/3NGZ-8JHN>]. *VMCTX: Vanguard Mega Cap Index Fund Institutional Shares*, VANGUARD, <https://investor.vanguard.com/investment-products/mutual-funds/profile/vmctx> (last visited Apr. 14, 2023) [<https://perma.cc/88TB-XHZC>].

10. “The cumulative breadth of possible ESG considerations is spectacular, and the level of resulting subjectivity this entails for an asset manager or commercial index provider in choosing constituent portfolio companies for an ETF index is tremendous.” Ryan Clements, *Why Comparability Is a Greater Problem Than Greenwashing in ESG ETFs*, 13 WM. & MARY BUS. L. REV. 441, 449 (2022).

with stronger climate records; however, this often not the case.<sup>11</sup> In fact, there is mounting evidence that ESG funds are not delivering on their stated ESG objectives.<sup>12</sup> Not only are 90% of stocks in the S&P 500 eligible for inclusion in ESG funds,<sup>13</sup> but fund managers do not design ESG funds to champion ESG issues. For example, BlackRock's iShares ESG Aware MSCI USA Index Fund, the largest ESG ETF, was *more heavily* invested in twelve fossil fuel stocks than the actual S&P 500;<sup>14</sup> in response to public scrutiny, BlackRock said the fund is *not* intended to offer investors the top scoring ESG companies.<sup>15</sup> Another ESG fund's largest and third largest holdings were ExxonMobil and Chevron.<sup>16</sup> The problem goes beyond the fund managers themselves and extends to the regulatory regime in place: The primary regulation

11. See INFLUENCEMAP, CLIMATE FUNDS: ARE THEY PARIS ALIGNED? 2 (2021) (finding that 71% of ESG funds had negative Portfolio Paris Alignment scores, and 55% of climate-themed funds received negative Paris Alignment scores. A negative Portfolio Paris Alignment score indicates that the securities within the fund are misaligned with global climate targets); see also Rajna G. Brandon et al., Eur. Corp. Gov't Inst., *Do Responsible Investors Invest Responsibly?* 4 (2021) (finding that ESG funds in the United States that signed the Principles for Responsible Investment pledge exhibited at best similar, if not significantly worse, portfolio ESG scores than uncommitted peers); the Principles for Responsible Investment is a global alliance of socially responsible investors created in 2005 by United Nations Secretary-General, Kofi Annan. Over 3,500 investors have signed the pledge, which allows an organization to "publicly demonstrate its commitment to including environmental, social and governance (ESG) factors in investment decision making and ownership." Become a Signatory, U.N. Principles for Responsible Inv., <https://www.unpri.org/signatory-resources/become-a-signatory/5946.article> [<https://perma.cc/93JP-6Z9W>] (last visited Mar. 16, 2023).

12. See generally Jonathan B. Berk & Jules H. van Binsbergen, *The Impact of Impact Investing* (Aug. 23, 2021) (working paper) (on file with Stanford Graduate School of Business and University of Pennsylvania, The Wharton School) (concluding that divestment strategies have had little impact on corporate behavior and will likely have little impact going forward); see also Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE, art. 3, 2021, at 1 (arguing Engine No. 1's success in getting candidates elected to ExxonMobil's board was ineffective because the hedge fund has not provided specific recommendations on how ExxonMobil can transition to a leader in the clean energy sector).

13. Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUSINESSWEEK (Dec. 10, 2021), <https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/> [<https://perma.cc/M3Y6-A63U>]. Such a high level of eligibility suggests the criteria are not particularly stringent, and therefore cannot be that differentiated from the general market.

14. *Id.* While the paper *supra* note 3, published April 2021, identified this same fund owning eleven securities in the energy sector, this number grew to twelve by December 2021.

15. *Id.*

16. Lan Anh Tran, *Why Are There Oil Companies in My ESG Portfolio?*, MORNINGSTAR (June 21, 2022) <https://www.morningstar.com/articles/1098856/why-are-there-oil-companies-in-my-esg-portfolio> [<https://perma.cc/83J2-8F56>] (these energy securities were the firm's largest and third-largest holdings despite explicitly screening out companies involved in the extraction of thermal coal, thermal coal generation, and oil sands from the fund's index).

that governs fund naming conventions, the Names Rule,<sup>17</sup> only requires funds to adhere to their investment thesis for 80% of the fund. Put simply, an ESG fund could invest 20% of its assets into securities that counteract the fund's potential ESG impact and not violate the Names Rule. The potential mismatch between ESG fund names and their investments is why some have concluded the moniker is "often useless," and describe the effort of determining an ESG fund's approach like navigating the "wild west."<sup>18</sup>

This disconnect between the conception and reality of ESG funds has been widely documented by reporters,<sup>19</sup> former industry leaders,<sup>20</sup> and even regulators. In 2021, the Securities and Exchange Commission's (SEC) Division of Examinations published a Risk Alert on ESG funds, observing instances of "potentially misleading statements regarding ESG investing processes and representations regarding the adherence to global ESG frameworks."<sup>21</sup> Since then, the Commission has brought enforcement actions against funds that have misleading ESG disclosures,<sup>22</sup> and as recently as February 2023, has

17. 17 C.F.R. 270.35d-1.

18. Tim Quinson, *ESG Study Shared with SEC Reveals Fund Labels Are Often Useless*, BLOOMBERG (Jan. 11, 2022), <https://www.bloomberg.com/news/articles/2022-01-11-esg-study-shared-with-sec-reveals-fund-labels-are-often-useless> [https://perma.cc/5DLS-VE2P].

19. See, e.g., Patricia Kowsmann & Ken Brown, *Fired Executive Says Deutsche Bank's DWS Overstated Sustainable-Investing Efforts*, WALL ST. J. (Aug. 1, 2021), <https://www.wsj.com/articles/fired-executive-says-deutsche-banks-dws-overstated-sustainable-investing-efforts-11627810380> [https://perma.cc/998Z-9AEP] (reporting that DWS's former sustainability chief believes that DWS misrepresented its ESG capabilities in its annual report).

20. For example, Tariq Fancy, BlackRock's former Chief Investment Officer of Sustainable Investing, wrote: "Sustainable investing boils down to little more than marketing hype, PR spin and disingenuous promises from the investment community. Existing mutual funds are cynically rebranded as 'green'—with no discernible change to the fund itself or its underlying strategies—simply for the sake of appearances and marketing purposes." Tariq Fancy, *Financial World Greenwashing the Public with Deadly Distraction in Sustainable Investing Practices*, U.S.A. TODAY (Mar. 16, 2021), <https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashing-column/6948923002/> [https://perma.cc/G2DC-JXLE]; see also Kowsmann & Brown, *supra* note 19 (reporting that DWS's former sustainability chief believes that DWS misrepresented its ESG capabilities in their annual report).

21. SEC, DIVISION OF EXAMINATIONS' REVIEW OF ESG INVESTING 2 (Apr. 9, 2021). Further, the SEC noted "a lack of policies and procedures related to ESG investing . . . documentation of ESG-related investment decisions that was weak or unclear . . . and compliance programs that did not appear to be reasonably designed to guard against inaccurate ESG-related disclosures and marketing materials." *Id.*

22. See Andrew Ramonas, *ESG Cases Remain Enforcement Priority at SEC, Top Official Says*, BLOOMBERG L. (Nov. 4, 2022) (reporting, among other cases, that one asset manager reached a \$1.5 million settlement with the SEC over alleged ESG misstatements concerning its mutual funds).

continued to document deceptive ESG disclosures.<sup>23</sup> These issues are particularly acute because ESG funds are popular with retail investors, who generally struggle to comprehend financial information, let alone information in a sector with a lack of standardized definitions and norms.<sup>24</sup> As retail investors (especially environmentally-conscious millennials)<sup>25</sup> continue to invest in ESG funds at record levels,<sup>26</sup> and often do so with the intent to achieve positive ESG outcomes,<sup>27</sup> effective regulation is more essential than ever. In sum, ESG fund names do not always match their investments, nor do they disclose key information that would alert investors to these shortcomings—a phenomenon this Note calls the ESG fund labeling problem.

To address this problem, the SEC proposed two rules in May 2022. One of the rules would regulate how funds use ESG-related terms in their names.<sup>28</sup> The other would provide investors with a standardized disclosure framework that classifies ESG funds into different categories based on the extent to which they consider ESG factors within their respective investment selection processes.<sup>29</sup> In turn, funds would then need to disclose information regarding their ESG criteria, which would vary in length and substance depending on the extent to which those ESG factors play into their investment selection processes.<sup>30</sup>

While the two proposed rules, if adopted, would help reduce investor confusion and bring standardization to an industry in need, this Note argues that the proposals fall short of fully resolving the ESG

23. Andrew Ramonas, *Investors Face Deceptive ESG Reporting, SEC Enforcement Boss Says*, BLOOMBERG L. (Feb. 1, 2023).

24. The CEO of the industry's largest ratings agency conceded that "ordinary investors piling into [ESG] funds have no idea" how his company's ratings methodology worked in that they do not focus on the risk the company presents to the world, but in reality, the other way around. Simpson et al., *supra* note 13.

25. Millennial interest in ESG funds is explored in further depth *infra* Part II(A)(2).

26. Allison H. Lee, Comm'r, SEC, *Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation*, Keynote Remarks at PLI's 52nd Annual Institute on Securities Regulation (Nov. 5, 2020) ("There is really no historical precedent for the magnitude of the shift in investor focus that we've witnessed over the last decade toward the analysis and use of climate and other ESG risks and impacts in investment decision-making.").

27. Maitane Sardon, *A Guarded Generation: How Millennials View Money and Investing*, WALL ST. J. (Mar. 13, 2020), <https://www.wsj.com/articles/the-recession-left-millennials-loaded-with-debtand-cynical-11583956727> [<https://perma.cc/K5KT-CJ34>].

28. Investment Company Names, 87 Fed. Reg. 36,594 (proposed June 16, 2022).

29. Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (proposed June 17, 2022).

30. *Id.*



fund labeling problem. In particular, this Note calls for the SEC to modify the Names Rule to require ESG funds to invest a higher percentage of their assets in securities that comply with their investment strategies than is required under the current 80% threshold. Specifically, under the SEC's proposed taxonomy, "ESG-Focused" and "Impact" funds<sup>31</sup> should face a more stringent investment allocation requirement than 80%. To further ease investors' task of identifying which funds align with their investing objective, this Note proposes that all ESG funds should be required to include a label in their names<sup>32</sup> to quickly inform investors of the extent to which the fund uses ESG factors in its investment selection processes.

This Note proceeds in three parts. First, Part II will provide context on the ESG fund landscape, including the retail investor base's interest in ESG investing, the different types of ESG investing strategies, and key features of the SEC's May 2022 proposed rules. Building on this background, Part III will analyze data collected from the summary prospectuses of the leading ESG mutual funds and ETFs to examine the ESG fund labeling problem in action, and how the SEC's proposals would (or would not) impact the status quo. Then, after providing insights on retail investors' habits and preferences, Part III will show how the SEC's proposed rules do not fully resolve the ESG fund labeling problem. Part IV will then suggest ways the SEC can modify its proposals to ensure funds are investing and disclosing in ways that align with their names and investors' expectations.

Just as consumers cannot determine which cereal best matches their dietary goals without understanding the nutritional information on the cereal box, investors cannot understand which ESG funds best achieve their investment objectives without more clarity.

## II. ESG FUNDS, RETAIL INVESTORS, AND THE SEC'S REGULATION OF OPEN-END FUNDS

Given the rapid growth and popularity of ESG investing, ESG funds have outgrown the pre-existing regulatory framework, leading to a

31. Under the SEC's proposals, ESG-Focused and Impact funds use ESG factors as a "significant or main consideration in selecting investments or in engaging with portfolio companies." Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654, 36,657 (proposed June 17, 2022).

32. Specifically, the labels should be the names of the categories of ESG funds developed under the SEC's May 2022 proposed rules.

confusing environment where funds are using ESG terminology without providing much clarity on what it means.<sup>33</sup> Part II(A) examines the history and growth of the ESG movement to show how the sector came to be the all-encompassing umbrella it is today. Part II(B) then provides demographic information on the retail investors and millennials who are driving retail investor interest in ESG investing. Then, Part II(C) describes the SEC's current regulations for open-end fund disclosures and fund names, breaks down the proposed regulations from May 2022, and highlights the Names Rule, which plays a key role in one of the SEC's May 2022 proposed rules.

### A. The ESG Fund Landscape

Before examining the size and scope of today's ESG fund universe, this section briefly covers the history of the ESG movement to provide the necessary context<sup>34</sup> to understand how the sector expanded from its roots to become the sprawling, diverse, and confusing behemoth it is today. The rapid growth of the ESG industry, along with the increasing number of interests that fall under the ESG umbrella, has led to a status quo in which the ESG label could mean one of several different things, which can confuse investors<sup>35</sup> and hinder ESG causes.

#### 1. From SRI to ESG

The tradition of selective investing was originally started by religious groups to avoid businesses that conflicted with their beliefs and values.<sup>36</sup> During the late 1960s, the Socially Responsible

33. As a result of the lack of industry clarity, "ETF investors are left with cornucopia of product choice with very little (if any) standardized means of making adequate comparative or evaluative judgments other than performance." Clements, *supra* note 10, at 450.

34. A detailed history of the ESG movement is beyond the scope of this Note. For a more complete history, see Max M. Schanzenbach & Robert M. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 392-97 (2020).

35. The SEC has also recognized how the lack of standardization in ESG labeling has the potential to confuse investors. ESG SUBCOMM., SEC ASSET MGMT. ADVISORY COMM., DISCUSSION DRAFT: POTENTIAL RECOMMENDATIONS OF THE ESG SUBCOMMITTEE 4 (Dec. 1, 2020) ("The potential harm we as a subcommittee perceive is little ability to verify truth in labelling for investment products that use ESG branding, which could result in misleading investors.").

36. The concept of investing according to moral or ethical beliefs has existed for centuries. RUSSELL SPARKES, *SOCIALLY RESPONSIBLE INVESTMENT: A GLOBAL REVOLUTION* 46 (John Goodchild & Clive Callow eds., 2002) (detailing the history of an eighteenth-century Methodist Church pastor who spoke out against profiting from the alcohol and slave trades). The first investment fund to apply an exclusionary approach was the Pioneer Fund, which avoided industries based on the

Investing (SRI) movement gained mainstream traction in the United States as a way to reflect investors' political and social values, and was primarily driven by activism on issues including the civil rights campaign and opposition to college endowment funds profiting from the Vietnam War.<sup>37</sup> Both of these campaigns utilized exclusionary investing strategies,<sup>38</sup> meaning funds would entirely avoid businesses that did not reflect their values.

The next significant SRI movement applied financial and social pressure in South Africa to end Apartheid.<sup>39</sup> Although the majority of the SRI movement was exclusionary-based, some investors began working with firms that agreed to "abide by certain principles of nondiscrimination in their South African operations."<sup>40</sup> This can be seen as an early example of an engagement investment strategy, which does not require investors to eschew industries altogether. Rather, investors leverage their position as shareholders to advocate for the adoption of policies that better align with their values.

Eventually, the SRI movement began to incorporate governance factors<sup>41</sup> and prioritize environmental conservatism,<sup>42</sup> and rebranded as "ESG."<sup>43</sup> The ESG moniker more directly acknowledges the key issues of the modern era,<sup>44</sup> and with this name change, began "appealing to investors' financial interests, as well as their ethical sense, by asserting that SRI funds could be both morally and financially superior to other funds, offering lower risk and higher returns."<sup>45</sup>

religious beliefs of its founder. It was created in 1928—and is included *infra* section III(A)—as one of the ten largest ESG mutual funds. Schanzenbach & Sitkoff, *supra* note 34, at 392.

37. SPARKES, *supra* note 36, at 48.

38. *Id.*

39. *Id.*

40. Schanzenbach & Sitkoff, *supra* note 34, at 393.

41. *Id.* at 396.

42. For example, the Exxon Valdez oil spill in 1989 and litigation during the 1990s was a major "public alarm" that drove investors to actively consider environmental issues. SPARKES, *supra* note 36, at 61.

43. The term "ESG" itself was first coined in a United Nations' Global Compact in 2004 titled "Who Cares Wins: Connecting Financial Markets to a Changing World."

44. See Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1819, 1820 (2021) (noting that ESG investing includes a "dizzily" array of ESG issues, such as climate change, human capital management, human rights, cybersecurity, diversity and inclusion, corporate tax policy, corporate political spending, executive compensation practices, and more).

45. Schanzenbach & Sitkoff, *supra* note 34, at 396.

## 2. The Current ESG Landscape

Following the early days of SRI, the ESG investing industry has boomed, both with respect to the amount of assets under management<sup>46</sup> as well as the diverse interests that are included under the ESG umbrella.<sup>47</sup>

While it is undisputed that the ESG industry has grown considerably, widely-varying methodologies on which investments classify as “ESG” or “sustainable” make it difficult to pinpoint the industry’s exact size.<sup>48</sup> For example, while the Global Sustainable Investment Alliance (GSIA) estimates that sustainable assets under management in the United States are over \$17 trillion<sup>49</sup> (a number some have openly expressed skepticism over),<sup>50</sup> Morningstar, one of the ESG industry’s leading data and ratings providers, reported that by the end of 2021, assets in U.S. sustainable funds were \$357 billion.<sup>51</sup> Even though this estimate is meaningfully lower than GSIA’s, Morningstar noted the \$357 billion number was a high water mark for the ESG industry in the United States and represented a four-fold increase in ESG fund assets over the past three years.<sup>52</sup>

Notably, the ESG fund industry’s expansion has occurred in spite of several market headwinds<sup>53</sup> and over a period in which non-ESG funds have experienced less consistent growth. In 2020, open-end funds lost a record \$370 billion, which doubled the record of \$180 million of outflows set in 2019.<sup>54</sup> Over the same two-year period,

46. Alyssa Stankiewicz, Morningstar Manager Rsch., Sustainable Funds U.S. Landscape Report 2021: Another Year of Broken Records 1 (2022).

47. See Rose, *supra* note 44.

48. These stark differences also point out another instance where the ESG industry could benefit tremendously from standardized methodologies.

49. Global Sustainable Inv. All., Global Sustainable Investment Review 2020 5 (2021).

50. Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, BLOOMBERG GREEN (Feb. 3, 2022), <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021> [<https://perma.cc/WK86-G2PX>].

51. STANKIEWICZ, *supra* note 46.

52. *Id.* Having such broad ranging estimates from reputable sources signals another instance in which the lack of industry standards can undermine ESG causes.

53. The Covid-19 pandemic led to a “shedding” of \$240 billion from the U.S. equity fund market in 2020 and exacerbated the general investing trend away from active funds and toward lower-cost, passive funds. See Adam Sabban, *U.S. Fund Flows Smashed Records in 2021*, MORNINGSTAR (Jan. 19, 2022), <https://www.morningstar.com/articles/1075161/us-fund-flows-smashed-records-in-2021> [<https://perma.cc/T7QL-D4BR>].

54. Tony Thomas, *U.S. Fund Flow Records Fell in 2020*, MORNINGSTAR (Jan. 20, 2021), <https://www.morningstar.com/articles/1017899/us-fund-flow-records-fell-in-2020> [<https://perma.cc/S25E-SZJ2>].

sustainable funds more than doubled their net inflows each year.<sup>55</sup> In 2021, sustainable fund flows netted nearly \$70 billion, an increase of 35% of the record set in 2020,<sup>56</sup> and maintained this strong performance while the broader U.S. fund market set its own record with more than \$1 trillion in net flows for the year.<sup>57</sup> In 2022, the ESG fund space continued to outgrow the overall fund industry (growing 0.9% compared to the overall U.S. fund universe, which contracted by 1.3%), even during a period of weaker macroeconomic conditions and specific “concerns about greenwashing and a political backlash against ESG investing.”<sup>58</sup> Specifically, ESG funds netted \$3.1 billion in annual inflows in 2022, but this was “well below the average \$47 billion annual collection these funds had enjoyed over the previous three years.”<sup>59</sup>

The widely-varying performances of individual ESG funds in 2022 offer additional perspective on the importance of these funds’ investing strategies in weaker economic conditions. In 2022, the S&P 500 fell 19.4%;<sup>60</sup> over the same period, some ESG funds beat the S&P 500, while others lagged behind. For example, the Morningstar US Sustainability Index outperformed the broader market, falling 18.9% in 2022.<sup>61</sup> Similarly, the Morningstar Women’s Empowerment Index (which is overweight energy and underweight technology due to gender diversity within those sectors), fell 17.2%, which also beat the broader U.S. market.<sup>62</sup> On the other hand, funds with heavier exposure to the technology sector and less exposure to energy, like the Morningstar US Sustainability Leaders Index, lagged the S&P 500, falling 24.5% in 2022.<sup>63</sup> The differing performances of ESG funds in

55. Jon Hale, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, MORNINGSTAR (Jan. 28, 2021), <https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights> [https://perma.cc/9LVQ-2NDS].

56. STANKIEWICZ, *supra* note 46.

57. *Id.* at 10.

58. Alyssa Stankiewicz, *The 2022 U.S. Sustainable Funds Landscape in 5 Charts*, MORNINGSTAR (Feb. 17, 2023), <https://www.morningstar.com/articles/1138540/the-2022-us-sustainable-funds-landscape-in-5-charts> [https://perma.cc/424F-WXXB].

59. *Id.*

60. Leslie Norton, *ESG Investing Keeps Pace with Conventional Investing in 2022*, MORNINGSTAR (Jan. 12, 2023), <https://www.morningstar.com/articles/1132007/esg-investing-keeps-pace-with-conventional-investing-in-2022> [https://perma.cc/5BB9-R5VX].

61. *Id.* The fund’s above-market performance is partially attributed to its avoidance of particular securities, including Amazon.com and Tesla, “which both performed horribly during the year.” *Id.*

62. *Id.*

63. *Id.*

2022 speak “to the fact that sustainable investing is a diverse field that can take many forms,”<sup>64</sup> and only bolster the position that investors ought to be provided with more tools to understand how a particular fund incorporates ESG considerations into its investment selection process, as variances in methodology can have a meaningful impact on fund performance.

Similarly, there is also confusion over the exact size of the global ESG industry. The GSIA estimated the global ESG market was a \$35.3 trillion industry as of 2020, which accounted for over one-third of all assets under management.<sup>65</sup> Meanwhile, Morningstar estimated that the global ESG industry’s 53% growth in 2021 brought the industry’s assets under management to \$2.7 trillion.<sup>66</sup> Reuters reported that in 2021, investors worldwide poured a record \$649 billion into ESG funds, up from the \$542 billion and \$285 billion that flowed into ESG funds during 2020 and 2019, respectively.<sup>67</sup> Like in the U.S. market, ESG funds slowed their growth on a global level; in 2022, global ESG fund assets were reported to have reached about \$2.5 trillion, with growth largely driven by European investors.<sup>68</sup> Before 2022, it was reported that 10% of worldwide fund assets are now in ESG funds,<sup>69</sup> and the most bullish analysts estimate that 60% of mutual fund assets will be managed through a sustainability lens by 2025.<sup>70</sup>

In addition to the record assets under management and inflows into ESG funds, there has been a sizable increase in the number of funds employing ESG strategies and incorporating ESG language into their disclosures. As of 2019, in the United States, there were 564 funds that made references to ESG factors in their prospectuses,<sup>71</sup> and overall, 718 mutual funds and 94 ETFs with ESG assets.<sup>72</sup> The number of fully ESG-focused funds has grown dramatically as well; specifically, there were 534 sustainable funds (374 of which were

64. *Id.*

65. Global Sustainable Inv. All., *supra* note 49, at 5.

66. SPARKES, *supra* note 36.

67. Ross Kerver & Simon Jessop, *Analysis: How 2021 Became the Year of ESG Investing*, REUTERS (Dec. 23, 2021), <https://www.reuters.com/markets/us/how-2021-became-year-esg-investing-2021-12-23/> [<https://perma.cc/T3GC-9UW8>].

68. Brian Baker, *ESG Investing Statistics 2023*, Bankrate (Jan. 31, 2023), <https://www.bankrate.com/investing/esg-investing-statistics/#stats> [<https://perma.cc/YZJ5-4P3X>].

69. KERVER & JESSOP, *supra* note 67.

70. *Id.*

71. John Hale, Morningstar, *Sustainable Funds U.S. Landscape Report: More Funds, More Flows, and Impressive Returns in 2020* 4 at n.4 (2021).

72. US SIF Found., *2020 Report on U.S. Sustainable and Impact Investing Trends* (2020).

open-end funds and ETFs) available in the United States in 2021, a 36% increase over the record set in 2020.<sup>73</sup> In 2021 alone, 121 new sustainable funds were launched, breaking 2020's record of 71.<sup>74</sup>

With the rise in number of ESG funds has come an increase in funds that label themselves as ESG. Of these funds, the number that include "ESG" or related terms<sup>75</sup> in their names has skyrocketed, from 65 in 2007<sup>76</sup> to 311 by March 2020.<sup>77</sup> What is less clear is how these funds distinguish themselves, approach ESG investing, or incorporate specific ESG principles and strategies into their respective investment selection processes.

### 3. The Different ESG Investing Strategies

While older iterations of ESG investing primarily implemented exclusionary approaches to avoid businesses that did not reflect their political, social, religious, or moral values, they often paid the price in the form of lower returns.<sup>78</sup> Since then, a litany of ESG investing approaches<sup>79</sup> have been developed that purportedly enable individuals to invest in accordance with their values and simultaneously achieve risk-adjusted returns.<sup>80</sup> Investors' wide-ranging motivations for investing in ESG funds have led to the development of several ESG investing strategies that weigh returns and impact differently; identifying how a particular strategy balances

73. SPARKES, *supra* note 36, at 1.

74. *Id.*

75. Request for Comment on Fund Names, 85 Fed. Reg. 13,221 (Mar. 2, 2020). The SEC used the following search terms: "ESG," "Clean," "Environmental," "Impact," "Responsible," "Social," and "Sustainable." *Id.* at n.23.

76. *Id.*

77. Letter from Aron Szapiro & Jasmin Sethi, Morningstar, to the U.S. Securities and Exchange Commission in Response to Request for Comment on Fund Names (May 5, 2020).

78. Pieter J. Trinks & Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 J. BUS. ETHICS 193, 194 (2017) (concluding that excluding controversial stocks generally leads to suboptimal financial performance); *but see* Benjamin R. Auer & Frank Schuhmacher, *Do Socially (Ir)responsible Investments Pay? New Evidence from International ESG Data*, 59 Q. REV. ECON. & FIN. 51, 51 (2016) (finding a difference between U.S. investors who can follow an ESG-based investment style and still obtain a performance similar to the broad market and European investors who tended to pay a price for socially responsible investing).

79. For more information on the various ESG investment strategies and the ensuing potential for investor confusion, *see* Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 404–408 (2021).

80. *E.g.*, TENSIE WHELAN ET AL., ESG AND FINANCIAL PERFORMANCE: UNCOVERING THE RELATIONSHIP BY AGGREGATING EVIDENCE FROM 1,000 PLUS STUDIES PUBLISHED BETWEEN 2015–2020 2–3, 5 (2021) ("ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches.").

seeking return and impact is crucial to understanding a fund's priorities and its potential ESG impact (or lack thereof).

In other words, ESG investing strategies can be placed on a spectrum between two opposing priorities: returns and impact.<sup>81</sup> Return-focused ESG funds incorporate ESG factors into their investment selection processes along with other material information with the goal of enhancing their financial performance.<sup>82</sup> In contrast, impact-focused funds “use ESG analysis as a significant part of the investment thesis to respond to investors’ objectives and accomplish sustainability-related outcomes while seeking financial returns.”<sup>83</sup> Put simply, return-focused ESG funds use ESG data to maximize *profit*, while impact-focused funds use ESG data to maximize *ESG outcomes*.<sup>84</sup> Under the SEC’s proposed taxonomy, Integration funds fall closer to the profit-maximization end, whereas ESG-Focused and Impact funds are further toward the impact-focused end of the spectrum.

Funds employ various non-exclusive investing strategies to achieve a balance of these two objectives. Although strategies are labeled differently across the industry,<sup>85</sup> this Note adopts the GSIA’s framework,<sup>86</sup> which breaks ESG investing into seven categories: (1) Negative/Exclusionary Screening;<sup>87</sup> (2) Positive/Best-in-Class

81. Malcom Baker et al., *How Do Investors Value ESG? 1* (Dec. 2022) (working paper) (on file with Nat’l Bureau of Econ. Rsch.) (explaining that this assumption comes from a traditional finance theory with efficient capital market pricing, where an investment in ESG products involves a tradeoff where investors sacrifice financial returns for the psychic and societal benefits of promoting non-financial social and environmental objectives); *see also* Whelan et al., *supra* note 80, at 2–3, 5 (collecting models that show empirically that investor interest in ESG leads to a reduction in returns).

82. INV. CO. INST., *FUNDS’ USE OF ESG INTEGRATION AND SUSTAINABLE INVESTING STRATEGIES: AN INTRODUCTION 2–4* (2020).

83. *Id.*

84. ESG outcomes can range from investing in businesses that have lower carbon emissions than their competitors, to investing in companies researching carbon capturing technology.

85. Compare Thomas Brigandi et al., *The Seven Asset Owner Approaches to ESG*, ENTERPRISING INV. (Sept. 5, 2019), <https://blogs.cfainstitute.org/investor/2019/09/05/the-seven-asset-owner-approaches-to-esg/> [<https://perma.cc/6QVK-77WT>] (breaking ESG investing into seven approaches: Negative Screening, Climate Change, Diversity & Inclusion, ESG Indexation, Frameworks & Standards, Active Ownership, and Integration) with *ESG 101: What is Environmental, Social and Governance?*, MSCI, <https://www.msci.com/esg-101-what-is-esg> [<https://perma.cc/9VRG-JKRB>] (last visited Mar. 25, 2023) (listing five common ESG investing strategies: Bottom-up ESG Integration, Top-down ESG Integration, Best-in-Class Selection, Thematic Investing, and Active Ownership). While these frameworks are just a few of many in existence, the inconsistencies and overlap between them is emblematic of the ESG industry’s larger problem of incomparability.

86. Global Sustainable Inv. All., *2018 GLOBAL SUSTAINABLE INVESTMENT REVIEW 7* (2019).

87. Negative/Exclusionary Screening is “the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria.” *Id.*



Screening;<sup>88</sup> (3) Norms-Based Screening;<sup>89</sup> (4) ESG Integration;<sup>90</sup> (5) Sustainability Themed Investing;<sup>91</sup> (6) Impact/Community Investing;<sup>92</sup> and (7) Corporate Engagement and Shareholder Action.<sup>93</sup> Under this framework, Negative/Exclusionary Screening, ESG Integration, and Corporate Engagement and Shareholder Action are the three most commonly used strategies globally.<sup>94</sup>

These seven strategies can be divided into two groups: those that seek to have an ESG impact by investing, and those that hope to make their impact by *not* investing. Funds that invest in companies to achieve their ESG impact typically employ ESG Integration, Positive/Best-in-Class Screening, Sustainability Themed Investing, Impact/Community Investing, and Corporate Engagement and Shareholder Action strategies. In contrast, funds that achieve ESG outcomes by not investing utilize Negative/Exclusionary Screening and Norms-Based Screening strategies.

Where exactly a given fund will land on the spectrum between return and impact will depend on which ESG investing strategies it utilizes and, if multiple are used, how it balances those strategies. For example, two Impact/Community Investing funds might have different ESG impacts depending on the extent to which they are willing to trade off a positive ESG result for yield. Recognizing that small differences in investing strategies can dramatically change a fund's potential returns and impact underscores the need for clarity so investors can confidently make the right decision for their personal investing objectives.

88. Positive Screening/Best-in-Class Screening is the "investment in sectors, companies or projects selected for positive ESG performance relative to industry peers." *Id.*

89. Norms-Based Screening involves the "screening of investments against minimum standards of business practice based on international norms," such as those issued by the United Nations. *Id.*

90. ESG Integration is "the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis." *Id.*

91. Sustainability Themed Investing is "investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)." *Id.*

92. Impact/Community Investing is "targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose." *Id.*

93. Corporate Engagement and Shareholder Action entails "the use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines." *Id.*

94. *Id.* at 3. Within the United States, ESG integration "continues to dominate." *Id.*

## B. Retail Investors, Millennials, and Their ESG Beliefs

Retail investors, and millennials in particular, have demonstrated a strong interest in ESG investing.<sup>95</sup> For example, one study found that investors were willing to pay an additional twenty-five basis points<sup>96</sup> for ESG investments.<sup>97</sup> And while ESG open-end funds are primarily funded by institutional investors,<sup>98</sup> the growth of retail investors' market share<sup>99</sup> in the sector speaks to their increasing importance and the imperative to consider their needs when developing regulations, as the SEC did in its May 2022 proposed rules.<sup>100</sup> This section details retail investors' interest in ESG investing, the motivations behind their interest, and why their needs ought to be considered.

While ESG investing is popular among all generations, millennials' interest is consistently and demonstrably stronger: In one survey in which 49% percent of the general population was "very interested" in ESG investing, 95% of millennials were;<sup>101</sup> and whereas approximately half of the general population had adopted at least one sustainable investing activity, two-thirds of millennials already had.<sup>102</sup> In addition to seeking sustainable investments, 84% of the general population wanted impact reports—something 91% of millennials wanted as well.<sup>103</sup> The strength and frequency with which

95. Morgan Stanley Inst. for Sustainable Inv., SUSTAINABLE SIGNALS: INDIVIDUAL INVESTOR INTEREST DRIVEN BY IMPACT, CONVICTION AND CHOICE 4 (2019) (reporting that 95% of millennials and 85% of the general population surveyed expressed a general interest in sustainable investing).

96. A basis point is one one-hundredth of a percentage point. *Basis Point*, SEC, <https://www.investor.gov/introduction-investing/investing-basics/glossary/basis-point> [<https://perma.cc/SZ6F-JRJ9>] (last visited Mar. 25, 2023). For perspective, forty basis points on a \$1,000 investment is \$4.

97. Baker et al., *supra* note 9, at 23. Interestingly, this number jumped even higher, to thirty-seven basis points, for those worried about climate change. *Id.* at 4.

98. BROADRIDGE, ESG: TRANSFORMING ASSET MANAGEMENT AND FUND DISTRIBUTION 9 (2020) (estimating that approximately 60% of ownership of ESG ETFs and mutual funds is from institutional investors, whereas 30% is from retail investors).

99. Paul Borges, *Launching Sustainable Investment into the Mainstream* 11–12 (2017) (MSc thesis) (on file with the Copenhagen Bus. Sch.) (explaining that the gap between institutional and retail investors' share of the ESG fund sector has steadily been closing).

100. *See e.g.*, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,668 ¶ 45 (proposed June 17, 2022) (asking whether certain proposed disclosure requirements would be difficult for retail investors to understand, and, if so, whether there are ways to make disclosures more accessible).

101. *See supra* note 96.

102. *Id.*

103. *Id.* at 2.

millennials engage in ESG-related activities suggests an investing ethos motivated by both financial and non-financial objectives: “Millennials are markedly different than their predecessors. The literature and market research unanimously conclude that, compared to prior generations, millennials are less interested in investment returns and more interested in their investments reflecting their social values.”<sup>104</sup>

Millennial interest in ESG investing further diverges from other generations when it comes to putting their money where their mouth is: One study found that while 57% of millennials will intentionally stop investing or choosing to invest in a company because of the impact the company’s products or services have on people’s health or well-being, only 42% of Gen Xers and 35% of boomers will do the same.<sup>105</sup> Millennials’ interest in achieving ESG objectives goes so far that an overwhelming majority—70%—would be willing to sacrifice some yield to achieve sustainable outcomes.<sup>106</sup> Another study found similar results on the willingness of millennials to sacrifice yield: “[W]hile the average investor in their twenties or thirties was willing to lose between 6% and 10% of their investments to see companies improve their environmental practices, the average Baby Boomer was unwilling to lose anything.”<sup>107</sup> These findings do not suggest that millennials are “indifferent to investment returns, but that they have a greater tendency to assess and even prioritize the social and real world effects of their investments.”<sup>108</sup> It also signals a strong interest in ESG investing strategies that fall closer to the impact end of the spectrum.

104. Michal Barzuza et al., *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1250. In fairness, the increased interest in sustainable investing by younger generations could signal their higher risk tolerance compared to older generations, which are closer to retirement, and must be more conservative with their investment decisions.

105. Allianz, *ESG ETHICS AND INVESTING: HOW ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IMPACT INVESTOR BEHAVIOR* 4 (2019).

106. Maitane Sardon, *A Guarded Generation: How Millennials View Money and Investing*, WALL ST. J. (Mar. 13, 2020), <https://www.wsj.com/articles/the-recession-left-millennials-loaded-with-debtand-cynical-11583956727> [<https://perma.cc/K5KT-CJ34>].

107. Alexander Gelfand, *The ESG Generation Gap: Millennials and Boomers Split on Their Investing Goals*, STAN. GRADUATE SCH. OF BUS. (Nov. 10, 2022), <https://www.gsb.stanford.edu/insights/esg-generation-gap-millennials-boomers-split-their-investing-goals> [<https://perma.cc/L25B-CDMY>].

108. Barzuza et al., *supra* note 104, at 1285.

Part of investors' willingness to sacrifice yield for positive ESG outcomes is likely driven by "emotional drivers;"<sup>109</sup> in other words, the belief that sustainable investment opportunities can move the needle on ESG issues. For instance, 85% percent of millennials believe their investment decisions could influence climate change, and 44% believe this strongly.<sup>110</sup> The combination of investing for both financial and non-financial reasons—i.e., for profit and for impact—demonstrates the unique nature of ESG investments and why regulations need to acknowledge their fundamental difference from other types of investments.<sup>111</sup>

The rapidly increasing popularity of ESG funds and millennials' voracious appetite for ESG products make it a lucrative offering for asset managers.<sup>112</sup> This is especially true because while the broader asset management industry has seen revenues as a percentage of total assets under management fall, "ESG funds typically charge fees 40 percent higher<sup>113</sup> than traditional funds, making them a timely answer to asset management margin compression."<sup>114</sup> As SEC Commissioner Mark Uyeda put it: "Touting a product as being 'ESG' is good for business."<sup>115</sup>

109. Sally Hickey, *Advisers Need to Tap into ESG Emotional Drivers, Says Aviva*, FIN. TIMES (May 24, 2021), <https://www.ftadviser.com/investments/2021/05/24/advisers-need-to-tap-into-esg-emotional-drivers-says-aviva/> [<https://perma.cc/4U2J-6EX5>].

110. Additionally, on the "S" front, 80% of respondents believed it was possible for their investments to create economic growth to lift people out of poverty. Morgan Stanley Inst. for Sustainable Inv., *supra* note 96; *see also* Ryan Clements, *Why Comparability Is a Greater Problem Than Greenwashing in ESG ETFs*, 13 WM. & MARY BUS. L. REV. 441, 448 (2022) (arguing that ESG ETFs have become an increasingly popular product fueled by investor desire for meaningful social change and a belief that investments can have a significant impact on a corporation's decision-making).

111. *See* Eric C. Chaffee, *Index Funds and ESG Hypocrisy*, 75 CASE W. RES. L. REV. 1295, 1304 (2021) (noting the goal of ESG investing is "dramatically different" than traditional index funds because the former is a form of principle-based investing, whereas the latter is profit-based).

112. Some even argue that the opportunity to attract millennial money over the next few decades is the key driver of large asset managers becoming more active ESG players. Barzuza et al., *supra* note 104, at 1250.

113. Management fees are those "paid out of fund assets to the fund's investment adviser for investment portfolio management." *Management Fee*, SEC, <https://www.investor.gov/introduction-investing/investing-basics/glossary/management-fee> [<https://perma.cc/63GR-3NKV>] (last visited Mar. 25, 2023). The expense ratio is "[t]he fund's total annual operating expenses, including management fees, distribution fees, and other expenses, expressed as a percentage of average net assets." *Exchange Ratio*, SEC, <https://www.investor.gov/introduction-investing/investing-basics/glossary/expense-ratio> [<https://perma.cc/C64G-Z5K6>] (last visited Mar. 25, 2023).

114. Kenneth P. Pucker & Andrew King, *ESG Investing Isn't Designed to Save the Planet*, HARV. BUS. REV. ONLINE (Aug. 1, 2022), <https://hbr.org/2022/08/esg-investing-isnt-designed-to-save-the-planet> [<https://perma.cc/G9SU-86XS>].

115. Mark T. Uyeda, Comm'r, SEC, Remarks at the California '40 Acts Group (Jan. 27, 2023).

The reason millennials' interest in ESG investing is particularly important is because the generation is expected to inherit trillions<sup>116</sup> over the next few decades in what some are calling the "largest transfer of wealth in history."<sup>117</sup> Because firms typically lose 70% to 80% of assets when transferred between generations,<sup>118</sup> the "asset managers who supply millennials [with] ESG investment options will be strongly positioned to attract new assets to the firm as well as retain beneficiary millennial clients,"<sup>119</sup> providing asset managers with tremendous incentive to offer ESG-labeled funds.

While interest in ESG investing is strong, and appears to be staying that way for the foreseeable future, consensus on the meaning of ESG fund names remains elusive, confusing investors, reporters, and regulators alike. The following section explores the current regulatory framework in place, along with the SEC's two proposed rules from May 2022. The section also details how investors who hope to enter the ESG fund market or learn more about ESG investment options are forced to overcome significant informational obstacles.

### C. The ESG Fund Regulatory Landscape

The SEC has spoken publicly about the lack of clarity surrounding ESG investing and ESG fund disclosures,<sup>120</sup> commented on the demand for SEC-mandated ESG disclosure frameworks,<sup>121</sup> and publicly

116. Although estimates differ, the consensus is that the potential inheritance is enormous. Compare Leena Dagade et al., Cerulli Assocs., *Global Retail Investors and ESG: Responsible Investing Converges with Accelerated Environmental and Social Imperatives 4* (2021) (estimating a \$61 trillion transfer between generations over the next 25 years) with Dave Nadig, *Evaluating Sustainability ETFs with MSCI*, ETF.com (June 12, 2017), <https://www.etf.com/sections/blog/evaluating-sustainability-etfs-msci> [<https://perma.cc/L4QP-GVZF>] ("We're in the middle of a \$30 trillion intergenerational wealth transfer from baby boomers to their children.").

117. Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose & Profit*, BLACKROCK, <https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter#:~:text=The%20World%20Needs%20Your%20Leadership,failing%20to%20do%20so%20effectively> [<https://perma.cc/EDJ6-DYFN>] (last visited Mar. 25, 2023).

118. Julian Seelan, *Invs. & Wealth Monitor*, SUSTAINABLE INVESTING: THE MILLENNIAL INVESTOR 44 (2019).

119. *Id.*

120. Elad L. Roisman, Comm'r, SEC, Keynote Speech at the Society for Corporate Governance National Conference (July 7, 2020) ("I do think that retail investors who want 'green' or 'sustainable' products deserve more clarity and information about the choices they have.").

121. Allison H. Lee, *A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC*, SEC (Mar. 15, 2021), <https://www.sec.gov/news/speech/lee-climate-change> [<https://perma.cc/B9JF-52TJ>] ("Investors are demanding more and better information

debated what (if anything) would be appropriate regulatory action.<sup>122</sup> In May 2022, the SEC proposed two rules that would change ESG fund naming conventions and disclosures. This section provides a brief overview of the disclosure and reporting requirements for open-end funds, and then highlights key features of the SEC's two proposed rules relevant to this Note. In particular, this section examines the Names Rule, a regulation of fund naming conventions that plays a key role in one of the SEC's two proposed rules.

### 1. Current and Proposed Requirements for All Open-End Funds

Open-end funds (including mutual funds and ETFs) are required to comply with Form N-1A, which mandates that a fund create and update its prospectus<sup>123</sup> and statement of additional information annually.<sup>124</sup> In these documents, funds disclose “their investment objectives and how they incorporate ESG criteria. They also disclose whether they follow an index strategy and, if so, the applicable index. In many cases, they also disclose their policies regarding voting or engagement.”<sup>125</sup> Form N1-A makes clear that a goal of the form is to facilitate the comprehension of financial information by retail investors.<sup>126</sup> Specifically, it states that the prospectus should avoid “lengthy legal and technical discussions” and “disproportionately emphasizing possible investments which are not a significant part of the fund.”<sup>127</sup>

on climate and ESG, and that demand is not being met by the current voluntary framework.”); *see also* Rose, *supra* note 44, at 1826–1830.

122. Allison H. Lee, *Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation*, SEC (Nov. 5, 2020), <https://www.sec.gov/news/speech/lee-playing-long-game-110520> [<https://perma.cc/TBP3-VWCW>] (“[F]inancial regulators like the SEC are not at the forefront of substantive policymaking to address climate change. We don’t set emissions standards, implement carbon pricing, or otherwise shape energy or environmental policy.”).

123. The SEC allows funds to deliver a summary prospectus, which is much shorter in length, in lieu of the full prospectus, for the benefit of retail investors. *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, 74 Fed. Reg. 4,545 (Jan. 13, 2009) (to be codified at 17 C.F.R. pts. 230, 232, 239, 274).

124. Form N1-A ii, SEC, <https://www.sec.gov/files/formn-1a.pdf> [<https://perma.cc/7CPR-CJKL>].

125. Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 407 (2021).

126. *See* SEC, *supra* note 123, at ii-iii (“[T]he prospectus disclosure requirements . . . are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters . . . . Disclosure in the prospectus should be designed to assist an investor in comparing and contrasting the Fund with other funds.”).

127. *Id.* at iii.

Over time, efforts have been made to amend these disclosures so they are more helpful to retail investors.<sup>128</sup> For example, the order and form in which information is presented in the summary prospectus is designed to promote standardization and to facilitate comparison across funds.<sup>129</sup> In late 2022, a rule was finalized that requires open-end funds to provide concise and visually engaging annual and semi-annual reports to alleviate concerns that retail investors found shareholder reports lengthy, difficult to use, and not well-suited to their needs.<sup>130</sup>

## 2. The SEC Steps In: Two Proposed Rules for ESG Funds

Given their previous public comments on the confusion surrounding ESG funds<sup>131</sup> and their proposed climate-related disclosures at the issuer level,<sup>132</sup> it was widely expected that the SEC would propose a rule to reduce misleading ESG fund labeling and disclosure practices as well. While the exact form and scope of any future regulation was unknown,<sup>133</sup> the SEC's Request for Comment in 2020 on the Names Rule<sup>134</sup> strongly suggested that the Names Rule would play a pivotal role in the SEC's plans.<sup>135</sup>

Those expectations came to fruition in May 2022 when the SEC proposed two rules that would change ESG funds' naming practices and required disclosures. The "Investment Company Names" rule

128. See Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PENN. L. REV. 1961, 1968 (2010); see, e.g., SEC, SEC IMPROVES DISCLOSURE FOR MUTUAL FUND INVESTORS (2008) (noting the newly modified mutual fund framework was developed in response to complaints that prospectuses were too lengthy, legalistic, and confusing).

129. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546 (Jan. 26, 2009) (to be codified at 17 C.F.R. pts. 230, 232, 239 and 274).

130. Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, 87 Fed. Reg. 72,759 (Nov. 25, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 270, and 274).

131. See Roisman, *supra* note 121; Lee, *supra* note 122.

132. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21,334 (Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, and 249).

133. A wide range of possibilities, ranging from inaction to strong intervention are described by the SEC itself. ESG SUBCOMM., SEC ASSET MGMT. ADVISORY COMM., UPDATE ON PROGRESS IN ESG SUBCOMMITTEE 7 (Sept. 16, 2020) ("E, S & G can vary broadly in how they are defined and what they imply in an investment context."). As an interim step, the SEC announced it formed a task force to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules" and also scrutinize "disclosure and compliance issues relating to investment advisors' and funds' ESG strategies." Press Release, SEC, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021).

134. Request for Comments on Fund Names, 85 Fed. Reg. at 13,221.

135. Curtis et al., *supra* note 79, at 411.

(the “Proposed Names Rule”) would regulate how funds use ESG-related terms in their names.<sup>136</sup> The “Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices” Rule (the “Proposed ESG Fund Rule”) would require ESG funds to disclose certain information depending on the extent to which those funds consider ESG factors within their respective investment selection processes.<sup>137</sup>

a. The Proposed ESG Fund Rule

The Proposed ESG Fund Rule is designed to “create a consistent, comparable, and decision-useful regulatory framework for ESG advisory services and investment companies to inform and protect investors while facilitating further innovation in this evolving area of the asset management industry.”<sup>138</sup> To this end, the SEC created a classification system that groups ESG funds into two groups. The proposal would then require funds to disclose, in a layered format, specific information regarding their investment strategies; the exact disclosure requirements would vary depending on the extent to which they consider ESG factors. The more a fund considers ESG factors, the more it must disclose.

The broadest group of funds under the proposal would be called “Integration” funds. Integration funds “consider one or more ESG factors alongside other, non-ESG factors in investment decisions.”<sup>139</sup> Under the SEC’s proposal, Integration funds may take into account ESG factors, but not in a way that would make them “dispositive compared to other factors.”<sup>140</sup> Because Integration funds do not give any particular weight to ESG factors, they would fall firmly at the returns end of the returns-impact spectrum referenced in Part II(A)(3).

Integration funds’ limited exposure to ESG factors is probably why the SEC stated that they cannot use ESG-related terms in their names;

136. Investment Company Names, 87 Fed. Reg. 36,594 (June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, and 274).

137. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 232, 239, 249, 274, and 279).

138. *Id.*

139. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,657 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 232, 239, 249, 274, and 279).

140. *Id.*



in fact, under the Proposed Names Rule, the SEC would consider an Integration fund's name to be materially deceptive or misleading if it indicated that the fund's investment decisions considered ESG factors.<sup>141</sup> This would mean that Integrations funds are not subject to the 80% investment policy (as there are no terms in the funds' names to trigger the rule). However, the SEC is also considering for the final rule whether to allow Integration funds to include ESG terms in their names so long as they identify themselves as "Integration" funds and whether there are benefits to permitting funds to use "ESG Integration" or similar terms in their names.<sup>142</sup> In addition to asking if Integration funds should be allowed to label themselves as such, the SEC is considering whether Integration funds could meet the Names Rule's 80% investment policy requirement, and whether adopting such a policy would "address the consistency of an integration fund's investment portfolio with the investment focus its name suggests."<sup>143</sup>

Unlike Integration funds, which do not weigh ESG factors any differently than other criteria in the investment selection process, "ESG-Focused" funds use one or more ESG factors "as a significant or main consideration in selecting investments or in engaging with portfolio companies."<sup>144</sup> For example, an ESG-Focused fund might exclude or include certain investments based on particular ESG criteria, like screens for carbon emissions.<sup>145</sup> Under the classification system referenced *supra* Part II(A)(3), ESG-Focused funds might employ Negative/Exclusionary Screening, Positive/Best-in-Class Screening, Norms-based Screening, or Corporate Engagement and Shareholder Action strategies.<sup>146</sup> Because these funds give ESG factors increased weight in the investment selection process, they would fall more toward the middle of the returns-impact spectrum, varying based on the extent to which they consider ESG factors in their investment selection process. Given the balance they seem to strike between achieving ESG outcomes and risk-adjusted returns, these seem like the type of investment opportunities that the above-mentioned 70% of millennials who were willing to sacrifice some yield for sustainable outcomes would be interested in.<sup>147</sup>

141. Investment Company Names, 87 Fed. Reg. 36,614 (June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, and 274).

142. *Id.*

143. *Id.*

144. Investment Company Names, 87 Fed. Reg. at 36,598.

145. *Id.*

146. Global Sustainable Invest. All., *supra* note 86.

147. Sardon, *supra* note 106.

The SEC created an additional label for a subset<sup>148</sup> of ESG-Focused funds called “ESG Impact” funds, which prioritize ESG objectives to an even greater extent. ESG Impact funds pursue “a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits.”<sup>149</sup> Impact strategies generally target portfolio investments that drive specific and measurable ESG outcomes.<sup>150</sup> Among the strategies listed *supra* Part II(A)(3), ESG Impact fund managers would most likely employ Sustainability Themed Investing and Impact/Community Investing strategies.<sup>151</sup> Given the greater extent to which these funds prioritize ESG outcomes, they are likely to fall near the impact end of the returns-impact spectrum. Despite creating this complex regulatory regime, the Proposed ESG Fund Rule does not define “ESG” or similar terms, but rather calls on funds themselves to disclose the ESG factors they consider and the manner in which they are considered.<sup>152</sup>

In addition, the Proposed ESG Fund Rule would add several disclosure requirements for ESG funds in their prospectuses, annual shareholder reports, and annual census-level reports. While the specifics of the requirements are beyond the scope of this Note,<sup>153</sup> the key feature of the Proposed ESG Fund Rule is that funds would be required to follow a layered approach to their disclosures and provide in plain English<sup>154</sup> certain information depending on whether the fund

148. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654, 36,657, at n.23 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

149. *Id.*

150. *Id.*

151. Global Sustainable Invest. All., *supra* note 49.

152. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36, 654, 36,660 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

153. The Note’s primary focus is highlighting how the Proposed Names Rule would continue to lead to uncertainty in the ESG fund space given all funds that incorporate ESG factors, whether they are Integration funds or Impact funds, face the same 80% requirement. For a more in-depth analysis of the two proposed rules, see Marc Ponchione et. al., *SEC Proposes Rules Relating to Registered Funds’ ESG Investments*, DEBEVOISE & PLIMPTON (July 12, 2022), <https://www.debevoise.com/insights/publications/2022/07/sec-proposes-rules-relating-to-funds> [<https://perma.cc/5B3B-HU2Y>].

154. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654, 36,659 at n.39 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279) (explaining how the proposed rule would “complement existing requirements that funds use plain English and disclose essential information in a concise and straightforward manner to help investors make informed investment decisions about the fund”).

is an Integration, ESG-Focused, or Impact fund.<sup>155</sup> Impact Funds, which focus the most on ESG outcomes, will be subject to the lengthiest disclosure requirements, while Integration funds will be subject to the fewest. Notably, all ESG-Focused funds, including Impact funds, would be required to complete a standardized disclosure table that would provide an overview of the fund's ESG strategy, which ESG strategies it implements, how the fund incorporates ESG factors into its investment decisions, and how the fund votes proxies and/or engages with companies about ESG issues.<sup>156</sup> For open-end funds like mutual funds and ETFs, this table would be housed at the beginning of its "risk/return summary" section of the prospectus, which summarizes key information about the fund's investments, risk, and performance.<sup>157</sup>

Certain aspects of the Proposed ESG Fund Rule will be analyzed *infra* Part II(A) to examine how the funds are currently disclosing key ESG-related information and how the proposed regime might impact the leading funds' practices. Specifically, this Note will show how new disclosure requirements in the Principal Investing Strategy sections of prospectuses will improve the status quo.

#### b. The Names Rule and the May 2022 Update

Before analyzing the SEC's Proposed Names Rule, this section will first provide context on the Names Rule in its original form to explain how and why the rule is potentially changing.

The Names Rule was promulgated by the SEC in 2001 pursuant to its authority<sup>158</sup> to enforce section 35(d) of the Investment Company Act of 1940, which prohibits registered investment companies (including mutual funds and ETFs) from adopting as part of their names "any word or words that the Commission finds are materially deceptive or misleading."<sup>159</sup> Since then, the Names Rule has served as an "investor protection measure designed to help ensure that investors are not misled or deceived by a fund's name."<sup>160</sup> After all, a

155. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36659 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

156. *Id.* at 36663.

157. *Id.* at 36663 n.59 (referencing Proposed Item 4(a)(2)(ii)(B), Instruction 1 of Form N-1A (codified at 17 C.F.R. 274.11A)).

158. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 208, 110 Stat. 3416, 3432 (codified at 15 U.S.C. § 80a-34(d)).

159. *Id.*

160. Request for Comments on Fund Names, 85 Fed. Reg. 13221 (Mar. 6, 2020).

fund's name is often the first piece of fund information an investor sees and it can have a "significant impact"<sup>161</sup> on their investment choice. The Names Rule has not been amended since its adoption in 2001.<sup>162</sup>

The crux of the original Names Rule is that, if a fund's name suggests a particular type of investment (e.g., the ABC Bond Fund), industry (e.g., the ABC Technology Fund), or geographic focus (e.g., the ABC Brazil Fund), the fund must invest at least 80% of its assets in the type of investment, industry, or geographic region suggested by its name.<sup>163</sup> Crucially, the Names Rule's 80% requirement does not apply to fund names that describe a fund's investment objective or strategy (e.g., the ABC Growth Fund).<sup>164</sup>

This bifurcation between investment types and objectives puts ESG funds in a gray area. ESG funds are not an investment *type*, like a sector fund. Nor are they clearly an investment *strategy*, like a growth fund. Yet they share characteristics with both. Even fund managers are not sure whether ESG fund names describe an investment type (subject to the 80% requirement), or an investment strategy (exempt from the 80% requirement).<sup>165</sup> The SEC itself has acknowledged that an ESG fund could be describing either an investment type or an investment objective depending on how a specific fund approaches ESG investing: "If the fundamental application is to determine 'inclusion' or 'exclusion' of certain assets, this is effectively proscribing an asset type or industry which are items already covered by the Names Rule. As such, a holdings requirement should apply."<sup>166</sup>

Before the May 2022 Proposed Names Rule, the SEC treated ESG funds as following an investment strategy. As such, the 80% rule did not apply.<sup>167</sup> The only form of investor protection for fund names describing a fund's objective or strategy was "the general prohibition on misleading names in Section 35(d), as well as other antifraud

161. *Id.*

162. Comm'r Caroline Crenshaw, *A Rose By Any Other Name: Statement on Proposed Amendments to the Names Rule*, SEC (May 25, 2022), <https://www.sec.gov/news/statement/crenshaw-statement-names-rule-052522#ftn8> [<https://perma.cc/95DD-B5QF>].

163. 17 C.F.R. § 270.35d-1(a) (2001).

164. Request for Comments on Fund Names, 85 Fed. Reg. 13222 (Mar. 6, 2020).

165. As the SEC staff notes, some funds treat "ESG" as an investment strategy, whereas others treat "ESG" as an investment type. Request for Comments on Fund Names, 85 Fed. Reg. 132223 (Mar. 6, 2020).

166. ESG SUBCOMM., *supra* note 133 at 7.

167. *Id.*

provisions of the Federal securities laws.”<sup>168</sup> This gray area shows how the Names Rule—and the asset-based test used to determine whether a fund is subject to the 80% requirement—is not fit to regulate ESG funds, which blur the line between investment types and strategies.

The SEC’s two proposed rules mitigate this dynamic in two ways. First, in the Proposed ESG Fund Rule, the SEC’s Integration, ESG-Focused, and Impact fund framework would help investors identify the extent to which a given fund incorporates ESG factors into its investment decisions. Second, and more directly, the Proposed Names Rule would eliminate this unnecessary distinction between investment types and strategies by expanding the Names Rule to “apply to any fund name with terms suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics,” including fund names that indicate the fund’s “investment decisions incorporate one or more ESG factors.”<sup>169</sup> According to the SEC, the reason to expand the Names Rule to cover fund names that describe an investment strategy is because “even where a fund’s name could be construed as referring to an investment strategy, it nevertheless can also connote an investment focus, and [the SEC] believe[s] this connotation is likely to be materially deceptive and misleading unless supported by an 80% investment policy.”<sup>170</sup> In so doing, the SEC has reframed the issue from being an exercise of whether a fund’s name describes an asset type or strategy, to simply asking whether “a fund name might connote a particular investment focus and result in reasonable investor expectations regardless of whether the fund’s name describes a strategy as opposed to a type of investment.”<sup>171</sup> To further bolster investors’ understanding of a fund name that incorporates ESG language, the Proposed Names Rule would require a fund to include definitions of the terms used in its name, in plain English,<sup>172</sup> “including the specific criteria the Fund uses to select the investments the term describes, if any,” in the fund’s disclosures.<sup>173</sup>

Applying labels like Integration or ESG-Focused fund should help investors more easily discern whether ESG considerations are central

168. Request for Comments on Fund Names, 85 Fed. Reg. 13222 (Mar. 6, 2020) at n.17.

169. Investment Company Names, 87 Fed. Reg. 36597 (June 17, 2022) (to be codified at 17 C.F.R. §§ 230, 232, 239, 270, and 274).

170. *Id.* at 36598.

171. *Id.*

172. *Id.* at 36646 (to be codified at 17 C.F.R. § 270.35d-1(a)(2)(iii)).

173. *Id.* at 36611; *see also id.* at Proposed Item 4(a)(1) of Form N-1A.

to a fund's investment selection process, or whether the fund is more passively integrating ESG factors. It might also eliminate cases of greenwashing in which a fund uses an ESG label for no other reason than to attract inflows.<sup>174</sup> At the same time, the proposed regime will require investors to learn a new taxonomy in an already jargon-loaded space. Furthermore, the proposed labels could lead to increased investor confusion because the system's structure eliminates much of the nuance between different ESG funds. For example, all "ESG-Focused" funds might be viewed as equally weighing ESG factors into the investment decision process, even if their particular strategies and ESG impact vary dramatically.<sup>175</sup> Part III will examine how this potential change might impact funds as well as retail investors, who often struggle to make sense of fund disclosures. It will also identify a second gray area for ESG funds: that an 80% requirement does not fit ESG funds, which seek to have extra-market impacts and can have their objectives directly mitigated by the non-complying parts of their funds (i.e. the 20%).

### III. THE ESG FUND LABELING PROBLEM IN ACTION

To better understand how the current regulatory framework is failing to provide investors with the clarity they need to make informed investment decisions and how the SEC's proposed rules would affect the status quo, this Part examines how the leading ESG open-end funds are naming themselves and disclosing key ESG information. Just as a cereal box ought to help a consumer determine whether a cereal aligns with their dietary objectives, ideally, a fund's name and disclosures should enable an investor to determine whether a fund is a good match for their specific investing goals. Because investors have widely varying ESG objectives, disclosure ought to make clear how a fund approaches ESG investing so individuals can invest with increased knowledge and confidence.

The data presented below is not intended to provide a complete view of the ESG fund landscape. However, because the sample set is

174. However, the consensus is that such egregious greenwashing is rare. See Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs*, 13 WM. & MARY BUS. L. REV. 441, 457 (2022) ("There is little evidence that greenwashing is pervasive in asset management or ETFs.").

175. For instance, a clean energy fund that solely invests in clean energy companies and a large mutual fund that applies an ESG Integration strategy but has a negative Paris climate score might both be labeled an "ESG-Focused" fund. This might bolster the latter and dilute the uniqueness of the former.

comprised of the largest open-end funds,<sup>176</sup> it is indicative of how industry leaders are disclosing ESG information and representative of an investor's experience researching ESG funds. After considering how the SEC's proposed regulatory regime might resolve the ESG fund labeling problem, Part III(B) provides information on retail investors' research and investing habits to consider whether these proposals address the needs of retail investors.

#### A. An Investor's Experience Researching ESG Funds

The data below is derived from twenty ESG funds: ten ETFs and ten mutual funds.<sup>177</sup> The twenty funds selected were the ten largest ESG funds by assets under management<sup>178</sup> in their respective categories.<sup>179</sup> Tables 1 and 2 below identify the funds along with their assets under management.

<b>Table 1: Ten Largest ESG ETFs</b>		
<b>Ticker</b>	<b>Full Name</b>	<b>Assets Under Management (figures shown as \$ millions)</b>
ESGU	iShares ESG Aware MSCI USA ETF	\$14,157
ESGD	iShares ESG Aware MSCI EAFE ETF	\$7,260

176. The sample set was initially developed on October 12, 2021, with data from the Bloomberg Terminal. The funds were identified by searching for funds domiciled in the United States that met the following criteria: Fund Types of "Open-End Fund" and/or "Mutual Fund," and with the General Attributes of "ESG" or "Socially Responsible." At that time, these funds were the ten largest mutual funds and ETFs. The source data is on file with the author.

177. See SEC, MUTUAL FUNDS AND ETFs, *supra* notes 5–6 for definitions of mutual funds and ETFs.

178. All data on fund assets under management are from the Bloomberg Terminal. The assets under management, or "Total Assets" figures were last updated on April 5, 2023. The formula used to find the data is: "=@BDP("[TICKER] US Equity", "Fund Total Assets").

179. Although some of the largest mutual funds in the set were the institutional share classes of funds, the summary prospectuses are substantively identical for all share classes (i.e., the content in the summary prospectus of a fund's institutional share class is reflective of what a retail investor would see as well).

ESGV	Vanguard ESG U.S. Stock ETF	\$6,104
ESGE	iShares ESG Aware MSCI EM ETF	\$4,357
DSI	iShares MSCI KLD 400 Social ETF	\$3,511
VSGX	Vanguard ESG International Stock ETF	\$3,369
SUSA	iShares MSCI USA ESG Select ETF	\$3,239
SUSL	iShares ESG Aware MSCI USA Leaders ETF	\$3,156
EAGG	iShares ESG Aware U.S. Aggregate Bond ETF	\$2,736
USSG	Xtrackers MSCI USA ESG Leaders Equity ETF	\$1,216
<b>Total AUM</b>		<b>\$49,104</b>

**Table 2: Ten Largest ESG Mutual Funds**

<b>Ticker</b>	<b>Full Name</b>	<b>Assets Under Management (figures shown as \$ millions)</b>
PRBLX	Parnassus Core Equity Fund	\$25,317
VFTAX	Vanguard FTSE Social Index Fund	\$13,450
BAFWX	Brown Advisory Sustainable Growth Fund	\$6,737



PIODX	Pioneer Core Equity Fund	\$6,619
TSBIX	TIAA-CREF Core Impact Bond Fund	\$6,068
PARMX	Parnassus Mid Cap Fund	\$5,863
TRPSX	TIAA-CREF Social Choice Equity Fund	\$5,789
SEM VX	Hartford Schrodgers Emerging Markets Equity Fund	\$5,430
PNOPX	Putnam Sustainable Leaders Fund	\$4,996
MGGPX	The Global Opportunity Portfolio	\$2,541
<b>Total AUM</b>		<b>\$82,009</b>

The purpose of using the data is to demonstrate what an investor's experience might be like researching ESG funds and attempting to determine from their disclosures which fund best matches their investing objectives. Therefore, the "Investment Objective"<sup>180</sup> and "Principal Investment Strategies"<sup>181</sup> from the summary prospectuses for each fund were aggregated and analyzed<sup>182</sup> for similarities, differences, notable features, and whether they could be classified as utilizing a specific ESG investing strategy.<sup>183</sup> The research will show that funds are failing to achieve the SEC's aforementioned objectives

180. This section provides a brief, one-sentence overview of the fund's main investment goal.

181. This section goes into significantly more detail than the Investment Objective section and fully explains a fund's investment strategy. It can often be several pages of information.

182. The content in the Principal Investing Strategies sections of the funds' summary prospectuses were sometimes over 15,000 words and were therefore too long to include in a table within the Note. However, all prospectuses in this Note are on file with the author, who can be reached at: cb2189@columbia.edu.

183. See Global Sustainable Inv. All., *supra* note 49 (quotations from source can be found *supra* notes 87-92 for a refresher on ESG investing strategies).

of conveying important information in a concise and simple manner.<sup>184</sup> Where relevant, the SEC's proposed rules are also analyzed to consider whether they would be effective in reducing the ESG fund labeling problem.

Overall, ETFs utilized the ESG label and related terms in their names more than mutual funds, and appeared to incorporate ESG considerations more thoroughly than mutual funds. Because most mutual funds primarily utilized passive ESG investing strategies, under the SEC's proposed framework, there would likely be more "Integration" mutual funds. While ETFs incorporated ESG considerations more thoroughly into their investment selection processes than mutual funds, ETFs frequent utilization of both impact-focused and return-focused objectives together might complicate the effort to neatly classify these funds as either ESG-Focused or Integration funds under the SEC's proposed taxonomy. Similarly, although ETFs seemed to more thoroughly consider their ESG strategies than mutual funds, their disclosures were longer and more technical, which could potentially create comprehension challenges for retail investors.<sup>185</sup> The below takeaways explore these ideas in more detail.

### 1. Summary Prospectuses Are Not So Summary

While the SEC originally intended for a fund's summary prospectus to be approximately four pages in length,<sup>186</sup> only one of the twenty funds selected for analysis in this Note met that goal.<sup>187</sup> The average length of ETF summary prospectus was significantly longer than those of mutual funds (averages provided in Table 3).<sup>188</sup>

**Table 3: Summary Prospectus Lengths (PDF length)**

184. See SEC, Form N1-A ii, *supra* note 124 (quotations from source can be found *supra* notes 127-28).

185. Although the Proposed ESG Fund Rule attempts to remedy this issue through a layered disclosure format.

186. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546, 4548 (Jan. 26, 2009) (to be codified at 17 C.F.R. §§ 230, 232, 239, and 274).

187. ESG Mutual Fund and ETF Note Data (on file with author).

188. The length of each summary prospectus was calculated by downloading a PDF of each from the fund's site. *Id.*

ETFs	23.8 pages
Mutual Funds	9.7 pages

Notably, the larger asset managers had significantly longer summary prospectuses; for instance, two of BlackRock’s funds had *summary* prospectuses that were forty-six and sixty-eight pages, respectively.<sup>189</sup> Despite the greater length of ETF summary prospectuses, the Principal Investing Strategy sections of the two fund categories were relatively similar in length (data provided in Table 4).<sup>190</sup>

<b>Table 4: Average Word Count of Principal Investment Strategy Sections</b>	
ETFs	789.5 words
Mutual Funds	618.2 words

The majority of the funds sampled—especially ETFs—were front-loaded with legal disclaimers, making it difficult for readers to find where the key substantive information began.<sup>191</sup> On average, ETFs had thirteen pages of front-loaded disclaimers, whereas mutual funds averaged just 2.6 pages of disclaimers.<sup>192</sup> The added length and front-loading of disclaimers might confuse unsophisticated investors who do not know the type of information they are looking for. In addition, both of the SEC’s proposed rules compel additional disclosures: The Proposed ESG Fund Rule requires funds to describe in their prospectuses how they incorporate ESG factors into the investment selection process,<sup>193</sup> and the Proposed Names Rule calls on funds to

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36659 (June 17, 2022) (codified at 17 C.F.R. § 274.11A) (Amended Items 4).

define key terms in their names.<sup>194</sup> As a result, fund disclosures might become even longer than they already are, which has the potential to increase the burden on investors to sift through pages of information to find what they are looking for.<sup>195</sup> On the other hand, the Proposed ESG Fund Rule's layered disclosure format may result in an overall net reduction of disclosure length.<sup>196</sup>

## 2. ETF and Mutual Fund Naming Conventions

ETFs and mutual funds differentiated themselves from the get-go. Of the ten ETFs in the sample set, nine used the term "ESG" in the name of the fund.<sup>197</sup> In contrast, zero of the ten mutual funds used the "ESG" moniker, although five used a related term in the fund's name, such as "social," "impact," and "sustainable."<sup>198</sup> ETFs also used other subjective terms in their names in conjunction with the ESG label (e.g., "ESG Aware" and "ESG Leaders").<sup>199</sup>

This distinction between the observed naming conventions of ETFs and mutual funds suggests the two groups have differing perspectives on the role that ESG plays in the broader investment selection process. It also reveals where the SEC's proposed regime might have a larger impact. Given the stark difference between how ETFs and mutual funds named themselves in the sample set, under the new framework, ETFs would more likely be labeled "ESG-Focused" funds, and mutual funds would be labeled as "Integration" funds.<sup>200</sup> The SEC needs to decide whether it will require a fund which employs an "ESG-Focused" strategy to *add* a label to its name (e.g., the "XYZ Sustainable *ESG-Focused* Fund"), or if it will only require an "Integration" fund to *remove* a misleading term from its name. The current proposal is silent on the former but would require the latter.<sup>201</sup>

194. Investment Company Names, 87 Fed. Reg. 36594, 36611 (June 17, 2022) (codified at 17 C.F.R. § 274.11A-1) (Proposed instruction to Item 4(a)(1) of Form N-1A).

195. While the added information may increase the length of the disclosures, the information may be what helps investors better understand how a product considers ESG factors.

196. The downside to a layered disclosure format is that some information that some investors might find helpful will inevitably be more difficult to access.

197. ESG Mutual Fund and ETF Note Data (on file with author).

198. *Id.*

199. *Id.*

200. The idea that mutual funds more passively integrated ESG considerations into the investment selection process than ETFs is supported by the data in Part II(A)(1), which highlighted that 718 mutual funds, compared to 94 ETFs, incorporated ESG language into their prospectuses. See Stankiewicz, *supra* note 46.

201. Investment Company Names, 87 Fed. Reg. 36613 (June 17, 2022).

Part of the purpose of the proposed regime is to eliminate misleading fund names,<sup>202</sup> so it makes little sense to force a fund that is not using “ESG” or a related term in its name to add a label. In fact, this scenario was not present in the sample set, which suggests that it is likely a fund incorporating ESG factors in a meaningful way would self-identify as ESG. On the other hand, the absence of a clear indicator that a fund incorporates ESG factors into the investment selection process—especially exclusionary practices that sometimes underperform non-ESG benchmarks<sup>203</sup>—is also misleading to an investor who is only interested in ESG investing as a way to maximize profit, and who might not appreciate the extent that ESG factors play into the fund’s investment process.

Notably, the significant consequence of being labeled an “Integration” fund is that the fund cannot use ESG-related terminology in its name. But as shown above, just half of the mutual funds used related terminology, and none actually used the “ESG” label.<sup>204</sup> Therefore, if the SEC only decides to require Integration funds to remove misleading labels, the proposed regulation stands to have a larger impact on mutual fund names. As an alternative, the SEC could permit Integration funds to use the ESG-related terms in their names so long as they also use the “Integration” label, which would allow more funds to keep ESG-related terminology in their names. In fact, the SEC is considering this idea in its Proposed Names Rule.<sup>205</sup> Doing so would provide benefits to various groups of investors. Impact-focused investors can avoid these funds that do not sufficiently prioritize ESG factors for their needs. But the real benefit is gained by return-seeking investors, who can identify which funds consider ESG factors as part of a profit-maximization strategy. If these funds are not able to label themselves as ESG funds, the many investors who seek to invest in ESG funds as part of their returns-oriented strategy may not be able to easily find or identify these funds.

202. *Id.* at 36613–14 (detailing the SEC’s focus on targeting misleading fund names and promoting truth in advertising); *see also* Press Release, SEC, SEC Requests Comment on Fund Names Rule; Seeks to Eliminate Misleading Fund Names (Mar. 2, 2020), <https://www.sec.gov/news/press-release/2020-50> [<https://perma.cc/5F38-5JKF>].

203. *See* TENSIE WHELAN ET AL., *supra* note 80 at 7 (“ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches”).

204. *See* ESG Mutual Fund and ETF Note Data (on file with author).

205. Investment Company Names, 87 Fed. Reg. 36614 (June 17, 2022) (to be codified in 17 C.F.R. §§ 230, 232, 239, 270, and 274).

### 3. A Review of the Principal Investment Strategies Sections

While funds' Principal Investment Strategies sections provided specific ESG-related information, the language used was highly technical and presented in a visually unappealing format, making it difficult to understand or follow. The Principal Investment Strategies section for each fund described how ESG factors were considered within their overall investment selection process. Overall, disclosures seemed to flout the current requirement that funds use plain English and disclose key information in a concise and straightforward manner.<sup>206</sup>

Generally, ETFs were more descriptive of their investment criteria than mutual funds, although the criteria appeared to come from third parties rather than the funds themselves. Of the ten ETFs sampled, seven explicitly tracked an MSCI<sup>207</sup> index, six of which included the term "MSCI" in the name of the fund.<sup>208</sup> The fact the term "index" was used 298 times, "underlying" 172 times, "MSCI" 73 times, and "track" 28 times in the ETF Principal Investment Strategy sections strongly supports the notion that ESG ETFs outsourced the ESG fund investment universe curation to third-parties.<sup>209</sup>

ETFs were also more likely to describe specific ESG criteria that their funds considered. In their Principal Investment Strategy sections, ETFs mentioned "weapons" twenty-four times, "oil" eighteen times, "controversies" sixteen times, "coal" fifteen times, "nuclear" twelve times, and "power," "gas," "thermal," and "tobacco" each eleven times.<sup>210</sup> Meanwhile, mutual funds mentioned "fossil" seven times, "energy," "gas," and "oil" five times, "nuclear" four times, and "tobacco" and "coal" each three times.<sup>211</sup> Figures 1 and 2 in the Appendix show key word frequencies from the Principal Investment Strategy sections of the funds in the sample set.

Although providing specific ESG criteria helps investors understand a fund's potential investment universe, this information was generally hedged in complex financial jargon that can confuse investors, especially retail investors, and undermine the purpose of having

206. See SEC, Form N-1A General Instructions B.4(c) & C.1-3(c).

207. MSCI is a provider of indexes and climate-related data.

208. ESG Mutual Fund and ETF Note Data (on file with author).

209. *Id.*

210. *Id.*

211. *Id.*

requirements for simplified disclosure.<sup>212</sup> For example, BlackRock's iShares ESG Aware MSCI USA Leaders ETF (SUSL) wrote that it "seeks to track . . . a free float-adjusted market capitalization weighted equity index."<sup>213</sup> If an investor were to try to determine which ESG investing strategies the fund employed, they would see that the fund excludes securities "involved in the business of tobacco, alcohol, gambling, nuclear power . . . thermal coal and unconventional oil and gas . . . companies involved with conventional and controversial weapons, producers and major retailers of civilian firearms, as well as companies involved in very severe business controversies." A "controversy" was defined as an "instance or ongoing situation in which company operations and/or products allegedly have a negative environmental, social and/or governance impact."<sup>214</sup> From this, one might be able to determine the fund employs an Exclusionary Investing strategy.

However, an investor may not recognize that the fund also employs a Best-in-Class strategy,<sup>215</sup> and what that means in this specific context. The fund does not use the term "Best-in-Class," but instead says it is "comprised of companies with the highest ESG ratings from each sector of the Parent Index." Here, "Best-in-Class" appears generous: On a rating scale from "CCC" (lowest) to "AAA" (highest), all companies with an ESG rating of "BB" or higher are eligible for inclusion.<sup>216</sup> Plus, companies "involved in very severe business controversies" are also eligible as long as the ESG impact of their "very severe business controversy" does not exceed a three out of ten.<sup>217</sup>

While SUSL's summary prospectus provides some information on how ESG factors are incorporated into the investment selection process, it also raises questions and concerns. With respect to the security selection process, no governance factors are explicitly referenced; if the governance of securities was considered, this process was not disclosed. Additionally, any security that receives a "Key Issue" score of three or higher is eligible for inclusion; without more context, it is unclear whether that number is appropriate. Three

212. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36659 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

213. BlackRock iShares, ESG MSCI USA Leaders ETF, Summary Prospectus 2 (Dec. 30, 2020).

214. *Id.* at 2-3. Not all of BlackRock's funds defined "controversy" in the summary prospectus.

215. See INV. CO. INST, *supra* note 82 (defining a "Best-in-Class" strategy).

216. BLACKROCK ISHARES, *supra* note 213, at 2.

217. *Id.*

out of ten may seem low, but there is no way to know unless an investor undertakes significant independent research. It is unclear what corporate behavior would render a score of three, nine, or one.

Crucially, BlackRock discloses that while 90% of the fund will generally be invested the underlying index,<sup>218</sup> there is a remaining 10% which may be invested in a variety of other financial products. It is unclear whether that final 10% could be placed in investments that run counter to the fund's goals, like a money market fund that owns debt from a company that has previously been excluded from the underlying index for poor environmental practices.<sup>219</sup>

Finally, from a presentation standpoint, this entire section is presented in single-spaced paragraphs full of long sentences on a two-column page, without any visual aids or words with emphasis to distinguish important information. The section is loaded with complex financial jargon that warrants further explanation, yet little, if any, is provided. It would be challenging for almost anyone to quickly identify the key information they need.

Overall, the complex technical financial language, lack of explanations surrounding key ESG criteria, and unappealing presentation in the disclosures of both ETFs and mutual funds can confuse and overwhelm investors. This clearly runs counter to the SEC's goal that fund disclosures provide information in a concise and digestible manner.<sup>220</sup>

Perhaps the Proposed ESG Fund Rule can remedy some of these issues. While there was already a requirement in place for funds to disclose information in a concise and simple manner using plain English, the required ESG Strategy Overview table might provide fund managers with the forum to do that.<sup>221</sup> However, under the proposal, the table is slated to be housed in the Risk/Returns section of the prospectus, not the Principal Investing Strategies section. The Proposed ESG Fund Rule also would require any fund that uses

218. *Id.*

219. This would be like a cereal labeling itself as "sugar-free," yet that only being true for 90% of the cereal's contents and the rest of the box being filled with sugary, unhealthy cereal.

220. See Borges, *supra* note 99; see also Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36659 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

221. See Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36663 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279) (explaining the SEC created the table "to provide investors a clear, comparable, and succinct summary of the salient features of a fund's implementation of ESG factors").



internal methodologies or third-party data providers (which every fund in the sample set did) to disclose how it uses the methodology, third-party data provider, or both.<sup>222</sup> This might lead to more disclosure, but the problem before was not a lack of information, but rather, a deluge of technical jargon.

#### 4. The ESG Investment Strategies Utilized

Overall, the ESG investment strategies analyzed in this Note varied significantly and were not always clear. ETFs were more descriptive of their ESG investing strategies and were more likely to employ Exclusionary screens alongside an ESG Integration strategy, whereas mutual funds primarily utilized ESG Integration approaches and were less descriptive of specific ESG considerations. Because fund providers used different language to describe seemingly similar strategies,<sup>223</sup> it was generally difficult to classify funds as utilizing specific ESG investing strategies.<sup>224</sup> The lack of standardization makes comparing funds more challenging. Tables 5 and 6 show the author's best effort to identify the strategies employed by the funds in the sample set based on their Principal Investing Strategies sections.

<b>Table 5: ESG ETF ESG Investing Strategies</b>		
<b>Ticker</b>	<b>Full Name</b>	<b>ESG Investing Strategies</b>
ESGU	iShares ESG Aware MSCI USA ETF	Negative/Exclusionary Screening and ESG Integration

222. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36663 (June 17, 2022) (to be codified at 17 C.F.R pts. 200, 230, 232, 239, 249, 274, and 279).

223. On the whole, ETF ESG investing strategies were easier to discern than mutual funds. This phenomenon might be explained by the fact seven of the ten sampled ETFs were from the same asset manager, whereas the mutual fund sample was more varied. Nevertheless, one report tallied the number of different terms used to describe various forms of sustainable investing at nearly eighty. The report emphasized that even when firms provide explanations, having so many terms "adds a layer of complexity that may be challenging, particularly for retail clients." INST. INT'L FINANCE, IIF SUSTAINABLE FINANCE WORKING GROUP REPORT: THE CASE FOR SIMPLIFYING SUSTAINABLE INVESTMENT TERMINOLOGY 2-3 (Oct. 2019).

224. For example, the SUSL fund did not disclose it was employing a "Best-in-Class" approach, but rather, that it selected "securities of mid- and large- capitalization companies with the highest ESG ratings from each sector of the Parent Index." *Supra* note 215.

ESGD	iShares ESG Aware MSCI EAFE ETF	Negative/Exclusionary Screening and ESG Integration
ESGV	Vanguard ESG U.S. Stock ETF	Negative/Exclusionary Screening and Norms-based Screening
ESGE	iShares ESG Aware MSCI EM ETF	Negative/Exclusionary Screening and ESG Integration
DSI	iShares MSCI KLD 400 Social ETF	Negative/Exclusionary Screening and ESG Integration
VSGX	Vanguard ESG International Stock ETF Summary Prospectus	Negative/Exclusionary Screening
SUSA	iShares MSCI USA ESG Select ETF	Negative/Exclusionary Screening and ESG Integration
USSG	Xtrackers MSCI USA ESG Leaders Equity ETF	Negative/Exclusionary Screening and ESG Integration
SUSL	iShares ESG Aware MSCI USA Leaders ETF	Negative/Exclusionary Screening and Positive/Best-in-Class Screening
EAGG	iShares ESG Aware U.S. Aggregate Bond ETF	Negative/Exclusionary Screening and ESG Integration

**Table 6: ESG Mutual Funds ESG Investing Strategies**

<b>Ticker</b>	<b>Full Name</b>	<b>ESG Investing Strategies</b>
PRBLX	Parnassus Core Equity Fund	Negative/Exclusionary Screening (solely from "E") and ESG Integration
VFTAX	Vanguard FTSE Social Index Fund	Negative/Exclusionary Screening and ESG Integration

PIODX	Pioneer Core Equity Fund	ESG Integration <sup>225</sup>
PARMX	Parnassus Mid Cap Fund	Negative/Exclusionary Screening (solely from “E”) and ESG Integration
BAFWX	Brown Advisory Sustainable Growth Fund	Best-in-Class Screening, Negative/Exclusionary Screening, and ESG Integration
TRPSX	TIAA-CREF Social Choice Equity Fund	ESG Integration
TSBIX	TIAA-CREF Core Impact Bond Fund	Best-in-Class Screening (with a focus on “E” and “S”)
SEMVX	Hartford Schrodgers Emerging Markets Equity Fund	ESG Integration
PNOPX	Putnam Sustainable Leaders Fund	ESG Integration and Best-in-Class Screening
MGGPX	The Global Opportunity Portfolio	ESG Integration

Of the seven ESG investment strategies referenced, *supra* section II(A)(3),<sup>226</sup> the top funds typically employed just a few. The two most popular were ESG Integration and Negative/Exclusionary Investing.<sup>227</sup> The majority of ETFs (seven of ten) applied Exclusionary and ESG Integration approaches where the exclusions were absolute.<sup>228</sup> While some mutual funds also utilized Exclusionary

225. The fund’s prospectus explicitly says, “ESG considerations are not a primary focus of the fund, and the weight given by the adviser to ESG considerations in making investment decisions will vary and, for any specific decision, they may be given little or no weight.” PIONEER CORE EQUITY FUND, SUMMARY PROSPECTUS 5 (2021) (emphasis added).

226. GLOB. SUSTAINABLE INV. ALL., *supra* note 86; Kishan, *supra* note 50; Kerver & Jessop, *supra* note 67; Baker, *supra* note 68; HALE, *supra* note 71.

227. ESG Mutual Fund and ETF Note Data (on file with author).

228. *I.e.*, the funds entirely excluded securities in specific industries. Yet, as recently as 2019, eight of the ten biggest U.S. ESG funds were invested in oil-and-gas companies, including the iShares ESG MSCI USA ETF and Vanguard’s FTSE Social Index Fund. Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, WALL ST. J. (Nov. 11, 2019),

strategies, weakened disclosure language, such as the addition of the qualifier “generally,” made the strategy appear more like an aspirational guideline than a mandate.<sup>229</sup> Furthermore, the manner in which funds described their specific exclusionary criteria varied significantly depending on the funds’ specific objectives and different benchmark indexes, making it difficult to meaningfully compare strategies across funds. The different approaches seen within the Negative/Exclusionary Investing category are another example of why additional regulation is required to help investors distinguish between ostensibly similar funds, and a potential issue that might arise under the SEC’s proposed taxonomy when funds are broadly labeled as Integration or ESG-Focused funds.

The strategies employed by mutual funds and ETFs suggests the two groups have different philosophies on the role that ESG investing plays in their respective funds. Mutual funds tended to employ ESG Integration strategies alongside weaker screening strategies, whereas ETFs utilized ESG Integration strategies alongside other more impact-focused strategies to a greater extent. Given this dynamic, it appears that the sampled ESG mutual funds fall closer toward the return bookend of the returns-impact spectrum, and the sampled ETFs are further toward the impact end of the spectrum. Within the proposed taxonomy, mutual funds are more likely to become Integration funds, whereas ETFs might become “ESG-Focused” funds. Helping investors understand where exactly a specific fund will fall on this spectrum will facilitate understanding of the ESG fund universe and enable investors to determine which funds best align with their objectives.

None of the top funds employed Sustainability Themed Investing, Impact/Community Investing, or Corporate Engagement and Shareholder Action strategies. As mentioned in Part II(A)(3), this might partly explain why so many investors view ESG investing as primarily an Exclusionary Investing exercise. It also suggests that these largest funds will not be subject to the additional requirements imposed on Impact funds under the Proposed ESG Fund Rule.

<https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200> [<https://perma.cc/J7NS-UDTM>].

229. *Compare* iSHARES MSCI KLD 400 SOCIAL ETF, SUMMARY PROSPECTUS 2 (Sept. 1, 2021) (“[c]ompanies that MSCI determines have significant involvement in the following businesses are not eligible for the Underlying Index.”) (emphasis added), *with* TIAA-CREF SOCIAL CHOICE EQUITY FUND, SUMMARY PROSPECTUS 4 (Mar. 1, 2021) (“[t]he Fund will not generally invest in . . .”) (emphasis added). This further supports the idea that ETFs treated ESG investing as the fund’s asset type, whereas mutual funds treated it as the fund’s objective.

## 5. Funds' Treatment of the Names Rule

Although not mentioned explicitly in the summary prospectus of any fund, the Names Rule seems to be lingering behind the scenes. The 80% requirement was addressed in the Principal Investment Strategies sections of both ETFs and mutual funds, but only in ETFs with respect to ESG investing. More specifically, several ETFs explicitly stated their goal of investing at least 80% of their assets in accordance with their parent indexes, while other ETFs alluded to the requirement more generally.<sup>230</sup> Mutual funds that addressed investment allocation percentages normally did so in reference to the fund's general asset type (e.g., equities, emerging markets, or bonds), although one mutual fund disclosed it invested at least 80% of the value of its net assets in securities that meet their sustainability criteria.<sup>231</sup>

References to the 80% requirement, as well as the analysis *supra* Part III(A)(2) on the naming conventions of ETFs and mutual funds, suggest that the leading mutual funds tended to view the ESG label as describing the fund's investment strategy, whereas ETFs approached ESG investing as if it were the fund's asset type.<sup>232</sup> While the Proposed Name Rule's elimination of this dichotomy would establish that any fund that meaningfully considers ESG factors will be subject to the 80% requirement, it does not resolve the challenge investors face of discerning how a particular fund incorporates ESG criteria given the widely varying and vague terms fund managers use to describe their strategies.<sup>233</sup>

## 6. Where Funds Land on the Return-Impact Spectrum

As explained *supra* Part II(A)(2), all ESG funds may be placed along the spectrum between fully return-focused or impact-focused. Funds that use ESG Integration strategies tend to fall toward the return-

230. Compare DWS XTRACKERS MSCI USA ESG LEADERS EQUITY ETF, SUMMARY PROSPECTUS 2 (Dec. 18, 2020) ("[t]he fund will invest at least 80% of its total assets (but typically far more) in component securities of the Underlying Index") with VANGUARD ESG U.S. STOCK ETF, SUMMARY PROSPECTUS 3 (Dec. 22, 2020) ("[t]he Fund attempts to replicate the target index by investing all, or substantially all, of its assets in the stocks that make up the Index, holding each stock in approximately the same proportion as its weighting in the Index.").

231. Putnam Investments, Putnam Sustainable Leaders Fund, Summary Prospectus 3 (Oct. 30, 2021).

232. See Seelan, *supra* note 118, at 44 (arguing that because exclusionary strategies define a fund's investable universe, it more closely resembles an investment type than a strategy).

233. ESG Mutual Fund and ETF Note Data (on file with author).

focused end, as Integration funds use ESG data in an effort to maximize risk-adjusted returns. On the other hand, ESG-Focused and Impact funds use ESG data to maximize the impact of their investments, and thus land closer to the impact end of the spectrum.

The disclosures of the sampled ETFs do not explicitly indicate how they balance these two goals, which might frustrate investors hoping to gauge the extent to which the funds prioritize ESG objectives or returns. For instance, the Investment Objective section of the largest ETF in the sample set says: “The [fund] seeks to track the investment results of an index composed of U.S. companies that have positive environmental, social and governance characteristics as identified by the index provider while exhibiting risk and return characteristics similar to those of the parent index.”<sup>234</sup> This references both return-seeking and impact-seeking strategies, yet does not make it clear how the fund balances those objectives. At first glance, the explicit reference to ESG characteristics suggests the fund might be impact-oriented. However, the fact these ESG characteristics are considered with the underlying goal of tracking the fund’s underlying index suggests a focus on maximizing returns.

By combining a return-focused strategy (ESG Integration) with an impact-focused strategy (Negative/Exclusionary Screening), ESG funds, and, in particular, ESG ETFs, seek to provide the best of both worlds. However, this endeavor might actually result in worse outcomes. When funds attempt to maximize impact and profit—two seemingly opposing objectives<sup>235</sup>—situations arise where ESG funds have more exposure to oil companies than the traditional S&P 500.<sup>236</sup> In other words, tracking the performance of non-ESG benchmarks, in an effort to earn similar returns, pushes the funds towards the very stocks they are supposed to avoid. This reality likely runs counter to investors’ expectations of ESG funds, and without clear disclosure of this possibility, large swaths of well-intentioned retail investors might be unaware that a fund with the “ESG-Focused” label, and one they might have deliberately chosen to achieve positive ESG outcomes, provides more exposure to some of the most environmentally-

234. iShares MSCI iShares ESG Aware MSCI USA ETF, Summary Prospectus 14 (Sept. 1, 2021).

235. See Press Release, SEC, SEC Requests Comment on Fund Names Rule; Seeks to Eliminate Misleading Fund Names (Mar. 2, 2020), <https://www.sec.gov/news/press-release/2020-50> [<https://perma.cc/5F38-5JKF>].

236. Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUSINESSWEEK (Dec. 10, 2021), <https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/> [<https://perma.cc/CY64-F8Z7>].

harmful firms than had they chosen a traditional (and less expensive) non-ESG index fund.

This particular scenario is why this Note calls on the SEC to both: (1) require ESG-Focused funds to invest a higher percentage of assets in accordance with the fund's strategy than the current 80% requirement, and (2) require funds to prominently disclose when they are investing in securities excluded from the fund's investable universe (e.g., when an ESG-Focused fund invests in oil and gas companies that are screened from the fund's principal strategy).

## 7. A Potential Culprit for the ESG Fund Labeling Problem

A large criticism of the Proposed ESG Fund Rule is that it calls on funds to provide certain information that they might not have.<sup>237</sup> For example, the rule would require ESG-Focused funds to disclose in their annual reports data related to the aggregate impact of their holdings' greenhouse gas ("GHG") emissions.<sup>238</sup> However, this might not be possible if the securities the fund invests in do not disclose this information. ESG fund managers will point to the lack of mandated and consistent ESG-related disclosures at the issuer level, and argue that this makes it difficult, if not impossible, for them to employ many ESG investing strategies.<sup>239</sup> The dearth of ESG specific data on the issuer level might explain the popularity and appeal of Integration and Negative/Exclusionary strategies: ESG Integration strategies do not commit funds to any specific action besides the mere consideration of ESG information in the investment selection process; similarly, exclusionary strategies can be implemented effectively with a limited

237. See, e.g., Letter from Eric J. Pan, President & CEO, Investment Company Institute, to Vanessa A. Countryman, Sec'y, SEC (Aug. 16, 2022), <https://www.ici.org/system/files/2022-08/22-ici-cl-sec-esg-disclosure-proposal.pdf> [<https://perma.cc/PX2M-5QZ2>] ("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").

238. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36659 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, and 279).

239. Comm'r Hester Peirce, *We Are Not the Securities and Environment Commission—At Least Not Yet*, SEC (Mar. 21, 2022), [https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321#\\_ftnref2](https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321#_ftnref2) [<https://perma.cc/5JLL-QWRT>] ("... a company may not even be able to get the information it needs to calculate Scope 3 emissions. The company's customers and suppliers may not track this information. Even if its suppliers disclose their emissions information, a reporting company may not feel sufficiently confident in the information to include it in its SEC filings.").

knowledge base. The lack of consistent issuer-level data might also explain why summary prospectuses contain such varied language to describe the same general strategies. As the SEC's Asset Management Advisory Committee's ESG Subcommittee concluded, "the current, unguided approach has not resulted in consistent, comparable, complete and meaningful disclosure. The impact of the current approach could be poor transparency with the potential to mislead investors in investment products, as well as poor disclosure of material risks to investors in issuers' securities."<sup>240</sup> As demonstrated throughout Part III, the SEC's concern is clearly substantiated: ESG funds are struggling to develop clear, consistent, and transparent disclosures.

While funds and third-party index providers might look to point the finger at issuers, they are to blame in part as well. Although governance data is the most reliable of the ESG tripartite,<sup>241</sup> the funds sampled did not disclose any specific "G" criteria in their summary prospectuses.<sup>242</sup> Instead, the funds focused primarily on "E" considerations, and to a lesser extent, "S" factors as well.<sup>243</sup> Not only does this call into question the ability of the funds to fully execute on their stated criteria, but it also suggests that the ESG issues investors care about most—"E" issues—are the ones funds have the least information about.

Eventually, the SEC's landmark proposal in 2022 to require individual securities to disclose specific climate-related information will trickle down and improve the quantity and quality of data available to ratings providers and fund managers. However, that day will not come soon. The SEC's proposed rule is intended to be phased in over a period of several years.<sup>244</sup> Even assuming the extremely unlikely best-case scenario at the issuer level of full compliance and no litigation challenges<sup>245</sup> or reversals, fund providers will be unable to meet some of the SEC's proposed requirements. Ultimately, this

240. ESG SUBCOMM., SEC ASSET MGMT. ADVISORY COMM., DISCUSSION DRAFT: POTENTIAL RECOMMENDATIONS OF THE ESG SUBCOMMITTEE 4 (Dec. 1, 2020).

241. *Id.*

242. ESG Mutual Fund and ETF Note Data (on file with author).

243. *Id.*

244. The Enhancement and Standardization of Climate-Related Disclosures for Investors 87 Fed. Reg. 21334 (Mar. 21, 2022) (codified at 17 C.F.R. § 232.405(f) (2023)).

245. Within one day of the proposal's announcement, potential litigation disputes were already covered in the media. See e.g., Dan Papsun, *SEC's Climate Proposal Tees Up Test of 'Material' Info Standard*, BLOOMBERG L. (Mar. 23, 2022), <https://news.bloomberglaw.com/esg/secs-climate-proposal-tees-up-test-of-material-info-standard> [https://perma.cc/QYM2-UY64].



will force retail investors to continue to fend for themselves for the foreseeable future in determining which funds match their investing objectives.

#### 8. Reason for Further Concern

With overwhelmingly long documents, pages of legal disclaimers, confusing financial jargon, and varying industry terminology, retail investors face myriad challenges that make it difficult to confidently ascertain whether a nominal ESG fund matches their personal ESG objectives. The above data, on its own, raises several concerns about how funds managing over \$130 billion<sup>246</sup> in assets disclose their ESG strategies.

Even worse, fund practices are often inconsistent with their own disclosures. In 2021, the SEC staff observed instances where funds did not adhere to global ESG frameworks as claimed, and noted that some funds had holdings predominated by issuers with low ESG scores where such predominance was inconsistent with those firms' stated approaches.<sup>247</sup> The SEC staff also identified "unsubstantiated or otherwise potentially misleading claims regarding ESG investing in a variety of contexts."<sup>248</sup> This problem has continued into 2023,<sup>249</sup> even after the SEC brought enforcement actions against other fund providers.<sup>250</sup> As the next section will show, this alarming truth is even more troubling when reconsidered in light of insights into retail investors' behaviors and financial literacy.

#### B. A Perfect Storm: The Misalignment Between Retail Investors and ESG Fund Disclosures

As Part II(B) *supra* discussed at length, retail investors have a strong interest in ESG investing. Unfortunately, they also have a "striking ability to do the wrong thing" when it comes to making investment decisions.<sup>251</sup> Much of investors' confusion can be explained by poor

246. ESG Mutual Fund and ETF Note Data (on file with author).

247. SEC, Risk Alert: The Division of Examinations' Review of ESG Investing 4 (Apr. 9, 2021).

248. *Id.*

249. See Ramonas, *supra* note 23.

250. See Ramonas, *supra* note 22.

251. Andrea Frazzini & Owen Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns*, 88 J. FIN. ECON. 299, 319 (2008).

disclosure<sup>252</sup> and wrongly held beliefs.<sup>253</sup> But investors are partially to blame as well: they do not often consult disclosures, and when they do, usually do not consider them in great depth.<sup>254</sup> If they did, they might identify the ESG fund labeling problem highlighted in the previous section.

The below portion explores investor habits when researching funds and reading disclosures, and the implications of these findings within the ESG fund context. One analyst summarized the situation perfectly: “Most investors don’t spend a lot of time looking under the hood. But . . . if more knew that [ESG funds] were in fossil fuels, they’d think twice.”<sup>255</sup>

While the specifics of a fund’s investment strategy can be found in its prospectus, summary prospectus, annual reports, or statement of additional information, investors admittedly do not always read or comprehend such materials; several investors surveyed stated they do not review funds’ disclosure materials at all.<sup>256</sup> One study showed that 37% of investors review fund disclosures “some of the time,” and 12% “never” do.<sup>257</sup> Retail investors prefer visual aids, like graphs and charts: Respondents said they tend to skip over the long verbiage and legalese, such as the type highlighted in SUSL’s summary prospectus, *supra* Part III(A)(3).<sup>258</sup> Of what investors do read, they mostly focus

252. Daniel Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 Y. J. REG. 625, 656 (2019) (“[I]t borders on tautological to note that investors’ knowledge of ESG issues depends on their access to ESG information. Accordingly, making sustainability data more useable and more relevant to mainstream investors will help increase the investor community’s exposure to, and understanding of, sustainable investing.”).

253. Notably, one-fourth to one-third of investors believe that ESG investing is limited to traditional exclusionary screening. This misperception was most prevalent amongst the retail investor community. CFA INSTITUTE & PRINCIPLES FOR RESPONSIBLE INVESTMENT, ESG INTEGRATION IN THE AMERICAS: MARKETS, PRACTICES, AND DATA 59, 69 (2018).

254. See, e.g., Letter from Charles V. Callan, SVP Regulatory Affairs, Broadridge Financial Solutions, Inc., to Mr. Brent J. Fields, Sec’y SEC 3, 44 (Oct. 31, 2018), <https://www.sec.gov/comments/s7-12-18/s71218-4595392-176342.pdf> [<https://perma.cc/39GW-AXV8>].

255. Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, THE WALL ST. J., (Nov. 11, 2019), <https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200> [<https://perma.cc/KQ8H-AL7U>].

256. Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, 87 Fed. Reg. 72758 (Aug. 5, 2020) (to be codified in 17 C.F.R. §§ 200, 230, 232, 239, 249, 270, and 274).

257. Letter from Charles V. Callan, *supra* note 254, at 3.

258. As *supra* Part III(A) demonstrated, no funds incorporated the visual aids and charts respondents preferred, and all exclusively included long verbiage and legalese.

on the fund's performance and the portfolio's holdings.<sup>259</sup> Neither of these categories addresses the fund's ESG criteria, and the latter is not even required to appear in a summary prospectus. As seen in Part III(A), funds normally place information regarding their ESG strategy in the Principal Investment Strategies section. However, those are not widely consulted: Only 21% of investors "always" review the fund's investment strategy and objective, whereas 34% and 32% review those two respective categories "most of the time."<sup>260</sup>

After reading Part III(A), it should not come as a surprise why investors consider fund disclosures recondite.<sup>261</sup> Specifically, 72% of respondents surveyed said regulatory disclosures are "not easy" to understand, and just 4% said they are "very easy" to understand.<sup>262</sup> These findings are supported by other investor surveys, which have consistently found that investors view funds' shareholder reports as too lengthy and complicated, and difficult for the average investor to use to effectively find information of interest.<sup>263</sup>

A key driver of investor confusion was too much technical writing.<sup>264</sup> As Part III(A)(3) demonstrated, that was one of the main challenges in comprehending funds' Principal Investment Strategy sections, which were full of legalese and financial jargon. Additionally, ESG fund disclosures are often vague and technical with respect to describing their investment strategies, which can vary widely.<sup>265</sup> Because the ESG moniker encompasses such a broad range of objectives, and the terminology surrounding such strategies is not uniform,<sup>266</sup> the nuances that distinguish funds from each other are far from clear.

259. Letter from Charles V. Callan, *supra* note 254, at 22 (reporting that 41% of investors surveyed always review fund performance information, and another 34% doing so "most of the time." Additionally, 32% and 35% of surveyed investors review the portfolio holdings information, respectively).

260. *Id.*

261. Letter from Charles V. Callan, *supra* note 254, at 2.

262. *Id.* at 21–22.

263. *Id.* at 5–6 (reporting the responses from surveyed retail investors who generally found a mutual fund's disclosure documents to be too long and overwhelming, and preferred disclosures that can be read in a few minutes and that focus on essential information).

264. *Id.* at 23.

265. See e.g., Jon Hale, *4 Things to Keep in Mind About Sustainable Investing in 2022*, MORNINGSTAR (Jan. 10, 2022) <https://www.morningstar.ca/ca/news/217966/4-things-to-keep-in-mind-about-sustainable-investing-in-2022.aspx> [https://perma.cc/8QLA-9DBT] ("Sustainable investing is not a singular approach but instead represents a range of methods that investors can use to generate competitive investment returns while helping generate positive outcomes for people and planet.").

266. One industry expert says "the biggest frustration on behalf of investors is there's no standardization within [the ESG] industry." See Otani, *supra* note 255.

ESG funds also impose extra burdens on investors who hope to determine a specific fund's ESG characteristics; ESG investors are forced to figure out whether an "investment's combination of ESG strategy, ESG performance, financial return, and cost is suitable for them."<sup>267</sup> While it is true that an investor needs to determine whether an investment fits their financial needs and risk tolerance when making any investment decision, "the burden . . . is increased under the ESG mantle" given the lack of industry standardizations: "even the most motivated of investors will struggle to unpack what ESG means for a particular fund in a meaningful way."<sup>268</sup> And yet, "despite investors' seemingly limited competence, regulatory and market developments increasingly require retail investors to navigate the financial markets themselves."<sup>269</sup> Although the data is facially concerning, even more troubling is the very real possibility that those surveyed might be overstating their financial literacy.<sup>270</sup>

This is not just a problem for retail investors. Sophisticated investors also struggle to comprehend complex disclosures: "Disclosures often demand *more* than basic skill in reading texts and numbers. Disclosees must negotiate unfamiliar and complex problems where mistakes are easy, a full and exact command of data is needed, and one misunderstanding can be fatal."<sup>271</sup> Because struggling to understand complex financial information is shown to contribute to poor financial decision making,<sup>272</sup> complex and lengthy disclosures are likely to remain a significant headwind for all investors.

In sum, the fund disclosure landscape is ineffective for retail investors. As Carl Schneider and Omri Ben-Shahar explain, many investors struggle to understand disclosures "because they are not

267. Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1940 (2020).

268. *Id.*

269. Jill Fisch & Tess Wilkinson-Ryan, *Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice*, 162 U. PA. L. REV. 605, 606 (2014).

270. See OSCAR CONTRERAS & JOSEPH BENDIX, MILKEN INST., FINANCIAL LITERACY IN THE UNITED STATES 15 (2021) (reporting that most U.S. adults also tend to overestimate their financial knowledge and their ability to manage financial products and services, and finding that despite the low levels of financial knowledge reported by the study, more than 70% of respondents gave themselves high scores); see also SEC, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS (2012).

271. CARL SCHNEIDER & OMRI BEN-SHAHAR, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 86 (Princeton Univ. Press, 2014).

272. See generally Kristina Rennekamp, Processing Fluency and Investors' Reactions to Disclosure Readability (Feb. 2012) (Ph.D. dissertation, The Univ. of Ill. at Urbana-Champaign) (Wiley Online Library).

literate or numerate enough to decipher them without reasonable effort. This is both because levels of literacy and numeracy are surprisingly low and because the reading levels of disclosures are surprisingly high.”<sup>273</sup> The fact that investors need to undertake significant efforts to compare funds to each other—including decoding various ratings systems, ESG investing frameworks, and funds’ generic and technical language—and that they do not when researching other investment opportunities, strongly suggests the regulatory regime is not providing investors with sufficient support, nor are ESG funds adequately self-regulating.

It is possible that the SEC’s proposed rules will reduce many of the challenges investors face. After all, the ESG Fund Disclosure Rule would group funds into categories, require funds to produce more visually engaging disclosures and use plain English, include a standardized chart for ESG-Focused funds to utilize, and reorganize disclosure material for a more tailored approach. These efforts would mitigate some of the documented comprehension problems identified in this section. However, there still remains the problem that few investors consult these materials.

#### IV. A FRAMEWORK TO RESOLVE THE ESG FUND LABELING PROBLEM

As Parts II and III have shown, the ESG fund marketplace resembles a supermarket aisle where cereals are labeling themselves as “healthy” despite having similar sugar and caloric breakdowns to their traditional (and less expensive) counterparts. Not only that, but the cereal boxes are not providing consumers with the information they need to determine this.

Now, imagine a regulation was promulgated by the Food and Drug Administration (FDA) that mirrored the SEC’s proposed rules in many respects. To start, the rule classified “healthy” cereals into two main groups: “Health-Integrated” and “Health-Focused” cereals. “Health-Focused” cereals also included a subset of cereals, called “Health Impact” cereals, which prioritized the nutritional value of their cereals to an even greater degree. According to the rule, because “Health-Focused” cereals more meaningfully incorporated healthy ingredients into their cereals, they would face increased labeling and disclosure requirements. On the other hand, “Health-Integrated” cereals could not use any health-related labels in its name.

273. SCHNEIDER & BEN-SHAHAR, *supra* note 271, at 80.

If the sole purpose of selecting a cereal was to find the healthiest option, then a system like this one might make sense: Only the cereals that are sufficiently healthy according to the FDA would be able to market themselves with such labels, and consumers looking for healthy options would only be left with the healthiest of choices. But just as investors turn to ESG funds for a litany of reasons, consumers might turn to “healthy” cereals for a variety of reasons. Undoubtedly, some are looking for the healthiest cereal, but life experience suggests these cereals usually do not taste the best. Other shoppers might look for a cereal that tastes better than the healthiest option, but is still healthier than a traditional, full-sugar cereal. Just as investors interested in ESG funds balance returns and impact, consumers balance health and taste. And just as a “healthy” cereal might vary for consumers based on their specific dietary needs, investors’ preferences on an ESG fund’s priorities will differ as well.<sup>274</sup>

Similarly, imagine if the regulation required that only 80% of the cereal included in the box needed to meet the health criteria listed to qualify as a “Health-Focused” or “Health Impact” cereal. In fact, in order to make their “Health-Focused” cereals still taste good, brands include extra-sugary pieces of cereal in the box to counterbalance the taste from the healthier 80% that meets the “Health-Focused” standards. Surely, some consumers might be upset to learn that the cereals they bought specifically for health-purposes gave them as much, or even greater, exposure to the unhealthy ingredients they were trying to avoid.

This analogy is meant to show: (1) there are benefits to allowing Integration funds to label themselves accordingly, and (2) that the 80% investment allocation requirement cannot apply equally to all funds that incorporate ESG criteria, and for ESG-Focused and Impact funds, should be higher than 80%. While such a threshold may be appropriate for Integration funds, it would conflict with many investors’ “extra-market” expectations<sup>275</sup> if an ESG-Focused or Impact fund had a sizable portion of the fund not adhering to its investment criteria, or even worse, directly working against investors’ intentions and motivations for investing in the fund in the first place. The

274. For example, some ESG investors will look to have an impact by directly engaging with a corporation’s management, whereas other investors will use their funds to support companies with industry-leading environmental practices.

275. See Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFs*, 13 WM. & MARY BUS. L. REV. 441, 451 (2022) (noting that supporters of sustainable investing see it as a way to positively enact social and environmental change).

Proposed Names Rule will keep ESG funds in a gray area (albeit a different one). The below sections explore these ideas in more detail.

A. All ESG Funds Should be Required to Label Themselves According to the Classification under the SEC's Proposed Taxonomy

Under the proposed ESG Fund Disclosure Rule, the SEC would consider it materially deceptive or misleading for an Integration fund to use any ESG terminology in its name.<sup>276</sup> However, the SEC is also debating whether to permit Integration funds to label themselves using ESG terminology so long as they also include the “integration” label.<sup>277</sup> The SEC should.

To provide investors with the best opportunity to identify which funds incorporate ESG factors to the extent that most closely aligns with their personal investing objectives, the SEC should require all ESG funds—Integration, ESG-Focused, and Impact funds—to label themselves as such. Specifically, the terms, as defined by the SEC in the Proposed ESG Fund Rule or as modified in the final version, should be included in the funds' names (e.g., the “ABC ESG Integration Fund”), along with an accompanying explanation of the label's significance.

Some view ESG investing as a strategy to maximize returns. For these investors, any positive societal ESG-related benefit is incidental to their primary objective of maximizing profits. However, if these Integration funds cannot label themselves as such, investors interested in the profit-maximizing qualities of ESG strategies will struggle to find funds that consider ESG factors to the extent they desire. They may naturally turn toward ESG-Focused funds, but these funds, which consider ESG factors as a primary focus of the fund's strategy, might not deliver the returns these investors seek as they prioritize impact to a greater extent than the investor might be comfortable with. By allowing Integration funds to label themselves accordingly, the SEC can enable profit-seeking ESG investors to more easily find the funds that best match their objectives. Plus, the accompanying description—which makes clear the extent to which the Integration fund considers ESG factors—should mitigate investor confusion.

276. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36613–14 (June 7, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 74, 279).

277. *Id.* at 36614.

Relatedly, if Integration funds are required to use a label in their names, it would trigger the Names Rule and its 80% investing requirement. For many reasons, it might be difficult for a fund that passively considers ESG factors to adhere to the 80% policy the way an ESG-Focused fund might. Therefore, the SEC should consider whether to exempt Integration funds from the requirement, or to lower the percentage threshold. If a fund chose the former path, prominent disclosure of this fact in the fund's prospectus, and on their fund website as well, could alert investors to this exemption.

Investors would likewise benefit from ESG-Focused and Impact funds incorporating these labels into their names. As the SEC has recognized on several occasions, a fund's name is critical to investors and their ultimate decision to invest.<sup>278</sup> Therefore, funds should be required to include these classification labels in their names. Investors will be able to discern the extent to which a given fund incorporates ESG factors into its investment selection process, which ultimately, is one of the main objectives of the proposed rules.<sup>279</sup>

#### B. ESG-Focused and Impact Funds Should Have Higher Investment Allocation Requirements than 80%

While it is unrealistic for funds to achieve 100% compliance with the fund's investing strategy, this Note argues that an 80% investment policy is too low for ESG-Focused and Impact funds. Following the SEC's proposals, ESG-Focused and Impact funds are being held out as prioritizing ESG objectives to a significant extent, and therefore, should be abiding by their principal strategies for more than 80% of the funds.<sup>280</sup> For other funds subject to the Names Rule, their investors' objectives are not counteracted by how the other portion of the fund is managed. For instance, the "ABC Brazil Fund" can be invested in 20% non-Brazilian stocks, and that would not work against the goal of investing in Brazilian securities. But when ESG funds, which seek to balance impact and returns, invest in firms that are excluded from the 80% of the fund, they undermine the key reason

278. *See, e.g., id.* at 36654 (noting in the preamble to the Proposed Names Rule that the name of a fund can communicate a great deal to an investor, a fund's name is often the first piece of fund information an investor sees, and although investors should go beyond the name itself and look closely at a fund's underlying disclosures, a fund's name can have a significant impact on their investment decisions).

279. *Id.* at 36597-98.

280. This is especially true if the SEC decided to allow Integration funds to use ESG labels in their names and/or Integration labels become required to comply with the Names Rule's 80% policy.



why many invested in the fund in the first place: to have an extra-market impact with their dollars.<sup>281</sup> In other words, the goal for some investors (e.g., the investors discussed *supra* Part II(B)), is dramatically different than for those investing in other types of funds, because the former is a form of principle-based investing, whereas other forms of investing are typically profit-based. The 80% requirement is insufficient for principle-based investing, which ESG-Focused, and in particular, Impact funds, hold themselves out as prioritizing.

In response to the call for a heightened investment allocation requirement, many will argue that ESG funds, like all funds, need to diversify risk and achieve competitive returns; therefore, a higher requirement than 80% might hurt investors more than any incidentally higher compliance.<sup>282</sup> For example, in 2022, the energy sector significantly outperformed the general market, and ESG funds hoping to maintain competitive returns were forced to turn to energy stocks to accomplish this goal.<sup>283</sup> However, this effort to compete with non-ESG benchmarks results in awkward situations, like when ESG funds have greater exposure to energy stocks than their traditional counterparts,<sup>284</sup> or energy stocks become the largest holdings in ESG funds despite explicitly screening out these securities.<sup>285</sup>

To this end, this Note suggests an 85% and 90% investment requirement would be more appropriate for ESG-Focused and Impact Funds, respectively. These percentages still provide fund managers with breathing room to manage their funds, while more effectively limiting the ability for funds to contradict their names and mislead investors. This is particularly true for Impact funds, which are

281. See MORGAN STANLEY, *supra* note 95, at 4; Barzuza et al., *supra* note 104, at 1250; Sardon, *supra* note 106; Gelfdand, *supra* note 107; Hickey, *supra* note 109; Clements, *supra* note 110, at 448; Chaffee, *supra* note 111, at 1304.

282. See Otani, *supra* note 255 (noting that energy stocks reliably produce gains during recessions, which makes them an important group for asset managers).

283. Jing Pan, *ESG funds are Quietly Buying Oil Stocks to Chase Gains After Their Poor Performance in the First Half—Here's the 1 Big Energy Play They Really Like*, YAHOO! NEWS (Jul. 22, 2022), <https://www.yahoo.com/now/esg-funds-quietly-buying-oil-163000152.html> [<https://perma.cc/NF2L-ZMUM>].

284. See Simpson et al., *supra* note 13 (noting one of the largest ESG ETFs that tracked the S&P 500 had greater exposure to twelve fossil fuel stocks than the actual S&P 500).

285. Lan Anh Tran, *Why Are There Oil Companies in My ESG Portfolio?*, MORNINGSTAR (June 21, 2022) <https://www.morningstar.com/articles/1098856/why-are-there-oil-companies-in-my-esg-portfolio> [<https://perma.cc/5YHD-6QU2>] (identifying two ESG funds in particular oil companies where energy stocks were among the largest holdings of the funds despite explicitly screening out companies involved in the extraction of thermal coal and oil sands).

recognized under the proposed taxonomy as the funds that prioritize ESG impacts to the greatest extent.

C. Funds Should Be Required to Disclose Their Exposure to Securities That Do Not Align with Their Primary Investing Strategy

As the proposed regulatory regime only prescribes how a fund discloses its investment selection process for their primary (i.e., 80%) strategy, investors will struggle to determine how a potential investment allocates a meaningful portion of its resources. Under both the current and proposed regimes, investors are unaware of how one-fifth of the fund is invested. In particular, an ESG fund could be investing in securities that many of its investors were trying to avoid, as was the case with the largest ESG fund.<sup>286</sup> It should be clear to investors if and when funds are investing in ways that are counter to their names and stated objectives. This will help both the profit-driven ESG investor<sup>287</sup> and the ESG impact-focused investor identify which funds best align with their wide-ranging objectives.

To achieve this goal, this Note proposes that all ESG funds subject to the Names Rule should be required to clearly and prominently disclose what percentage of the fund is invested in securities that do not comply with the investment criteria for the 80% portion of the fund, updated on a monthly basis. This monthly cadence will offer investors a somewhat frequent datapoint to consider when deciding whether to invest (or remain) in a fund and provide fund managers ample time to comply with the furnishing of this information.

For example, if the “ABC Fossil Fuel Free Fund” has 2% of its portfolio in an energy sector ETF, which is invested in securities that would not qualify for the fund’s primary strategy, the fund should be required to disclose this fact to investors. Not only is this fair for investors to be able to identify which funds best align with their objectives, but in this situation, the fund’s name is technically no longer an accurate description of the fund. Data shows that energy stocks typically account for at most 5% of ESG funds’ total holdings.<sup>288</sup>

286. See Simpson et al., *supra* note 13.

287. This returns-focused investor, for instance, might tolerate a fund having significant exposure to companies that would not have been selected for the portfolio’s investment criteria. As such, they might choose a fund with significant exposure to carbon majors or low governance firms for the potential profit.

288. See Otani, *supra* note 255 (identifying two ESG funds where energy stocks made up 4% and 2.7% of the fund’s total holdings, which was in comparison to energy shares accounting for

For perspective, energy shares make up about 5% of the S&P 500.<sup>289</sup> If certain ESG funds are at the same level as the S&P 500 level, it will alert investors to the reality that they have the same exposure to energy securities as they would in a traditional index fund, while incurring significantly higher fees associated with an ESG Fund. For funds that are meaningfully below this 5% benchmark, disclosing this fact can help them attract inflows from investors who are seeking to limit exposure to the energy sector. It will also shine a light on an often-unspoken reality of ESG funds: that they have been “slow to reduce their exposure to fossil fuels,” which “can sometimes seem at odds with the language funds include in their prospectuses.”<sup>290</sup>

#### D. Potential Criticisms and Responses

While the SEC’s proposed regulations have the potential to reduce misleading fund names and provide investors with specific information in a standardized framework on how funds approach ESG investing, they also raise some concerns. One objection to ESG-related regulations raised by a handful of law professors is that those same criticisms “might be made with equal force against other types of funds” and ESG funds are wrongfully being singled out.<sup>291</sup> Therefore, before creating regulations specifically for ESG funds, they argue that policymakers ought to determine “if the purported ESG issue is one that affects the entire fund market.”<sup>292</sup> The example these professors provide is the Names Rule. While they acknowledge that “ESG terminology in a fund name provides investors with limited information about a fund’s approach,” they contend that because this is true of other terms commonly used in fund names, like “blue-chip” or “capital preservation,” “the vagueness of ESG-names seems no worse . . . than other types of names suggesting investment strategies.”<sup>293</sup>

4.3% of the S&P 500); *see also* Kevin Schmidt, *ESG on the Edge: Controversy Weighs on Sustainable ETFs*, CNBC (Sept. 11, 2022), <https://www.cnbc.com/2022/09/11/esg-on-the-edge-controversy-weighs-on-sustainable-etfs.html> [<https://perma.cc/F5U7-WPGB>].

289. S&P DOW JONES INDICES, S&P 500 FACTSHEET 5, <https://www.spglobal.com/spdji/en/indices/equity/sp-500/#data> [<https://perma.cc/5XWM-S2XP>] (last visited Mar. 11, 2023).

290. *See* Otani, *supra* note 255.

291. Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 449 (2021).

292. *Id.*

293. *Id.* at 450.

While it is true that the names of various types of funds can be confusing, the professors' argument does not account for the inherent differences between ESG funds and all other funds that justify developing ESG-specific regulations. First, when comparing the motivations behind investing in "blue-chip" and ESG funds, as they do, it becomes clear that for many retail investors, the decision to enter an ESG fund is often motivated by both financial and "emotional drivers,"<sup>294</sup> which is not generally true for other investments, which are solely profit-driven decisions. For example, an investor might be one of the 70% of millennials willing to sacrifice yield for ESG outcomes and invest in an ESG Engagement fund to pressure a company to adopt better environmental practices;<sup>295</sup> but there is no analogous emotional driver, or financial trade-off, when investing in a "blue-chip" or any other type of fund. In addition, other potentially confusing terms used in fund names (e.g., "blue-chip") have generally recognized definitions, but ESG-related terms do not.<sup>296</sup> Therefore, ESG funds warrant more regulation to ensure investors are not confused by nebulous ESG lingo.

Another inevitable objection raised against any new disclosures is that they will be a financial and administrative burden.<sup>297</sup> Such a concern is particularly relevant in the ESG space, where there is not even consensus over what ESG data is material,<sup>298</sup> nor is there standardized and accurate data for fund managers to rely on.<sup>299</sup> Therefore, any mandates to require specific ESG metrics might result in unnecessary costs to issuers.<sup>300</sup> While it is true that developing a new disclosure will lead to increased costs to produce and maintain

294. Sally Hickey, *Advisers Need to Tap into ESG Emotional Drivers, Says Aviva*, FIN. TIMES (May 24, 2021), <https://www.ftadviser.com/investments/2021/05/24/advisers-need-to-tap-into-esg-emotional-drivers-says-aviva/> [<https://perma.cc/H3XE-4UW7>].

295. Sardon, *supra* note 106.

296. Clements, *supra* note 110, at 26 (explaining that the subtle distinctions between ESG fund strategies can impair easy investor comparison and confuse investors about what they're actually investing in).

297. See, e.g., Peirce, *supra* note 239 (outlining several aspects of the SEC's May 2022 proposals that may be costlier to implement than the SEC anticipates).

298. See generally David Lopez et al., *The Materiality Debate and ESG Disclosure: Investors May Have the Last Word*, CLEARY GOTTlieb (Jan. 11, 2022), <https://www.clearygottlieb.com/news-and-insights/publication-listing/materiality-and-esg> [<https://perma.cc/NY84-XZWD>]; see also Dan Papsun, *SEC's Climate Proposal Tees Up Test of 'Material' Info Standard*, BLOOMBERG L. (Mar. 23, 2022), <https://news.bloomberglaw.com/esg/secs-climate-proposal-tees-up-test-of-material-info-standard> [<https://perma.cc/TAZ5-N4YM>] (providing context on how the SEC's firm-specific climate disclosures are fueling the materiality debate).

299. Peirce, *supra* note 239.

300. ESG SUBCOMM., *supra* note 240, at 4.

disclosures, they might help funds attract new inflows: 57% of investors surveyed stated that a lack of information and understanding of sustainable investments prevented them from investing in the sector in the past,<sup>301</sup> so clarifying such issues might lead to new dollars entering ESG funds. In turn, as it becomes easier for investors to identify which funds align with their ESG investing objectives, fund managers may earn back part of the compliance costs.

Another objection made in response to proposals to simplify disclosures is that it is a quixotic task. Not only do retail investors rarely read such materials,<sup>302</sup> but the complex information included in the disclosures of financial products like ESG funds cannot be made simple enough that those with financial literacy problems would be able to understand them.<sup>303</sup> If a disclosure framework were to break down the complexities into simpler terms, they argue, then disclosures will become even more cumbersome than they already are.<sup>304</sup>

Opponents of efforts to simplify disclosures are correct that breaking them down to the point where every concept is explained in the simplest terms possible would make disclosures prohibitively long and unwieldy. However, there is significant room to improve and simplify disclosures before they become over-simplified. As these same critics of simplifying disclosures admit,<sup>305</sup> even financially literate and numerate investors often struggle to understand disclosures. Seemingly, there are changes that can be made to make disclosures more accessible without becoming overly simplified to the point of concern.<sup>306</sup>

A final objection to additional regulation is that there is only so much legwork that regulation can do for an investor. Even the SEC

301. Schroders, *Global Investor Study: Is Information the Key to Increasing Sustainable Investments?* 5 (2019).

302. *See, e.g.,* INV. CO. INST., *UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 12* (2006) (reporting only 30% of surveyed mutual fund investors consulted shareholder reports before making their most recent purchase, and only 34% read the fund's prospectus); *see also* ABT SRBI, *MANDATORY DISCLOSURE DOCUMENTS TELEPHONE SURVEY 56* (July 30, 2008) (finding that nearly two-thirds of respondents who said that they received mutual fund prospectuses "rarely," "very rarely," or "never" read them).

303. SCHNEIDER & BEN-SHAHAR, *supra* note 273, at 92. "[S]implifying fails because the complex isn't simple and can't easily be made so." *Id.* at 123.

304. "[S]horter words means more words. Many words make forms repellently long and cognitively overwhelming." *Id.* at 127.

305. *Id.* at 86.

306. For instance, the ESG Strategy Overview table in the SEC's Proposed ESG Fund rule provides investors with a concise yet informative source for key details about a fund. *See supra* note 223.

staff recognizes the limits of regulation, acknowledging that at some point retail investors need to fend for themselves.<sup>307</sup> The SEC is correct that ultimately the responsibility lies in the investor's hands; however, that does not mean regulation cannot make it easier for investors to research and identify funds that best match their objectives. Given the industry's lack of standardized terms and definitions of fundamental ESG concepts, additional regulation can be worthwhile without being overboard.

## V. CONCLUSION

This Note has shown that regulation has become necessary to fix the ESG fund labeling problem. The need for regulation is particularly strong because ESG funds are a popular investment option amongst retail investors—an investor base that generally struggles to comprehend complex financial information. Specifically, ESG fund names have misled investors, and the funds' accompanying disclosures are not adequately explaining their specific ESG criteria in ways retail investors can understand. Therefore, regulation needs to be developed so all investors interested in ESG funds can more easily identify which funds align best with their personal investing objectives.

In many respects, the SEC's proposed rules achieve these objectives and reduce the ESG fund labeling problem; but they also fall short in critical areas, meaning investors may still struggle to identify which funds best align with their investing objectives. This Note therefore argued that the SEC should modify its proposed regulations to not only provide investors with the tools they need to make more informed investment decisions, but also require ESG funds to adhere to stricter investing and labeling requirements. These changes go to "the heart of [the] mission at the SEC, which is to protect investors by promoting transparency and accountability around investment decision-making."<sup>308</sup>

307. ESG SUBCOMM., SEC ASSET MGMT. ADVISORY COMM., UPDATE ON PROGRESS IN ESG SUBCOMMITTEE 8 (Sept. 16, 2020) ("Ultimately, a values-based decision rests on the shoulders of the investor. If they are unable to satisfactorily confirm alignment between a fund's assets, its stated strategy and the values they seek to support, they should pass on the investment opportunity").

308. Comm'r, Allison Herren Lee, *It's Not Easy Being Green: Bringing Transparency and Accountability to Sustainable Investing*, SEC (May 25, 2022), <https://www.sec.gov/news/statement/lee-statement-esg-052522> [<https://perma.cc/U92K-USUD>].

APPENDIX

Figure 1<sup>309</sup>

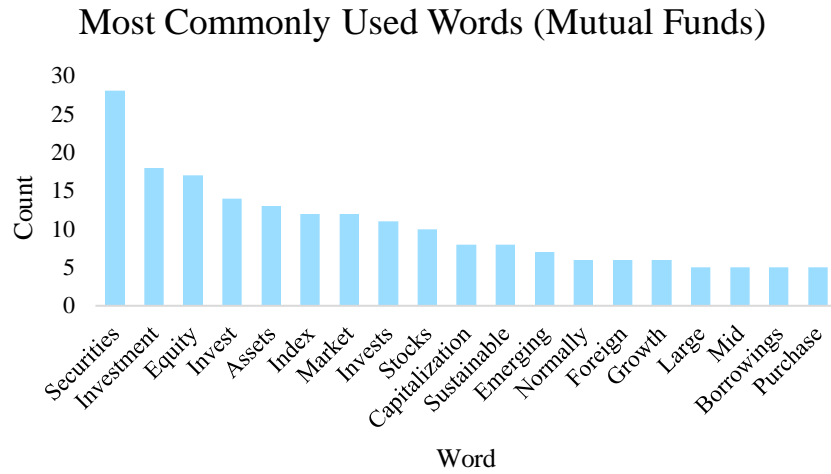
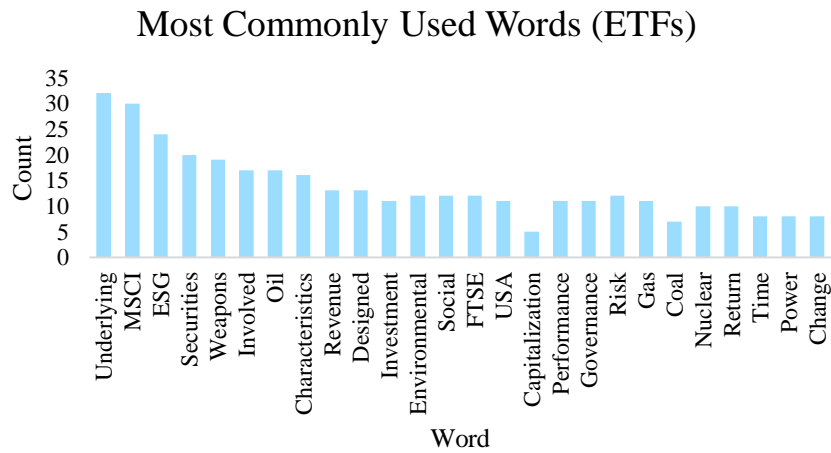


Figure 2<sup>310</sup>



309. ESG Mutual Fund and ETF Note Data (on file with author).

310. ESG Mutual Fund and ETF Note Data (on file with author).