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DO ESG MUTUAL FUNDS DELIVER ON THEIR PROMISES?

by Quinn Curtis, Jill Fisch, and Adriana Z. Robertson

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Corporations have received growing criticism for their role in climate change, perpetuating racial and gender inequality, and other pressing social issues. In response, shareholders are increasingly focusing on environmental, social, and corporate governance (ESG) criteria in selecting investments, and asset managers are responding by offering a growing number of ESG mutual funds.

But are these funds giving investors what they promise? This question has attracted the attention of regulators, with the U.S. Department of Labor (DOL) and the Securities and Exchange Commission (SEC) both taking steps to regulate ESG funds.

Combining comprehensive data on mutual funds with proprietary data from several of the most significant ESG ratings firms, we provide a unique picture of the current ESG environment with an eye to informing regulatory policy. We find that ESG funds offer their investors increased ESG exposure, vote their shares differently from non-ESG funds, and are more supportive of ESG principles. We also find that they do so without increasing costs or reducing returns.

We conclude that ESG funds generally offer investors a differentiated and competitive investment product that is consistent with their labeling and see no reason to single out ESG funds for special regulation.

I. Empirical Analysis

This section presents our empirical analysis of the differences between ESG funds and other mutual funds. We find that ESG funds generally deliver greater ESG exposure in their portfolio allocations than non-ESG funds, that they are more likely than other funds to oppose management in the proxy voting, particularly when votes are salient to ESG issues, and that they do not cost more or perform worse than similar non-ESG funds.

Table 1: ESG Mutual Funds in Our Sample

Panel A: Number of ESG Funds in Final Sample, by Type	
Identified by Fund Name	204
Identified Using Morningstar	241
Identified Using Either	303
Panel B: Selected Sub-Types of ESG Fund	
"Environmental" Funds	48
Indexed ESG Funds	69
Specialized ESG Funds	88

A. Portfolio Composition

We start by calculating what we term a fund's "ESG tilt"—the asset-weighted average of the ESG scores of the fund's portfolio companies, using ESG scores from four separate rating providers. We compare that tilt to the non-ESG funds in our sample. Figure 1 contains histograms using weighted issuer-level ESG. The shaded histograms represent the distribution of ESG funds, and the transparent histograms represent conventional funds. "ESG funds" refer to funds that either identify themselves as ESG by their name or are identified by Morningstar as ESG funds. The non-ESG funds include all funds in the Center for Research in Security Prices (CRSP) Survivorship Bias Free Mutual Fund Database (other than ESG funds) with enough data to produce a portfolio tilt score. The histograms are constructed using quarterly fund-level data.

The striking thing about Figure 1 (next page) is the consistency across the panels. Issuer-level ESG ratings are often criticized for being inconsistent with one another, yet using any of the measures of ESG tilt, we find that ESG funds have portfolios with higher ESG scores, on average, than non-ESG funds. The general shapes are similar,

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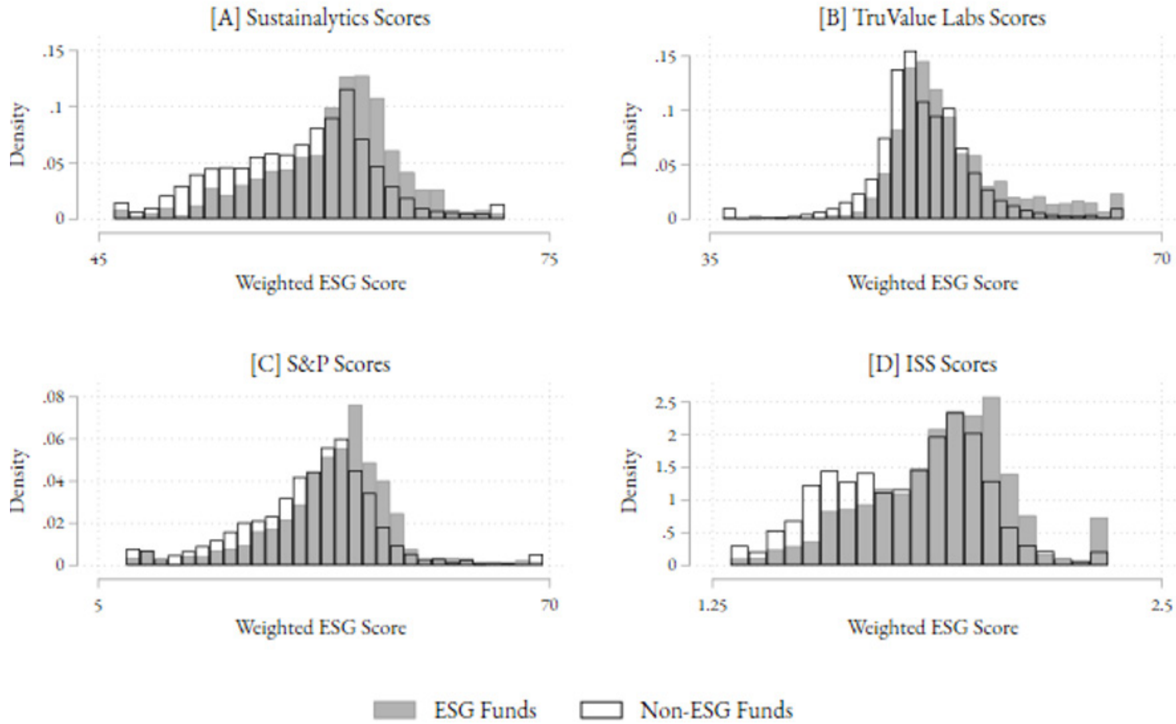
Authors' Note: The authors thank ISS, S&P, and TruValue for providing us with eheir ESG ratings.

Figure 1: ESG TILT Mutual Fund Portfolio: Weighed ESG Scores



but the distribution for ESG funds is shifted slightly to the right of the non-ESG distribution in all four panels. Notwithstanding this shift, there are some ESG funds with low ESG tilts, just as there are some funds that are not classified as ESG funds that have high ESG tilts. As a result, even if the average ESG fund has increased exposure to strong ESG companies, there could be a group of ESG funds that are conventional funds masquerading as ESG funds. We note, however, that different funds generally score in the bottom quartile, depending on which ESG rating is used to measure tilt.

There are some limitations to simply examining histograms. We therefore estimate a series of regressions and present the results in Table 2 (page 10632). The results are strikingly consistent. Using all four ESG ratings, and in both panels A and B, we find that ESG funds have portfolios that are substantially more tilted toward companies with high ESG ratings than non-ESG funds. The coefficients on the dummy variables are large and highly statistically significant These relationships are unlikely to be the result of chance: the p-values associated with all 16 of the coefficients are smaller than 0.001.

The category of "ESG funds" is extremely broad, and environmental concerns can be qualitatively different from governance concerns. We therefore investigate this issue further. We manually identify environmental funds by reading the summary prospectus of each ESG fund. We construct the "E-tilt" of each fund in a manner analogous to the ESG-tilt measures discussed above, using each provider's environmental scores. We then estimate a version of the regressions presented in Table 3 (page 10633), where the dependent variable is the environmental tilt of the fund, rather than the ESG tilt, and the independent variable of interest is an indicator variable for the relevant type of environmental funds.

The results are presented in Table 3. Using either Sustainalytics, S&P, or ISS scores, environmental funds tilt substantially more toward issuers with high environmental ratings than comparable non-environmental funds.

The biggest difference is in columns 3 and 4. Using environmental scores constructed using data from TruValue Labs, environmental funds identified using the names (column 3) have a slightly higher environmental tilt in their portfolios, although this difference is not statistically significant. Using funds identified by Morningstar, we find that while the point estimates are negative, the t-statistics are quite small, indicating that the relationship is null. This result may be related to inherent features of the TruValue ratings. Unlike the other ratings providers, TruValue's emphasis is on SASB categories, and it did not provide us with "pure" environmental ratings. We constructed the TruValue environmental ratings by identifying and aggregating the relevant SASB categories. This may have introduced noise into our measure, which would undermine the reliability of the estimates in columns 3 and 4.

B. *ESG Fund Voting Behavior*

We turn next to the question of whether ESG funds vote the shares in their portfolio companies differently from non-ESG funds. There are at least three reasons why we might expect ESG funds to vote against management. First, many ESG funds claim to be seeking to persuade

Table 2: ESG Portfolio Tilts—ESG/Non-ESG Funds

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG Name	1.775***		2.223***		3.048***		0.101***	
	(7.01)		(7.03)		(5.38)		(7.96)	
Morningstar		1.212***		1.539***		2.515***		0.051***
		(3.97)		(6.56)		(4.22)		(4.61)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.071	0.071	-0.002	-0.002	-0.002	-0.002	0.046	0.046
Number of ESG Funds	174	200	189	218	164	186	182	211

Panel B: ESG Tilt Measured by ESG Percentile

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG Name	12.377***		14.899***		11.873***		13.273***	
	(7.90)		(8.23)		(6.60)		(9.01)	
Morningstar		9.018***		12.355***		9.105***		7.498***
		(5.41)		(8.49)		(4.86)		(4.88)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.381	0.380	0.247	0.246	0.263	0.261	0.402	0.399
Number of ESG Funds	174	200	189	218	164	186	182	211

t-statistics, computed using standard errors clustered by fund, in parentheses. * $p<0.05$, ** $p<0.01$, *** $p<0.001$

corporations to align their behavior with ESG values.[1] We would expect such funds to disagree with management about issues with high ESG salience. Second, fund voting behavior might be more salient to the investors in ESG funds than it is to the investors in conventional mutual funds. ESG funds market themselves as advancing certain social goals, and their investors may expect the funds' votes to align with those goals, leading ESG funds to vote against management more often. Finally, ESG funds might simply be more independent of management because they are operated by companies that are less likely to seek out 401(k) business from their portfolio companies, which is often argued to induce funds to toe the management line.

We investigate whether ESG funds vote differently by regressing a variable indicating that the fund voted against management's recommendation on a variable indicating that the fund is an ESG fund. In models one through three, we use company-year dummy variables to control for the average characteristics of each portfolio company. This allows us to compare ESG funds' votes with the votes of conventional funds *at each particular company*. This control is important because of the propensity of ESG funds to hold different portfolios from conventional funds.

In the first three regressions, we include an indicator variable that takes the value 1 if the fund is part of an ESG family (more than 50% ESG funds based on the CRSP data) or 0 otherwise. This is important because mutual fund voting has historically been highly correlated at the family level, with many fund families voting in lockstep. By including separate variables to identify ESG funds and funds in ESG families, it is possible to determine whether ESG voting patterns are entirely driven by ESG-specialist fund families.

In columns 4 through 6, we replace the company-year dummy variables with dummy variables identifying unique combinations of companies and fund families in a particular year. This provides additional robustness against the possibility that ESG fund support for ESG issues is driven solely by ESG-focused families.

Table 4 (page 10634) presents the results. Column 1 examines the relationship between classification as an ESG fund and the propensity to support shareholder proposals over management objections. The results show that ESG funds are substantially more likely to oppose management by supporting shareholder proposals than other funds invested in the same company.

Column 2 examines the subset of ESG funds we identify as having an explicit environmental focus ("E" funds). These tests focus on shareholder proposals with ESG salience, but this regression controls for funds with an explicit environmental focus and shareholder proposals that raise environmental issues. The results show that E funds

1. *See* Khurram Gillani et al., *Active Engagement: How Top ESG Managers Make a Difference*, John Hancock Inv. Mgmt. (June 2, 2017), https://www.jhinvestments.com/viewpoints/esg/active-engagement-how-top-esg-portfolio-managers-make-a-difference [perma.cc/R4BV-8NYD].

Table 3: Environmental Portfolio Tilts—Environmental / Non-Environmental Funds

Panel A: E Tilt Measured by Weighted E Scores

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG Name x Environmental Fund	3.723*** (5.68)		1.644 (0.89)		5.488*** (3.75)		0.283*** (4.61)	
Morningstar x Environmental Fund		1.897* (2.10)		-1.627 (-0.64)		5.128* (2.46)		0.156* (2.22)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.106	0.106	0.021	0.021	0.004	0.004	0.062	0.061
Number of E Funds	38	19	41	21	36	18	40	20

Panel B: E Tilt Measured by E Percentile

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG Name x Environmental Fund	14.290*** (5.36)		2.058 (0.68)		11.647*** (3.34)		19.336*** (6.29)	
Morningstar x Environmental Fund		6.650 (1.81)		-2.556 (-0.60)		8.968 (1.88)		9.387* (2.30)
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46,432	46,432	50,658	50,658	41,778	41,778	48,304	48,304
adj. R-sq	0.106	0.106	0.021	0.021	0.004	0.004	0.062	0.061
Number of E Funds	38	19	41	21	36	18	40	20

t-statistics, computed using standard errors clustered by fund, in parentheses. * $p<0.05$, ** $p<0.01$, *** $p<0.001$.

are statistically no more or less likely than conventional funds to oppose management on shareholder proposals in general. However, when the shareholder proposals address environmental issues, "E" funds are far more likely than other funds to oppose management.

Column 3 looks at fund votes in uncontested director elections. The results in Column 3 show that ESG funds vote differently from non-ESG funds in these elections and are about twice as likely to withhold votes in an uncontested director election.

Columns 4 through 6 run the same set of regressions but with fixed effects at the firm x fund family x year level. The results are robust to these controls and are not driven by family effects.

In summary, we find substantial differences between the voting behavior of ESG and non-ESG funds. There is compelling evidence that they vote differently from their peers, and that a typical ESG fund's mission involves voting policies as well as stock selection.

C. Performance and Fees

We now ask whether ESG funds charge higher fees than comparable non-ESG funds. We consider both risk and opportunity cost, asking whether the returns offered by ESG funds differ systematically from those of comparable non-ESG funds. We adjust these returns for risk and look for differences between ESG and non-ESG funds.

We do not seek to settle the question of whether ESG investing is an advisable strategy here. Our goal is much narrower and more modest: to evaluate whether the empirical claims that underlie DOL's concerns about the inclusion of ESG funds in 401(k) plans are supported by the evidence. In other words, we look at ESG fund performance over our sample period for evidence suggesting that investors in such funds are bearing short-term costs in terms of reduced performance or increased risk.

To assess ESG fund fees, we regress expense ratios on our identifiers of ESG funds and present the results in Table 5 (page 10635). In this analysis we use fund class x year level observations, that is, one observation per fund share class per year. We also include a series of additional control variables and fixed effects in the regressions. First, we include objective code x year fixed effects. As in the tilt regressions presented in Tables 2 and 3, this allows us to ensure that we are comparing apples to apples by comparing the expenses of funds with similar investment objectives at the same time. We also control for whether a fund is an index fund.

We include three different controls for size, since fund fees are known to vary systematically by size.[2] First, we

2. Mutual funds enjoy economies of scale at both the fund level and the sponsor level. Vanguard founder Jack Bogle testified before the U.S. Congress that there are "staggering" economies of scale in the mutual fund industry. *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Cap. Mkts., Ins. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 108th Cong. 78 (2003) (statement of John C. Bogle, Founder, Vanguard Group); *see also* John A. Haslem, *Mutual Fund Economies of Scale:* Nature and Sources, J. Wealth Mgmt., Summer 2017, at 97.

Table 4: Likelihood of Voting Against Management Recommendation (LPM)—ESG/Non-ESG Funds

	Shareholder Props.		Unopposed Director Elections	Shareholder Props.		Unopposed Director Elections
	(1)	(2)	(3)	(4)	(5)	(6)
ESG Fund Indicator	0.126***		0.020***	0.117***		0.019***
	(4.16)		(3.29)	(5.55)		(4.71)
Enviro Fund Indicator		-0.036			0.063	
		(-1.02)			(1.25)	
Enviro Issue Indicator		-0.064***			-0.064***	
		(-18.63)			(-17.50)	
Enviro Fund x Enviro Issue		0.126**			0.137*	
		(3.07)			(2.51)	
ESG Family Indicator	0.271***	0.387***	0.238***			
	(7.95)	(17.75)	(6.16)			
Constant	0.460	0.469	0.060	0.463***	0.471***	0.061***
Firm x Year FE	Yes	Yes	Yes	No	No	No
Fund Fam. x Firm x Yr. FE	No	No	No	Yes	Yes	Yes
Observations	788,913	788913	14,438,612	788,913	788913	14,438,612
R-squared	0.283	0.282	0.205	0.653	0.652	0.515
Number of ESG Funds	231	223	223	231	223	223

t statistics, computed using standard errors clustered by fund, in parentheses. * p<0.05, ** p<0.01, *** p<0.001

include a control variable for the total net asset value of all funds managed by the fund manager. Second, we control for the total net asset value of the fund by adding up the size of all the fund's classes. Finally, we control for the total net asset value invested in the particular class itself. For all three of these variables, we use the natural logarithm of the size. We cluster standard errors by fund. The results in Table 5 show no evidence that ESG funds are more expensive, as measured by their expense ratios, than non-ESG funds.

In Table 6 (p. 10635), we present similar regressions to the expense-ratio regressions in Table 5. We use returns as the dependent variable in columns 1 and 2. In columns 3 and 4, we adjust these returns for risk by computing Sharpe ratios. An investment's Sharpe ratio, defined as its return divided by its standard deviation, is a common risk-adjusted performance measure. The Sharpe ratio captures the incremental return that an investor receives per unit of risk. A higher Sharpe ratio implies a higher risk-adjusted return. Because return data are available at the monthly level, we use fund class x month level observations and objective code x month fixed effects. Like Table 5, we control for objective codes and whether the fund is an index fund using fixed effects, and we include the manager, fund, and class controls for size. We cluster the standard errors by fund and month.

The results in Table 6 suggest that investors in ESG funds do not give up returns. Both returns and Sharpe ratios are higher for funds identified as ESG by their names (columns 1 and 4), and the point estimates are also positive for the funds identified by Morningstar, although the results are not statistically significant.

As in the portfolio tilt analysis, where we looked specifically at environmental funds, we repeat our analyses of costs and performance, focusing on two categories of funds. First, we investigate the differences, if any, between indexed ESG funds and actively managed funds with respect to fees and performance. Second, we investigate whether there are differences between "generic" ESG funds and specialized funds in terms of costs and performance.

We begin by splitting out indexed ESG funds from their actively managed competitors. We then repeat the analyses in Tables 5 and 6, this time including a variable indicating that a particular ESG fund is indexed. Because we are already including a variable to control for whether a fund is an index fund, adding in this new variable allows us to answer the question: do indexed *ESG* funds behave differently from actively managed ESG funds, in terms of either expenses or performance? The answer, with respect to fees, is no.

We also find that ESG index funds perform slightly better than actively managed ESG funds. This incremental performance boost is statistically significant at the 5% level with respect to raw returns (the analogue to columns 1 and 2 in Table 6), and is marginally significant (i.e., significant at the 10% level) with respect to Sharpe ratios. We hasten to add that these performance results are, by necessity, short-term, and may reflect a time period during which stocks in ESG funds performed particularly well. Nevertheless, they suggest that concerns about the performance of ESG funds may be overblown.

What about highly specialized ESG funds? We repeat the analysis presented in Tables 5 and 6, including a variable indicating that the fund is *both* an ESG fund *and* that

Table 5: Expense Ratios—ESG/Non-ESG Funds

	(1)	(2)
ESG Name	-0.00049	
	(-1.47)	
Morningstar		0.00017
		(0.70)
Class Size Control	Yes	Yes
Fund Size Control	Yes	Yes
Manager Size Control	Yes	Yes
Objective x Year FE	Yes	Yes
Index Fund FE	Yes	Yes
Observations	52,592	52,592
Adjusted R-squared	0.340	0.340
Number of ESG Funds	178	218

Table 6: Returns and Sharpe Ratios—ESG/Non-ESG Funds

	(1)	(2)	(3)	(4)
ESG Name	0.00214*		0.04917*	
	(2.62)		(2.80)	
Morningstar		0.00090		0.01647
		(1.86)		(1.62)
Class Size Control	Yes	Yes	Yes	Yes
Fund Size Control	Yes	Yes	Yes	Yes
Manager Size Control	Yes	Yes	Yes	Yes
Objective x Month FE	Yes	Yes	Yes	Yes
Index Fund FE	Yes	Yes	Yes	Yes
Observations	721305	721305	721186	721186
Adjusted R-squared	0.651	0.651	0.780	0.780
Number of ESG Funds	202	234	201	233

it is a highly specialized ESG fund, allowing us to investigate whether highly specialized funds behave differently than generic ESG funds.

Our findings are quite favorable for specialized funds. These specialized funds have lower expenses than either non-ESG funds or even generic ESG funds, although this difference is only statistically significant when we identify funds using the Morningstar list. Turning to performance, we find no statistically significant difference in any of the four specifications.

The results in this subsection indicate that ESG funds, on average, do not cost investors more than comparable funds in terms of higher fees, reduced returns, or diminished risk-adjusted performance.

II. The Implications of These Findings for Regulatory Policy

Our results stand in contrast to the criticisms of high costs, reduced performance, and greenwashing and generally point to a functional market.

As a result, we question the need for ESG-specific regulatory interventions. Rather, we argue that regulators should adopt a presumption against such interventions in the absence of clear evidence of ESG-specific problems. If there are issues with transparency around names or problems with fund costs, regulators should begin by questioning whether those issues are unique to ESG funds before making new rules targeting this segment of the market. Our results suggest that the answer to that question is generally "no."

A. The Empirical Picture

ESG funds offer their investors different portfolio and voting policies aligned with ESG goals as measured by ESG ratings, without higher fees, lower returns, or uncompensated risk. There is no evidence that ESG funds are not performing on ESG-specific matters, or that they are any worse than the rest of the mutual fund market on matters that are not ESG-specific.

The role of third-party information providers in improving the market is notable. Morningstar and ESG ratings providers have constructed extensive disclosure mechanisms well beyond what regulations require. These evaluations are inputs into our empirics. Our results should provide some comfort that this privately ordered system of information production is succeeding in providing useful information to investors.

B. The Pecuniary Benefits Debate

Much has been made of the possibility that ESG funds pursue social benefits at the cost of economic returns. If certain ESG funds are explicitly making decisions that sacrifice returns, we agree that this information should be disclosed to investors. And indeed, some funds do disclose on their websites that their investment strategy might lead them to sacrifice returns.[3] This disclosure should provide fiduciaries with clear and explicit notice that the funds' investment strategy might not be appropriate for an employer-sponsored pension plan under the Employee Retirement Income Security Act (ERISA). There is no need for any sort of ESG-specific rule here: plan sponsors can straightforwardly apply standard fiduciary principles in light of this disclosure and might reasonably exclude the fund from a 401(k) plan menu.

As a category, at least during the time period of our study, ESG funds performed a little better than other funds and cost about the same. If ESG funds do not seem

3. *See e.g.*, Eaton Vance, Calvert Balanced Fund Fact Sheet (2021), https://www.calvert.com/media/public/23932.pdf[perma.cc/YZ5S-L3WG].

to be making short-term financial sacrifices, the case for subjecting them to special scrutiny, as the originally proposed DOL rule sought to do, seems weak.

DOL should be conscious of a countervailing risk as well. If including ESG funds in retirement plans carries heightened liability risk for plan fiduciaries, such funds may simply be excluded from plan menus. ERISA fiduciary duties are backed by a private right-of-action, and plaintiffs' attorneys have enjoyed success in a recent wave of 401(k) lawsuits alleging excessive fees.[4] This has led 401(k) plans to simplify and streamline their menus,[5] often dropping high-fee options. Few will lament striking high cost-funds from plan menus,[6] but our results show that ESG funds offer something different from conventional funds without increased costs. Many savers *want* options attuned to ESG issues and offering these options may be a critical ingredient in encouraging younger investors to save.[7]

C. The Diversity of ESG Ratings

Some critics have called out the variety and low correlation of ESG ratings as suggesting that ESG investing lacks discernible content.

From an investor point of view, it seems less important that ESG ratings agree about individual companies than that they have consistency at the portfolio level. This portfolio-level consistency is what we find. While ratings are heterogenous, ESG funds tend to have higher ESG-tilt across the ratings we measure.

ESG fund managers might be diversifying across ESG ratings in portfolio selection, so that they exhibit ESG-tilt regardless of the ratings provider used to evaluate the fund. Alternatively, it may be the ESG fund managers are engaging in their own independent evaluations of companies so that their portfolios exhibit a commitment to ESG in aggregate that the various ratings providers successfully measure.

Neither of these hypotheses is consistent with greenwashing, or even "lazy" ESG investing where fund managers delegate portfolio management to ESG rating providers. Instead, it is most consistent with the idea of fund managers taking the information contained within these ratings into account in making their investing decisions either explicitly or implicitly through independent research.

D. An ESG-Neutral Agenda for Regulators

Our results suggest that the market for ESG mutual funds is functioning reasonably well, and regulators should be responsive to that reality.

In our view, the most productive approach regulators can take when it comes to ESG funds is to adopt a presumptive stance of "ESG neutrality." Notably, this is the approach that DOL took in its rule on financial considerations in asset selection for retirement plans. The initial draft of the rule emphasized that ESG funds could only be included in plans if fiduciaries conducted sufficient diligence to establish that such funds would ultimately generate an optimal trade off of risk and return for investors.[8] In the final version of the rule, DOL instead focused on the types of diligence that prudent fiduciaries should conduct before selecting an investment option, regardless of the strategy.[9]

In our view, neutrality rather than special scrutiny is the correct approach. The SEC's "Names Rule" for mutual funds is an example.[10] The inclusion of ESG terminology in a fund name provides investors with limited information about a fund's investment approach. But the same is true of many other terms that are commonly used in fund names: "growth," "capital preservation," and "blue-chip" all connote strategies in broad terms but are hardly concrete. The vagueness of ESG names seems no worse to us than other types of names suggesting investment strategies.

We find no evidence that "sustainable" funds present a more pressing informational problem than more conventional terms like "growth," or that investors are more likely to be misled by one name than the other.

III. Conclusion

We collected data on ESG funds and provided a framework for interrogating these concerns. Our empirical results provide no justification for regulatory invention. Analysis reveals that ESG funds do not present distinctive concerns from either an investor protection or a capital markets perspective. Funds that market themselves as employing an ESG investment strategy invest and vote differently from funds that do not purport to do so. ESG funds do not appear to be charging investors higher fees or sacrificing returns relative to their traditional counterparts. Our findings suggest caution in curbing the marketing of ESG products or limiting their use by ERISA fiduciaries.

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4. *See* George S. Mellman & Geoffrey T. Sanzenbacher, Ctr. for Ret. Rsch., 401(k) Lawsuits: What Are the Causes and Consequences? (2018), https://crr.bc.edu/wp-content/uploads/2018/04/IB_18-8.pdf [perma.cc/76H2-CAKU].
5. *See* Jamie McAllister & Greg Ungerman, Callan Inst., 2019 Defined Contribution Trends Survey (2019), https://www.callan.com/uploads/2020/05/8d05737f54f9edfccfb9db29d070ff67/callan-dc-trends-survey-2019.pdf [perma.cc/V6HM-JVW8].
6. *See* Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans*, 124 Yale L.J. 1346 (2015).
7. *See, e.g.*, Melissa Karsh & Emily Chasan, *BlackRock, Wells Fargo Are Betting on Ethical Investing Funds for 401(k)s*, Bloomberg (June 13, 2018, 10:54 AM), https://bloomberg.com/news/articles/2018-06-13/blackrock-wells-fargo-are-said-to-push-esg-funds-for-401-k-s [perma.cc/229T-WTGR].
8. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113, 39115 (proposed June 30, 2020) (to be codified at 29 C.F.R. pt. 2550).
9. *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550).
10. Investment Company Names, 66 Fed. Reg. 8509 (Feb. 1, 2001).

C O M M E N T

REGULATION OF ESG INVESTING IS STILL NECESSARY

by Stephen Hall

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I. Introduction

Environmental, social, and governance (ESG) investing is a strategy for allocating investment funds on the basis of the extent to which the operations of a company, or a portfolio of companies, affect the environment, advance social justice, or follow good corporate governance practices. It is of intense and increasing interest to millions of investors who seek to minimize financial risks and maximize their financial returns. It also appeals to investors who seek to align their investments with their core personal values.

An important question is how the Securities and Exchange Commission (SEC)—and to a lesser degree, the U.S. Department of Labor (DOL)—should regulate ESG investment offerings in mutual funds and other types of funds. Three distinguished scholars have conducted some empirical analysis to gauge the need for additional regulatory oversight in this area.[1] Taken at face value and without delving into any aspect of the methodology, the findings themselves are encouraging, at least as far as they go. Their analysis indicates that ESG mutual funds really do offer their investors increased ESG exposure, vote shares in ways that support the ESG principles, and do so without increasing costs or reducing returns for investors. If true, these findings bode well for the ESG investment movement.

But a key question is what conclusions follow from these findings. The authors contend that, in light of their study, there is no reason to single out ESG funds for special regulation or what they refer to as "regulatory intervention."

Here, we part company, at least to a degree. First, let's note some common ground. To the extent the authors oppose regulatory attempts to limit investor access to ESG products or to curtail their use by Employee Retirement Income Security Act (ERISA) fiduciaries, we agree. For that reason, we opposed the DOL's ideological and misguided attempt to inhibit the use of ESG investments by ERISA fiduciaries. Fortunately, the DOL under the Joseph Biden Administration has amended that rule, and in March it survived a Congressional Review Act resolution of disapproval thanks to President Biden's veto.

However, our core point is that there are still good reasons for additional regulatory requirements governing ESG funds. Such measures are necessary for at least three reasons: to protect investors from abuse; to bring order to a complex and confusing market by requiring clear, standardized, and comparable disclosures; and to maintain investor confidence in the integrity of this evolving market so that ultimately it can fulfill its potential. In short, regulation in the ESG market is necessary not only to protect investors, but also to foster an environment in which it can thrive. And indeed, the SEC has headed in this direction by proposing two important rules, one to prevent the use of misleading fund names and the other to provide investors in ESG funds with more detailed, consistent, and comparable disclosures.

II. The Nature of the ESG Market Makes Regulation Necessary and Appropriate

Before briefly fleshing out these points, it is important to highlight the attributes of ESG investing that influence our thinking on the need for additional regulation. ESG investing is in huge demand; it is experiencing explosive growth; it is attracting trillions of dollars of investor funds; it has spawned a confusing and complex ESG investment industry; it offers attractive profits for funds that can take advantage of investors' enormous appetite for ESG investing; and there is every reason to believe that the trend will continue, as the vast majority of millennials favor ESG investing.

At the same time, investors are confronted by a daunting array of investment options and a lack of clear and consis-

Author's Note: Better Markets is a nonprofit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets. A substantial amount of our advocacy is focused on improving the securities markets, and that includes fighting for important investor protections, including anti-fraud provisions and clear and comprehensive disclosures that investors need to make informed financial decisions.

1. *See* Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?* 120 Mich. L. Rev. 393 (2021).

tent information about those options. There are hundreds of ESG mutual funds, hundreds of ESG rating providers using different methodologies, and countless ESG indexes that track companies using various ESG metrics. And as the authors note in their article, there isn't even a common, clear definition of exactly what ESG means.

Given this backdrop, the threat of investor abuse remains high. In addition, the need for greater clarity, uniformity, and comparability in the disclosure of information about ESG investing should be clear.

The case gets even stronger given the appropriate role for preventive regulation. The authors' perspective reflects too much of the "fingers crossed, let's leave well enough alone" approach. Given the massive scale, popularity, and importance of ESG investing, the optimal approach is to get ahead of potential and foreseeable problems. As the U.S. Court of Appeals for the District of Columbia (D.C.) Circuit has said, regulatory agencies have the latitude to "adopt prophylactic rules to prevent potential problems before they arise. An agency need not suffer the flood before building the levee."[2] Thus, even if the ESG fund marketplace were generally in good order, the SEC would be justified in establishing guardrails to head off future problems.

Let's now turn to the three specific reasons why regulation relating to ESG funds is warranted—investor protection, disclosure, and market confidence.

III. Targeted Regulation Will Help Curb Abuses

With respect to investor protection, there have been and continue to be patterns of misconduct in the world of ESG-focused funds, warranting vigilant enforcement as well as additional regulatory measures. The SEC's actions reflect these concerns.

In March 2021, the Commission announced the creation of the Climate and ESG Task Force within the Division of Enforcement to focus on inadequate disclosures and material misstatements in ESG-related disclosures.[3] One month later, in April 2021, the SEC's Division of Examinations issued a Risk Alert. It found that the "rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks."[4] The Alert went on to discuss several specific "observations of deficiencies and internal control weaknesses" identified during the examinations of investment advisers and funds with respect to ESG investing. These risks included unsubstantiated or misleading claims of ESG approaches, proxy voting inconsistent with ESG strategy, inadequate internal controls, weak or unclear documentation, and more. The Commission has also issued a number of Investor Bulletins and other releases focused on concerns surrounding ESG investing. It continues to bring enforcement actions against issuers and funds for misconduct in climate and ESG-related disclosures, including cases against BNY Mellon[5] in May 2022 and against Goldman Sachs[6] in November 2022.

Beyond enforcement, the SEC has also taken regulatory action to address potential abuses in the ESG marketplace. In June 2022, it published a rule proposal to fortify what is known as the Names Rule.[7] That rule already requires funds to adopt a policy to invest at least 80% of their assets in accordance with the investment focus that the fund name suggests. The recent proposal would expand this requirement and apply it to fund names suggesting a focus on investments that have particular characteristics, including names indicating that the fund's investment decisions incorporate one or more ESG factors. The rule would also require enhanced disclosures about how fund names track their investments, prospectus definitions of the terms used in a fund's name, and the retention of records regarding how a fund complies with the rule.

This effort to curtail the use of misleading fund names stems from the reality that fund names have an exceptionally powerful influence on investors. Evidence shows that with the mere mention of the ESG factors in a name, funds can almost instantly attract huge inflows from investors.[8]

IV. Targeted Regulation Will Ensure Investors Receive the Clear and Consistent ESG Disclosures They Need and Want

Another area where regulatory intervention is especially important is in the realm of disclosure. The fact is that investors do not have access to clear, consistent, and comparable information on which to base their investment decisions when it comes to ESG investments. The SEC has moved on this front as well. In June 2022, along with the Names Rule, it published a proposal that would require investment companies to disclose to investors, and report to the SEC, additional information regarding their ESG investment strategies, depending on the extent to which a fund uses the ESG factors in its investment selection and

2. Stilwell v. Office of Thrift Supervision, 569 F.3d 514, 519 (D.C. Cir. 2009).
3. U.S. Securities and Exchange Commission, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, https://www.sec.gov/news/press-release/2021-42 (last visited May 21, 2023).
4. U.S. Securities and Exchange Commission Division of Examinations, *The Division of Examinations' Review of ESG Investing* 2, https://www.sec.gov/files/esg-risk-alert.pdf (Apr. 9, 2021).
5. U.S. Securities and Exchange Commission, *SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Consideration*, https://www.sec.gov/news/press-release/2022-86 (last visited May 21, 2023).
6. U.S. Securities and Exchange Commission, *SEC Charges Goldman Sachs Asset Management for Failing to Follow Its Policies and Procedures Involving ESG Investments*, https://www.sec.gov/news/press-release/2022-209 (last visited May 21, 2023).
7. Investment Company Names (File No. S7-16-22, RIN 3235-AM72); 87 Fed. Reg. 36594 (June 17, 2022), https://www.sec.gov/rules/proposed/2022/33-11067.pdf.
8. *See* Better Markets, *Re: Investment Company Names (File No. S7-16-22, RIN 3235-AM72); 87 Fed. Reg. 36,594 (June 17, 2022)* [Better Markets' Aug. 16, 2022 Comment Letter to the SEC on Investment Company Names], https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_SEC_Investment_Company_Names.pdf (last visited May 21, 2023).

engagement process, framed in terms of integration funds, ESG focused funds, and ESG impact funds.[9]

The rule would require additional specific disclosures regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures; implement tabular disclosures to allow investors to compare ESG funds at a glance; and require certain environmentally focused funds to disclose the greenhouse gas emissions associated with their portfolio investments. Finally, the Proposal would require funds to use formats that provide investors with machine-readable data for their ESG disclosures.[10] The SEC's release clearly sets forth the rationale for the rule:

> The proposed amendments to these forms and associated rules seek to facilitate enhanced disclosure of ESG issues to clients and shareholders. The proposed rules and form amendments are 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.[11]

V. Targeted Regulation Will Help ESG Thrive

The SEC's reference to innovation is a good segue to the last reason why we support additional reform in the ESG investment market: Strong regulation of ESG funds will actually help this important movement thrive. New protections and requirements, including those the SEC has recently proposed, will satisfy investor demand for the accurate and complete information they need to make optimal investment decisions, and it will fortify investor confidence in the integrity of the ESG market. In short, strong regulation means investor trust, which means greater investor participation, which means more robust and efficient capital allocation, better returns, and more social good. These benefits accrue whether investors are seeking ESG-related investments to save the planet or to reap better financial returns from companies that are positioned to adapt and profit from climate change and other trends.

VI. The Industry's "Sky Is Falling" Strategy Is Baseless

It is important to emphasize one more point that underlies much of the debate surrounding the wisdom of new regulation. So often, attempts to fend off new rules are premised on the notion that regulation imposes crushing burdens on the financial industry or even harms investors by reducing choices and stifling innovation.

These dire predictions are seldom if ever borne out. Recall just this one early example: When the state and federal securities laws first emerged a century ago, they were greeted with howls of protest portraying them as attacks on legitimate businesses that would stifle capitalism. Yet, it is precisely those laws that have created the environment in which our markets and ultimately our economy have thrived. The SEC and all of us must view these attacks with skepticism and follow the goals that underlie the securities laws, which are protecting investors, preserving the integrity of the markets, and promoting robust capital formation.

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9. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices (File No. S7-17-22, RIN 3235-AM96); 87 Fed. Reg. 36654 (June 17, 2022), https://www.sec.gov/rules/proposed/2022/33-11068.pdf.
10. *See* Better Markets, *Re: Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices* [Better Markets' Aug. 16, 2022 Comment Letter to the SEC on Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices], https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_ESG_Disclosures.pdf (last visited May 21, 2023).
11. 87 Fed. Reg. at 36654.

COMMENT

ESG IS INVESTMENT STRATEGY

by Anne Kelly

Anne Kelly is Vice President of Government Relations at Ceres and leads the Ceres Policy Network, Business for Innovative Climate and Energy Policy.

The authors' article, *Do ESG Mutual Funds Deliver on Their Promises*, is a timely and insightful piece with several important conclusions. I have three principal observations to add to the commentary on the paper: (1) Securities and Exchange Commission (SEC) regulations that would require stricter definitions and more robust disclosure are important for the health and legitimization of the ESG market; (2) climate risk is financial risk—investors want to make money, and the ESG market is providing them with an opportunity to do so; and (3) despite the positive results identified by studies like that conducted by Curtis et al., at the state level, several problematic bills have been passed to restrict investment practices by prohibiting the consideration of ESG and other factors, and these bills are projected to cost taxpayers millions of dollars. I address these points below.

First, robust disclosure is essential for the decisionmaking of investors, and enhanced climate risk disclosure will enhance the ESG market by allowing investors to understand the nature of climate risk and make decisions accordingly. There is an important distinction between the valuable disclosure requirements that are emerging from the SEC and the efforts to regulate ESG by state legislatures that I mention below. Informing investors is critically important given that the area of ESG investing is growing and evolving rapidly. Heightened transparency would help fortify the role of ESG investing, and the SEC's proposed regulations take an important step in that direction. They should be finalized quickly and without watering down the core climate risk and greenhouse gas disclosure provisions.

Second, several experienced investors have spoken on the topic of ESG investing and have emphasized that climate risk is investment risk. Investors strive to make profitable returns and must consider the long-term impacts of their investments. They use investment strategies and make decisions that revolve around prudent risk management and opportunity optimization. Thus, as climate change worsens and the marketplace shifts in response to climate and related risks, investors can be expected to increase their interest in the investment opportunities offered by ESG funds.

Third, despite the favorable performance of ESG funds identified in the Curtis et al. study and the growing importance to investors of climate change and the energy transition, ESG opponents have introduced roughly 140 bills in state legislatures this year that would limit state investment practices by prohibiting the consideration of non-pecuniary factors. Many of these bills appear to target ESG factors in particular. They miss the mark because, as I noted above, climate risk and financial risk are inherently intertwined and climate risk can only be expected to grow. Legislators are increasingly realizing that ESG investing is risk-based investing, though, and Ceres is leading an initiative called "Freedom to Invest," which points out that politicians should not be telling investors what considerations they should include in their private investment decisions and state pensioners should not be losing their retirement funds because of the politicians' preferences. Fortunately, many of the ESG restriction efforts have been scuttled amid revelations about the millions of dollars in additional taxpayer costs that would arise from these policies.

In short, the Curtis et al. paper is an important contribution to our understanding of the importance and effects of ESG investing. Policymakers at the federal and state levels would do well to allow financial disclosure to do what it does best: enable investors to make informed choices to reduce financial risk, which these days must include climate risks.

Editors' Note: Anne Kelly's Comment is based on an edited transcription of her remarks at the Environmental Law and Policy Annual Review conference. See 2022-2023 Environmental Law and Policy Annual Review Conference, available at https://www.eli.org/environmental-law-and-policy-annual-review.