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Table of Contents

Buyer Beware: The Paradox of ESG & Passive ESG Funds

Dana Brakman Reiser and Anne Tucker*

Abstract

ESG funds have attracted a flood of retail investment by offering individuals an opportunity to do well financially while they do good by advancing environmental, social and governance goals. This paper relies on hand-collected data to show that a lack of transparency and an absence of regulation prevent both actively and passively managed ESG funds from consistently delivering on that promise. Actively managed funds highlight a great variation that exists among funds bearing the ESG label. Passively managed funds rely on black-box algorithms provided by unregulated third parties. Overall, our findings reveal little coherence in the ESG fund concept, suggesting investors should act cautiously when considering purchasing an ESG fund. In the absence of transparency and regulation, investors must choose an ESG fund with care while trying to discern investment fact from marketing fiction.

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TABLE OF CONTENTS

INTRODUCTION

ESG investing—using strategies that incorporate environmental, social and governance practices of investee firms in portfolio composition and management—is growing by leaps and bounds. Fund houses launched 102 new ESG funds in just three years between 2015 and 2017, while only 90 had been launched in the prior 14 years.[1] Fund growth in this area outpaces growth in traditional mutual fund and exchange traded fund (ETF) markets. ESG funds gained $6.7 billion assets under management (AUM) in 2017,[2] representing an almost ten percent rise from the prior year's $5.8 billion inflow, which itself tripled the 2015 increase. Much of this growth combines ESG strategies with the increasingly popular passive strategies that have swept U.S. fund markets more generally.[3] Passively managed funds composed 30% of the total sustainable funds market in 2017.[4] No longer a niche or specialty area, ESG investing today is massive. Global ESG assets under management are frequently pegged at just under $23 trillion.[5]

ESG strategies offer investors an enticing combination of traditional investment assurances and far more ambitious objectives. In addition to savings or wealth building, these products are intended to combat the risks posed by poor governance practices that threaten the stability of capital markets and the economy writ large. They are also intended to counter the existential threats posed by social inequality and climate change. But the substance of environmental, social and governance considerations in ESG investing is essentially unregulated. Merely flagging the use of ESG factors satisfies securities regulation disclosure mandates, but does little to illuminate for investors how a particular investment product will use these factors or how to assess whether it has done so effectively. In non-ESG investing, profit, income, and growth have consistent meanings across products, so their disclosure alone allows investors to make useful comparisons between them. In contrast, what qualifies as environmental, social or governance performance is unclear and contested. Mere disclosure that a fund practices ESG investing will do little to unpack these terms for investors.

[1] *See* Morningstar, Sustainable Funds U.S. Landscape Report, Jan. 2018 at 6, at https://cdn.ymaws.com/dciia.org/resource/collection/8606CD14-06A5-4277-9507-C397C1C8DEA0/Sustainable_Funds_Landscape_013018.pdf.

[2] *See id.* at 11-12. Investor interest in ESG funds, alongside market appreciation, drove a 37% annual increase in assets to $445 billion in 2017. *See* Bloomberg Intelligence, *Sustainable Investing Grows on Pensions, Millennials*, Apr. 4, 2018, at https://www.bloomberg.com/professional/blog/sustainable-investing-grows-pensions-millennials/.

[3] Passive management refers to the practice of building a fund portfolio to match an external index or set of rules for firm inclusion and retention, such as funds with portfolios constructed to match the S&P500 or Russell 3000 indexes of companies. *See* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POLITICS, 298, 298-99 (2017). Passive contrasts with active management, under which fund managers select investments for inclusion and retention in a fund portfolio based on their own research and predictions about the investment's quality and fitness for a fund. *See id.* As passive strategies require far less research and ongoing assessment, they are associated with lower fees. *See id.* Passive investment strategies are rising in popularity in large part because, net of fees, on aggregate they tend to match or outperform active alternatives. *See id.* For statistics on the size and growth of passive investing, *see id*. and *see also infra* notes 33-37.

[4] *See* Morningstar, *supra* note 1, at 8.

[5] *See* Bloomberg Intelligence, *supra* note 2 ("Variously labeled as sustainable, responsible or ethical investing, the field encompasses 26% of assets under management globally — almost $23 trillion — according to the Global Sustainable Investment Alliance.").

Other possible sources of regulation to define and regularize the ESG concept likewise provide little insight to investors. The Department of Labor can function as a kind of shadow securities regulator through its oversight of ERISA-governed plans.[6] Its limited guidance on ESG investing, though, is a fairly foreboding warning – ERISA fiduciaries may engage in ESG investing (whatever that may be) but they are reminded that they cannot do so in any way that would sacrifice returns for beneficiaries. This cautionary instruction does nothing to help delineate the ESG marketplace for investors or product creators.

The rise of passive ESG investing necessarily relies on the proliferation of ESG indexes and other metrics against which these funds construct their portfolios. An ESG index fund cannot be launched without an ESG index to track. The content of ESG indexes could be subjected to regulation, which would indirectly regulate ESG investment products. But while indexes have become hugely influential in the market, they are developed as proprietary systems by private companies, and exist entirely outside the reach of the current U.S. financial regulatory architecture.[7] The ESG concept thus acts more as a product signal and branding mechanism than it does a promise of a specific investment strategy or avoided externalities.

This Article explores the current state of ESG investing in this relative legal vacuum, and the many factors driving its development. Part I details how ESG investing has been operationalized, focusing closely on the new trend of passive ESG and the special challenges it raises. A key contribution of this Part is its compilation of data drawn from a study of the operations of 31 actively- and passively-managed ESG funds, along with 7 non-ESG comparators. In an attempt to discern whether ESG funds are doing something consistent – and consistently different from non-ESG funds – and whether their actions likely align with investor expectations, we hand collected the investment strategy disclosures, fees, portfolio holdings, shareholder proposal voting records, and tracking errors for each of these funds. Our results confirm that the ESG label alone conveys little information to investors; fund operations vary widely among ESG funds and often overlap with those of non-ESG funds.

As legal regulation only weakly confines ESG investment activity, the next two Parts turn to the force that is driving its growth and implementation: the market. Part II focuses on the role of demand in the growth of the field. Recognizing that ESG investors with different goals (and subject to different regulatory regimes) will have varying appetites for ESG products, this Part maps the contours of the contributions of individual and various types of institutional investors to ESG demand. Part III then turns to the supply side, some of which has thus far gone largely unexplored and underappreciated. It identifies the incentives that investment product creators – fund complexes and index providers in particular – have to expand the footprint of ESG investing. The collective takeaway of these Parts exposes serious gaps between reality and the

[6] *See* Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339,350-56 (2017) (describing the Department of Labor's overlapping jurisdiction with the SEC in an article criticizing the former's 2016 rule designating securities brokers as fiduciaries under ERISA).
[7] *See* Securities and Exchange Commission, *Fast Answers: Market Indices*, (stating "[t]he SEC does not regulate the content of these indices and is not endorsing those described here"), at https://www.sec.gov/fast-answers/answersindiceshtm.html.

reasonable expectations of investors and society about the capacity of ESG investing to solve social problems.

Part IV returns to the question of regulation. It first considers how market forces may shift to incentivize greater accountability and consistency in ESG investment products. Then it sketches the potential legal paths securities regulation, ERISA law, and regulation of index providers might follow to narrow the gap between ESG investor expectations and reality, and offers recommendations for future research. Part V briefly concludes.

I. ESG INVESTING EXPLORED

A. Introduction to ESG Investing

ESG investing has longstanding roots, spanning examples as diverse as the limitations placed on investment under Sharia law, John Wesley's instructions for his followers to avoid stocks that conflicted with Methodist religious teachings, and the environmental and South African divestment movements.[8] Early iterations of socially-inflected mutual fund offerings often screened out of "sin" stocks, such as equity in companies that produced alcohol, armaments or tobacco.[9] These exclusionary (or "negative") screen investment products, which go by many names, have been available for decades. Until recently, however, they attracted only a niche audience of highly-committed investors, as the business case for such investing was, at best, unclear.

Exclusionary screens' necessary limits on diversification raise concerns that using these strategies to incorporate environmental, social or governance factors in investment will reduce financial returns. Some studies have borne out these concerns; others showed negative screens could be applied without a loss of financial return.[10] Negative screening continues to be an important component of ESG investing today.[11] For example, the Vanguard FTSE Social Index excludes "weapons, tobacco, gambling, alcohol, adult entertainment, and nuclear power" companies.[12] New funds utilizing negative screens also continue to come online. In the wake of the Parkland school shootings, fund giant BlackRock offered institutional investors the ability to exclude gun stocks from their portfolios and created gun-free ETFs.[13]

[8] *See* Lloyd Kurtz, *Socially Responsible Investment and Shareholder Activism*, 248, 248-55, *in* THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY (Andrew Crane et al. eds. 2008).
[9] *See* Casey C. Clark & Andy Kirkpatrick, *Impact Investing Under The Uniform Prudent Investor Act*, 32 PROBATE & PROPERTY 32, 33 (March/April 2018).
[10] *See, e.g.*, Pieter Jan Trinks& Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 J. BUS. ETHICS 193 (2017) (testing a wide variety of negative screens and finding they frequently result in underperformance); Samuel A. Mueller, *The Opportunity Cost of Discipleship: Ethical Mutual Funds and Their Returns*, 52 SOCIOLOGICAL ANALYSIS 111 (1991) (finding 9 out of 10 mutual funds negatively screened for compliance with ethical restrictions underperformed the market).
[11] *See* Stuart Kirk, *How ESG Can Have Unintended Consequences*, FT.COM (Sept. 27, 2018), at https://www.ft.com/content/e32bb67e-ebc9-3407-a83b-b2524a688222 ("Stock screening is by far the most popular way to invest based on ESG principles, accounting for more than three-quarters of responsibly managed assets globally.")
[12] Vanguard FTSE Soc. Index Fund, Summary Prospectus (Form 497K) (Dec. 3, 2018).
[13] *See* Leslie P. Norton, *BlackRock's Larry Fink: The New Conscience of Wall Street?*, FIN. NEWS LONDON, June 26, 2018, at https://www.fnlondon.com/articles/blackrocks-larry-fink-the-new-conscience-of-wall-street-20180626. As a major index fund provider, these new funds did not dislodge BlackRock as a large investor in weapons companies,

Numerous other strategies have also been developed to incorporate ESG factors in investing, including both active and passive approaches to composing portfolios of high performing ESG companies. Some active funds practice full integration, considering ESG factors as part of the valuation process for every investment decision.[14] For example, at the Morgan Stanley Institutional Global Opportunity Fund "investment processing integrates analysis of sustainability with respect to disruptive change, financial strength, environmental and social externalities and governance."[15] Other active ESG strategies require portfolio companies to post minimum performance on ESG factors for inclusion in a fund or include leading ESG companies in a fund to tilt a fund's overall composition in that direction.[16] Still others develop thematic ESG investment products like clean energy, water or other specialized investment funds. The AB Sustainable Global Thematic A Fund, for example, "identifies sustainable investment themes that are broadly consistent with achieving the United Nations Sustainable Development Goals."[17] Passive ESG funds rely on specially-designed ESG or sustainability indexes to build their offerings, and will be discussed in more detail in Part I.B.

In addition to using various strategies to incorporate ESG factors into investment selection, ESG funds also practice engagement.[18] They utilize their power as shareholders – to vote for directors, on fundamental transactions and shareholder proposals, make shareholder proposals, and more informal efforts to influence management – to drive ESG changes in investee companies.[19] To

including the manufacturer of the gun used at Parkland. Negative screens are incompatible with a pure index strategy, though BlackRock and other index fund providers have pledged to engage with gun manufacturers on issues raised by mass shootings. *See, e.g.*, Matt Levine, *BlackRock Ends Up in an Awkward Place on Guns,* BLOOMBERG.COM, Apr. 8, 2018, at https://www.bloomberg.com/opinion/articles/2018-04-08/larry-fink-s-blackrock-ends-up-in-an-awkward-place-on-guns; Liz Moyer, *Student Activist David Hogg Calls for Boycott of Vanguard and Blackrock over Gunmaker Ownership*, CNBC.COM, Apr. 17, 2018, at https://www.cnbc.com/2018/04/17/student-activist-david-hogg-calls-for-boycott-of-vanguard-and-blackrock-over-gunmaker-ownership.html (noting some activists' calls to boycott BlackRock and other index fund providers).

[14] *See* Amir Amel-Zadeh & George Serafeim, *Why and How Investors Use ESG Information: Evidence from a Global Survey*, 74 FIN. ANALYSTS J. 87, 93-95 (2018) (finding 34.4% of investors in the survey used full integration; again US investors lagged Europeans, with the only 27.2% of the former using engagement strategies, and 35.9% of the latter); Robert G. Eccles, Mirtha D. Kastrapeli, & Stephanie J. Potter, *How to Integrate ESG into Investment Decision-Making: Results of a Global Survey of Institutional Investors*, 29 J. APPLIED CORP. FIN. 125-26 (2017) (finding only 21% utilized this strategy in a global study of asset owners and managers).

[15] Morgan Stanley Institutional Fund, Inc., Summary Prospectus (Form 497K) (Apr. 30, 2018).

[16] *See* Amel-Zadeh & Serafeim, *supra* note 14, at 93-95 (describing these strategies and reporting relatively lower levels of use than engagement and full integration, as reported by survey participants); Eccles, Kastrapeli & Potter *supra* note 14, at 125-26 (reporting greater use of such techniques, 37% for best-in-class selection and 29% for thematic investing, in a global study of asset owners and managers).

[17] AB Sustainable Global Thematic Fund, Summary Prospectus (Form 497K) (Oct. 31, 2018).

[18] *See* Amel-Zadeh & Serafeim, *supra* note 14, at 94-95 (finding 37.1% of global investors utilizing engagement strategies, though this finding was dominated by European investors; only 27.1% of US investors reported using this strategy, while 40% still used negative screening; 48.5% of European investors in the study utilized engagement); Eccles, Kastrapeli, & Potter, *supra* note 14, at 125-26 (reporting 21% of respondents used engagement strategies a global study of asset managers and asset owners who either implemented ESG investing already or planned to do so, while 47% used negative screening).

[19] *See* Alex Gorman, *Exit vs. Voice: A Comparison of Divestment and Shareholder Engagement*, 72 N.Y.U. ANN. SURV. AM. L. 113, 132-42 (2017).

some degree, as most ESG funds are composed of equity securities,[20] they cannot help engaging, as they are called upon to vote their shares. Many ESG fund sponsors, however, see engagement as an important component of their ESG orientation.[21] For example, Calvert, sponsor of several ESG funds in our sample, considers engagement one of its "four pillars of responsible investment" and reports on its website that it uses both its formal voting rights and more informal ability to influence investee management and practices to "influence positive social and environmental practices."[22]

Table 1 below illustrates different ESG investment strategies, as stated in funds' investment strategy disclosures.

Table 1: ESG Investment Strategies

Category: ESG Scoring/Screening	**Ex:** Vanguard FTSE Social Index[23]
ESG attributes of companies are scored and higher scoring companies are selected for investment or inclusion in an index. Conversely, non-ESG attributes (i.e., tobacco, armaments, etc.) may exclude a company from investment.	
Category: ESG Integration	**Ex:** Morgan Stanley Inst Global Opp. [24]
Considering ESG factors as part of the valuation process for every investment decision	
Category: ESG Active Governance	**Ex:** Calvert Equity Fund[25]
Voting in support of ESG favorable resolutions through proxy voting, propose ESG favorable shareholder resolutions, and engage management on ESG related issues.	
Category: ESG Operationalized Portfolio	**Ex:** AB Sustainable Global Thematic A[26]

[20] *See* Morningstar, *Passive Sustainable Funds: The Global Landscape*, May 2018, at 5, *available at* https://www.morningstar.com/lp/passive-esg-landscape?cid=RED_RES0002 (noting "embryonic" stage of development of the sustainable fixed-income market).
[21] Engagement also enables non-ESG branded funds to respond to ESG concerns in their investment portfolios. Indeed, engagement is likely to be the *only* available strategy for passive funds locked into non-ESG indexes to address ESG issues in their portfolios.
[22] Calvert, *Four Pillars of Responsible Investing*, at https://www.calvert.com/engagement-pillar.php.
[23] Vanguard FTSE Soc. Index Fund, Summary Prospectus (Form 497K) (Dec. 3, 2018). "The Index is market-capitalization weighted and includes primarily large- and mid-cap U.S. stocks that have been screened for certain criteria related to the environment, human rights, health and safety, labor standards, and diversity. The Index excludes companies involved with weapons, tobacco, gambling, alcohol, adult entertainment, and nuclear power."
[24] "The investment process integrates analysis of sustainability with respect to disruptive change, financial strength, environmental and social externalities and governance (also referred to as ESG)." Morgan Stanley Institutional Fund, Inc., Summary Prospectus (Form 497K) (Apr. 30, 2018). "[R]esearch is guided by The Calvert Principles for Responsible Investment, which provide a framework for considering environmental, social and governance ("ESG") factors that may affect investment performance." Calvert Equity Fund, Summary Prospectus (Form 497K) (Feb. 1, 2018).
[25] Consider also the statement by Clearbridge Sustainability Leaders Fund. "[S]ustainability is not limited to environmental stewardship, but also includes a company's policies in regard to treating employees fairly and furthering their professional development, interacting in a positive way within its local community, promoting safety at all times, managing its supply chain responsibly, and employing corporate governance practices that are shareholder friendly and transparent. … It is also the subadviser's intention to ***engage and encourage management to improve*** in certain ESG areas identified by the subadviser." Clearbridge Sustainability Leaders Fund, Summary Prospectus (Form 497K) (Mar. 1, 2018) (emphasis added). "We encourage companies to improve corporate behaviors and contribute to a more sustainable and equitable society. Our most visible forms of shareholder advocacy are proxy voting and shareholder resolutions. We engage on issues that we believe have a financial impact on companies, which include social and sustainability issues." Calvert Four Pillars of Responsible Investing, https://www.calvert.com/engagement-pillar.php.

Companies	
ESG-focused theme such as clean water, clean energy, solar, or sustainable development goals.	

Studies have found that incorporating a wide array of ESG investment strategies, like those identified above, outperforms negative screening alone.[27] In a comparison of portfolios using ESG factors with non-ESG portfolios, the former often outperformed the latter, and provided lower volatility and risk.[28] An influential study of firm performance also found that "firms with strong ratings on *material* sustainability topics outperform firms with poor ratings on these topics."[29] A metastudy of over 2000 studies of ESG investment performance concluded that "the business case for ESG investing is empirically well founded" and that "[i]nvesting in ESG pays financially."[30] It still remains difficult to conduct industry-wide studies because ESG investing practices are so wide-ranging, and costs of utilizing these strategies can be high,[31] but data showing ESG investing need not sacrifice returns – and indeed may increase them – is beginning to mount.

B. Passive ESG

The latest development in ESG investing is its convergence with passive strategies tracking indexes to offer investors both diversification and competitive pricing.[32] Unlike active funds, in which fund managers seek to pick winning investments and avoid losing ones as they construct their portfolios, passive investments utilize an externally created index and map their portfolios to it as much as possible. For example, the iShares Core S&P 500 ETF seeks to match its portfolio to the S&P 500. Fund returns track those of the underlying index, and costs are

[26] "The Adviser identifies sustainable investment themes that are broadly consistent with achieving the United Nations Sustainable Development Goals. Examples of these themes may include energy transformation, resource preservation, equality and opportunity, and improving human health and safeguarding lives, and the themes are expected to change over time based on the Adviser's research. In addition to this "top-down" thematic approach, the Adviser also uses a "bottom-up" analysis of individual companies, focusing on prospective earnings growth, valuation, and quality of company management and on evaluating a company's exposure to environmental, social and corporate governance ("ESG") factors." AB Sustainable Global Thematic Fund, Summary Prospectus (Form 497K) (Oct. 31, 2018).
[27] *See, e.g.*, Gunnar Friede, Timo Busch, & Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 210 (2015); Michael L. Barnett & Robert M. Salomon, *Beyond Dichotomy: The Curvilinear Relationship Between Social Responsibility and Financial Performance*, 27 STRAT. MGMT. J., 1101 (2006) (collecting studies reaching contradictory conclusions and arguing that the divergence can be explained in part by the variation in methods used by different socially responsible investing techniques).
[28] *See* Tim Verheyden, Robert G. Eccles, & Andreas Feiner, *ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification*, 28 J. APPLIED CORP. FIN.47, 50-51 (2016).
[29] Mozaffar Khan, George Serafeim, & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, 91 ACCOUNTING REV. 1697, 1716 (2016).
[30] Friede et al., *supra* note 27, at 212.
[31] *See, e.g.*, Michael Cappucci, *The ESG Integration Paradox*, 30 J. APPLIED FIN. 22, 23-26 (2018).
[32] *See* Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *Passive Investors* (2018 draft), *available at* http://ssrn.com/abstract=3192069. Professors Fisch, Hamandi and Davidoff Solomon describe passive strategies as exploding to "the point where there are now more indices than publically-traded U.S. stocks." *Id.* at 10. In addition to tracking indices, passive strategies may convert traditional active investment into a rules based approach, or strategies that combine 80% passive with 20% active strategies. *See id.* The proliferation of passive and passive-like strategies dilutes the concept beyond the point of a singular definition or consensus. *See id*.

reduced by eliminating much of the need for research and expertise in portfolio construction (the "active" part of management).

Passive investing is a huge trend. Fund houses launched over 600 new index funds in 2017. In the same year, investors added $223 billion in net cash flows to index mutual funds, accounting for over 26% of the total mutual fund market.[33] Market experts predict the passive market will exceed actively managed funds by 2024.[34] Passive funds captured 70% of new investor fund flows in 2017,[35] accounting for a total of 35% of long-term funds.[36] Passive ESG funds now coming online track fledgling indexes of leading ESG companies, offering investors a lower-cost and seemingly less risky alternative to active management while still pursuing environmental, social and governance excellence. As noted above, they now compose nearly a third of the sustainable funds market.[37]

Exchange-traded funds—ETFs—are a passive investment product permutation with shares, as the name suggests, traded on an exchange.[38] Trading fund shares on an exchange allows for price fluctuations and trading throughout the day, as compared to the end of day pricing and trade clearing with traditional mutual funds. Many, but not all, ETFs track an index.[39] The Investment Company Institute (ICI) valued the 2017 U.S. ETF market at $3.4 trillion in assets,[40] with 79 ESG ETF funds trading almost $8 billion in assets.[41] In November, 2018, iShares ETF funds experienced the highest monthly inflows out of the entire ETF market with $25.3 billion of new investment dollars.[42] Two of iShares' ESG-focused funds (iShares Core MSCI Emerging Markets and iShares Edge MSCI Minimum Volatility) contributed the strongest inflows.[43] Other ETF providers are likewise generating new ESG ETF offerings.

33 *See* Investment Company Institute, 2018 Investment Company Factbook, 75-76, *available at* https://www.ici.org/pdf/2018_factbook.pdf.

34 *See, e.g.*, Trevor Hunncutt, *Index Funds to Surpass Active Fund Assets in US by 2024: Moody's*, REUTERS, Feb. 2, 2017, at https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN .

35 *See* Morningstar, *Annual U.S. Fund Fee Study*, Apr. 30, 2018, *available at* https://www.morningstar.com/lp/annual-us-fund-fee-study.

36 *See* Investment Company Institute, *supra* note 33, at 41.

37 *See* Morningstar, *supra* note 1, at 8.

38 *See* SEC, Investor Bulletin: Exchange-Traded Funds (ETFs), Aug. 2012, at 1, https://www.sec.gov/investor/alerts/etfs.pdf. Another key feature of ETFs is that the trading price of fund shares fluctuates throughout the day, as opposed to once-a-day priced NAV for traditional mutual funds. *See id.* at 2. The trading price of an ETF share may be above or below the NAV for the underlying fund assets. *See* Investment Company Institute, *supra* note 33, at 85.

39 *See* Investment Company Institute, *supra* note 33, at 88. Index-based ETFs use several methods such as (1) index plus tracking of index through market capitalization, (2) benchmarking using additional factors like sales or book value, and (3) factor-based metrics that include screening indexes, weighting and further customization to achieve various investment strategies (diversification, low volatility, market alignment or variation, etc.). *See id.*

40 *See* Investment Company Institute, *supra* note 33, at 86; *see also* Statista, *Total Net Assets of US ETFs in 2017 is $3.4trillon*, at https://www.statista.com/statistics/295632/etf-us-net-assets/.

41 *See* ETF.com, *Socially Responsible ETF Overview*, at https://www.etf.com/channels/socially-responsible.

42 *See* Morningstar.com, Morningstar Reports U.S. Mutual Fund and ETF Asset Flows for November 2018 (Dec. 21, 2018), https://shareholders.morningstar.com/newsroom/news-archive/press-release-details/2018/Morningstar-Reports-US-Mutual-Fund-and-ETF-Asset-Flows-for-November-2018/default.aspx.

43 *See id.* The iShares 1-3 Year Treasury Bond, a non-ESG fund, is the third named fund contributing to the strong monthly inflows. *See id.*

Specially crafted ESG indexes are the backbone of these passive ESG funds. For example, along with its negative screen, the Vanguard FTSE Social Index relies on an index that "is market-capitalization weighted and includes primarily large- and mid-cap U.S. stocks that have been screened for certain criteria related to the environment, human rights, health and safety, labor standards, and diversity."[44] Indexes created by MSCI are quite popular. For example, the iShares MSCI USA ESG Select ETF tracks MSCI's USA Extended ESG Select Index, "which is an optimized index designed to maximize exposure to favorable environmental, social and governance ("ESG") characteristics, while exhibiting risk and return characteristics similar to the MSCI USA Index."[45] Interestingly, ESG indexes can also include negative screens of their own. For example, the MSCI Index used to compose the iShares MSCI KLD 400 Social ETF specifically excludes companies with "significant involvement" in "alcohol, tobacco, gambling, civilian firearms, nuclear power, controversial weapons, nuclear weapons, conventional weapons, adult entertainment and genetically modified organisms."[46]

ESG indexed mutual funds and ETFs claim to combine two of the most powerful trends in investing: passive strategies and ESG. For investors looking for low-cost, guilt-free saving or wealth-building vehicles, they would seem the perfect solution. Further, with a reliable ESG index, fund houses could harness the return-enhancing value of environmental, social and governance actors at manageable and marketable costs. But concerns about whether ESG investing can deliver on its tremendous promise, particularly in its low-regulation environment, persist in passive investing.

Passive vehicles' reliance on indexing also introduces unique issues regarding index creation and utilization. In an index fund, it becomes important to consider how closely the fund actually tracks its accepted index. As portfolios deviate from the index, certainty about the fund's ESG performance – at least as measured by the index selected – diminishes. This role for index providers can make them immensely powerful, but they are also intensely private. Inserting index providers into the ESG investment process increases its complexity and opacity for investors. These features of passive ESG funds make them a fascinating addition to the canvass as we unpack the challenges to realizing the goals of ESG investment.

C. Our Study

The literature on ESG investing combined with the fast-paced, multifaceted growth of the practice suggests there will be great variation in ESG investment products available on the market. Rather than react to this mere likelihood of variation, we examined key attributes of 31 top ESG funds on the market, along with a select group of non-ESG comparators. Our findings add specificity and substance to the arguments we address. Our study contained three distinct groups: ESG Funds, ESG Passive Funds (index and ETF), and non-ESG Comparison Funds.[47] To generate our list[48] of the "top" ESG Funds, we combined 2017 AUM[49] with 2017 annual

[44] Vanguard FTSE Soc. Index Fund, Summary Prospectus (Form 497K) (Dec. 3, 2018).
[45] iShares MSCI USA ESG Select ETF (Form 497K) (Aug. 31, 2018).
[46] iShares MSCI KLD 400 Social ETF, Summary Prospectus (Form 497K) (Aug. 31, 2018).
[47] *See* Appendix I *infra*.
[48] There is not widespread consensus of the "top" ESG funds because it depends on preference for type of ESG impact, how to define ESG and how to balance with financial returns. After exhausting our research skills in trying to unearth a pre-existing list, we opted to compile our own.

returns[50] and Morningstar sustainability ratings.[51] This list captured three passive funds that we transferred to our ESG Passive Funds list, leaving 17 in our ESG Funds sample. To generate the other 11 ESG Passive Funds, we used a Morningstar report of the top US Passive Sustainable Funds,[52] which is also based on 2017 year-end data. For our Non-ESG Comparison Funds, we researched the fund families in our ESG Funds and ESG Passive Funds samples to see if the fund house carried a similar asset-class mutual fund or ETF product that did not have an ESG component. There are 7 funds in our Non-ESG Comparison Funds sample. Appendix I lists the funds we review in this Article.

To investigate how ESG is being operationalized, our study observed and compared five key attributes of the funds in our samples. We reviewed the ESG and ESG Passive Funds' investment strategy disclosures to identify how and how thoroughly these funds describe their ESG investment approaches. We compared fund fees across the ESG and ESG Passive Fund samples, and in comparison to industry standard fees, to determine how inclusion of ESG considerations impacts the cost of investing. Fund portfolio holdings and voting records on ESG shareholder proposals provided insights on distinctiveness. Do ESG and ESG Passive Funds invest in different portfolio companies than non-ESG funds? Are they more willing to oppose management in support of shareholder proposals geared toward enhancing portfolio company ESG performance? Finally, we considered the tracking errors posted by ESG Passive Funds. Tracking error reveals the difference between the composition of a passively managed mutual fund or ETF and the underlying index against which it is constructed. As ESG Passive Funds are constructed against indexes of high-performing ESG companies, larger tracking errors indicate alternative (lesser?) ESG performance, with other consequences.

We collect our data primarily from fund disclosures available on EDGAR after filing with the Securities Exchange Commission (SEC) including the Form 497K Summary Prospectus, which discloses funds' investment strategies and risks, Form N-CSR, which reports fund holdings, and Form N-PX, which reports fund votes. We also make use of fund websites and publicly available mutual fund data compiled by a number of financial data websites such as Morningstar. Our data points are illustrative and not conclusive, with the intent to contextualize the conversation. Our results and analysis appear below.

1. Investment Strategies

As a first cut, investors must determine whether an investment's combination of ESG strategy, ESG performance, financial return, and cost is suitable for them. While this is a familiar task for all investors—to pick the asset best suited to your risk tolerance and financial needs—the burden of the task is increased under the ESG mantle. Typical research tools include the summary (or full) prospectus, fund website, third party financial sites like Morningstar, or materials provided

[49] *See* Morningstar, *Sustainable Funds U.S. Landscape Report*, Jan. 2018, *available at* https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Sustainable_Funds_Landscape.pdf?cid=EMQ.
[50] *Id.*
[51] *Id.; see also* Morningstar.com, *Morningstar Sustainability Rating*, Aug. 24, 2016, at https://www.morningstar.com/articles/745467/morningstar-sustainability-rating.html (explaining Morningstar's sustainability ratings).
[52] *See* Morningstar, *Passive Sustainable Funds: The Global Landscape*, p. 16, May 2018, *available at* https://www.morningstar.com/lp/passive-esg-landscape?cid=RED_RES0002.

through an employer-sponsored defined contribution plan. Traditional investors spend little time with these materials, but perhaps ESG investors are more motivated.

Unfortunately, even the most motivated of investors will struggle to unpack what ESG means for a particular fund in a meaningful way. Our review of ESG Funds' summary investment prospectus[53] investment strategy statements varied widely. The level of funds' disclosures related to their ESG practices ran the gamut from silence, to boilerplate, to specific statements. For example, JPMorgan Emerging Markets Equity A, 2018 497 filing investment strategy statement contains no ESG-specific disclosure. [54] In the 608 word investment description, zero are devoted to describing how it is an ESG fund. The Neuberger Berman Socially Responsible Investment fund provides an example of a specific disclosure, with over 70% of the entire disclosure devoted to ESG. It states:

> The Portfolio Managers look for those [portfolio companies] that show leadership in environmental, social and governance considerations, including progressive workplace practices and community relations. In addition, the Portfolio Managers typically look at a company's record in public health and the nature of its products. The Portfolio Managers judge firms on their corporate citizenship overall, considering their accomplishments as well as their goals. While these judgments are inevitably subjective, the Fund endeavors to avoid companies that derive revenue from gambling or the production of alcohol, tobacco, weapons, or nuclear power. The Fund also does not invest in any company that derives its total revenue primarily from non-consumer sales to the military. Please see the Statement of Additional Information for a detailed description of the Fund's ESG criteria. Although the Fund invests primarily in domestic stocks, it may also invest in stocks of foreign companies… . [55]

In the middle of the two extremes are generic and moderate statements of ESG commitment. The Parnassus Endeavor Investor disclosure exemplifies a generic statement, providing that "The Adviser also takes environmental, social and governance ("ESG") factors into account in making investment decisions."[56] TIAA-CREF Social Choice Equity Institutional offers an example of a moderate ESG disclosure describing specific attributes of the environmental (E), social (S), and governance (G) factors contributing to portfolio selection. [57]

[53] When available we reviewed the summary prospectus, the 497K, over the full prospectus as the summary prospectus is designed to be the most suitable for individual investors. The SEC describes the summary prospectus as a "few pages long and contains key information about a fund." SEC, *Mutual Fund Prospectus*, Investor.gov, at https://www.investor.gov/additional-resources/general-resources/glossary/mutual-fund-prospectus (last visited Jan. 30, 2019). Funds must present standardized information so investors "can readily compare different mutual funds." *Id*.

[54] JPMorgan Emerging Markets Equity Fund, Summary Prospectus (Form 497K) (Mar. 1, 2018).

[55] Neuberger Berman Equity Funds, Summary Prospectus (Form 497K) (Mar. 29, 2018) (containing 398 ESG words out of 562 total investment strategy words).

[56] Parnassus Endeavor Fund, Summary Prospectus (Form 497K) (May 1, 2018) (containing 16 ESG words out of a 384-word investment strategy statement, therefore dedicating just 4.1% of the investment strategy disclosure to ESG).

[57] TIAA-CREF Social Choice Equity Fund, Summary Prospectus (Form 497K) (Mar. 1, 2018) (containing only 77 ESG words out of a 668-word disclosure).

Examining the ESG Passive Funds sample, we find a similar range of silence to specific disclosure types. Out of the 14 funds in our ESG Passive group; 13 included ESG-related language ranging from bland or generic statements (3),[58] to moderate (4),[59] to specific statements (6).[60] The final fund was silent, devoting zero words in its statement of investment strategy to describe its ESG specific investment approach. In the moderate category, 3 of the 4 funds come from the same fund family (Praxis) and include identical disclosures of the fund family's ESG boilerplate. This standard disclosure provides more information than generic ESG references, but does little to distinguish the different ESG strategies offered *between* the Praxis funds for consumers looking to understand their range of ESG investment options. With other fund families, like iShares, we observe variation between the strategy disclosures of different passive ESG funds the fund family fields. For example, the iShares MSCI ACWI Low Carbon Target ETF 497K disclosure defines two dimensions of carbon exposure ("carbon emissions and potential carbon emissions from fossil fuel reserves"), describes carbon scoring, identifies the underlying index (MSCI), and further explains the portfolio construction.[61] The strategy disclosed for iShares MSCI USA ESG Select ETF is also specific, but specifically different, describing its use of "an optimized index designed to maximize exposure to favorable environmental, social and governance ("ESG") characteristics, while exhibiting risk and return characteristics similar to the MSCI USA Index" and further detailing the index's methodology.[62] The Green Century MSCI International Index Funds, another specific ESG disclosure, likewise describes the underlying index composition utilized, as well as the fund's environmental focus on carbon exposure through fossil fuels, and exclusions screens applied to the portfolio.[63]

ESG investment strategies and the disclosures describing those strategies to investors vary significantly between funds. What is the harm in an undefined and undemarcated ESG scope?

[58] *See e.g.*, Vanguard FTSE Soc. Index Fund, Summary Prospectus (Form 497K) (Dec. 3, 2018) (including in its disclosed investment strategy that "[t]he Index is market-capitalization weighted and includes primarily large- and mid-cap U.S. stocks that have been screened for certain criteria related to the environment, human rights, health and safety, labor standards, and diversity.")
https://www.sec.gov/Archives/edgar/data/52848/000093247118007540/spi_223122018.htm

[59] *See e.g.*, iShares MSCI KLD 400 Social ETF, Summary Prospectus (Form 497K) (Aug. 31, 2018) ("[M]arket capitalization index designed to target U.S. companies that have positive environmental, social and governance ("ESG") characteristics. As of April 30, 2018, the Underlying Index consisted of 403 companies identified by MSCI Inc. (the "Index Provider" or "MSCI") f.... MSCI analyzes each eligible company's ESG performance using proprietary ratings covering ESG criteria. Companies that MSCI determines have significant involvement in the following businesses are not eligible for the Underlying Index: alcohol, tobacco, gambling, civilian firearms, nuclear power, controversial weapons, nuclear weapons, conventional weapons, adult entertainment and genetically modified organisms.").

[60] *See e.g.*, Calvert Global Water Fund, Summary Prospectus (Form 497K) (June 15, 2018) ("The companies in which the Fund invests operate businesses, business units or business lines that (i) provide clean drinkable water or wastewater management, (ii) manufacture products, such as pumps, pipes and valves, and provide services that help to cultivate clean water infrastructure systems, (iii) manufacture products or provide services related to the construction, planning, design, or engineering of infrastructure that improves water efficiency and/or delivery, (iv) develop, manufacture, distribute and/or install equipment or technologies for the treatment, separation and purification of water, including membranes, ultra-violet, desalination, filtration, ion exchange, and biological treatment, (v) offer technologies that promote water conservation and the efficient use of water, such as metering or recycling, (vi) are leaders in water efficiency or water re-use in high-intensity water industries, or (vii) provide innovative solutions to global water challenges").

[61] iShares MSCI ACWI Low Carbon Target ETF (Form 497K) (Nov. 29, 2018).

[62] iShares MSCI USA ESG Select ETF (Form 497K) (Aug. 31, 2018).

[63] Green Century Funds, Summary Prospectus (Form 497K) (May 15, 2017).

The vagueness and variation in ESG funds empowers fund managers. ESG fund strategy statements can be broad and vague, committing to, for example, "invest[] in forward-thinking companies with more sustainable business models"[64] or "employ[] a sustainable rating system based on its own, as well as third-party, data to identify issuers believed to present low risks in ESG".[65]

Beyond identifying the three qualifying attributes—"E" "S" & "G" – when funds discuss ESG investing, they do so using different definitions, qualification, and metrics. TIAA-CREF's dedicated ESG fund describes ESG as follows:

> [t] he Fund's investments are subject to certain ESG criteria. The ESG criteria are implemented based on data provided by independent research vendor(s). All companies must meet or exceed minimum ESG performance standards to be eligible for inclusion in the Fund. The evaluation process favors companies with leadership in ESG performance relative to their peers. Typically, environmental assessment categories include climate change, natural resource use, waste management and environmental opportunities. Social evaluation categories include human capital, product safety and social opportunities. Governance assessment categories include corporate governance, business ethics and government and public policy. How well companies adhere to international norms and principles and involvement in major ESG controversies (examples of which may relate to the environment, customers, human rights and community, labor rights and supply chain, and governance) are other considerations.
>
> The ESG evaluation process is conducted on an industry-specific basis and involves the identification of key performance indicators, which are given more or less relative weight compared to the broader range of potential assessment categories. Concerns in one area do not automatically eliminate an issuer from being an eligible Fund investment. When ESG concerns exist, the evaluation process gives careful consideration to how companies address the risks and opportunities they face in the context of their sector or industry and relative to their peers. The Fund will not generally invest in companies significantly involved in certain business activities, including but not limited to the production of alcohol, tobacco, military weapons, firearms, nuclear power and gambling products and services.[66]

Even this extensive discussion leaves many open questions to the fund manager and its delegates. How far superior to a company's peers must its performance be to constitute "leadership"? What are the social performance categories? It appears that no minimum level of E, S or G performance is required; how does leadership in one arena compensate for poor performance in another? When, and on what basis, will the negative screen be ignored? Of course, part of the value of investing in a fund is relying on an expert's wisdom and expertise. Adding ESG issues to this domain, however, broadens this reliance and increases fund managers' power, not only over investment and engagement decisions made on this basis, but also potentially over the

[64] Pax World Funds Series Trust I (filing on behalf of Pax Global Environmental Mrkts Instl) (Form 485A) (Feb. 1, 2018).
[65] Amana Income Fund, Summary Prospectus (Form 497K) (Sept. 28, 2018).
[66] TIAA-CREF Social Choice Equity Fund, Summary Prospectus (Form 497K) (Mar. 1, 2018).

attention and priority given to ESG issues (and environmental, social and governance issues each independently) by portfolio companies. As these players motivated by financial return create demand for ESG metrics (or produce them in-house), these metrics will also be developed to identify return-protecting and palatable companies, but not necessarily transformative change.

Even when funds share a passive ESG strategy, a seeming niche of the market with considerable overlap, substantial variation persists. Because an ESG label does not represent a clear investment strategy, even when associated with passive funds, it primarily serves a branding function for the investing public. The market signal that a fund is "ESG" seems to be more about the normative "good" an investment can provide rather than signal how the investment works or the degree to which a fund even pursues ESG. A useful analogy may be to a fictional fund calling itself a "success" fund (something funds are not allowed to do). Investors may be drawn to the label and idea of success without having a clear understanding of why the fund may or may not achieve investment success. Market signals of this sort increase the burden on the investing public to unpack the labels and differentiate the investment products offered.

In short, the ESG investment market now designs products with a range of investment strategies, varying levels of commitment to ESG, and fluid definitional boundaries around what counts as ESG. Important questions about how a fund operationalizes ESG remain after this review. The opacity of the ESG investment market imposes a significant burden on investors to distinguish between ESG investments and identify the appropriate ESG strategy and outcome (for them) within the range of options. With opacity comes unchallenged leeway for managers and index providers, all shielded from public review.

2. Fees

Cost is a key consideration in both choosing and designing investment products. Investors select products with fees they are willing to pay, and fund creators design products with fees that will make them competitive, yet profitable. Lower fees have been a tremendous force in the investment market, driving the rise of passive investing. Applying an ESG lens necessarily introduces additional costs into portfolio construction. In active funds, managers must research and evaluate the ESG performance of potential portfolio companies, and continue to assess them over time. In passive ESG funds, managers must purchase access to an index from an outside firm or dedicate resources to developing an index or rules-based model of their own. The cost of these extra burdens is likely passed along to ESG investors in the form of higher fees.

Our sample shows a range of fees associated with ESG investment products. The average expense ratio is 1.09, but with a widely divergent range of fees from .18 (TIAA Cref Social Choice Equity fund) to 1.47 (Domini Impact International fund). The range of fees for passive ESG funds also varied considerably with a low of .19 in the Calvert US Large Cap Core Responsible Index and the highs around 1.30 for funds targeted on international markets (Praxis International Index at 1.32) or specific sectors (Calvert Global Water at 1.28). The greatly reduced cost of executing passive strategies compared to active strategies, which require individual portfolio asset oversight and monitoring, account for the different fees.[67] Consider

[67] *See e.g.*, Sustainable Investing, *Stratifying Expense Ratios: An Explanation*, at https://www.sustainableinvest.com/stratifying-expense-ratios/ ("What affects fees? "The average expense ratio for

average mutual fund fees of .51- .59 for all mutual funds compared to .09 for index equity funds.[68] Our ESG Passive Funds average lower fees (.68) than the active ESG Funds sample (1.09 fees), but not this low. Table 2 below reports fees in our review of ESG and ESG Passive Funds.

Table 2: ESG Fees

ESG Funds (top 17)	**Expense ratio**	**Passive ESG**	**Expense ratio**
Pax Global Environmental Mrkts Instl	0.98	Vanguard FTSE Social Index Inv.	0.2
Morgan Stanley Inst Global Opp I	1.12	Calvert US Large Cap Core Rspng Idx I	0.19
Calvert Emerging Markets Equity I	1.27	iShares MSCI KLD 400 Social ETF	0.5
RBC Emerging Markets Equity I	1.13	PowerShares Water Resources ETF	0.62
AB Sustainable Global Thematic A	1.29	PAX MSCI EAFE ESG Leaders Index Instl	0.56
Amana Income Investor	1.12	iShares MSCI USA ESG Select ETF	0.5
Domini Impact International Equity Inv	1.47	Guggenheim S&P Global Water ETF	0.63
Eventide Gilead N	1.39	iShares MSCI ACWI Low Carbon Target ETF	0.2
Neuberger Berman Socially Rspns Inv	0.84	Calvert Global Water A	1.28
Parnassus Mid-Cap	0.99	Guggenheim Solar ETF	0.7
Hartford Schroders Emerging Mkts Eq I	1.50	Green Century MSCI International Index Fund - Institution	0.98
Amana Growth Investor	1.09	Praxis Growth Index Fund A	0.98
Calvert Equity A	1.06	Praxis International Index A	1.32
TIAA-CREF Social Choice Eq Instl	0.18	Praxis Value Index A	.94

mutual funds varies according to a number of considerations. The most important ones are: (1) whether the fund is actively or passively (index fund) managed…").

[68] *See* Investment Company Institute, *supra* note 33, at 118, 124. A Morningstar report on 2017 fees based on a sample of 25,000 funds found the average expense ratio to be .52%. *See* Morningstar, *supra* note 35, at 1. Investor fund flows into lower-fee fund options, like indexes, drive average fees down. *See id.* at 7-8.

Parnassus Endeavor Investor	0.95		
JPMorgan Emerging Markets Equity A	1.35		
Parnassus Core Equity Investor	0.87		
Average expense ratio	1.09		.68

In addition to revealing considerable variation across all ESG funds, we find passive ESG funds charge lower fees than those using active strategies, but higher fees than these average non-ESG index products. Recent Morningstar research found similar results, reporting that while sustainable funds are competitive on fees, sustainable ETFs fees tended to be higher than average.[69] These findings undermine the low-fee value proposition of passive strategies, but are easy to understand. Higher fees in passive ESG investing are a direct result of the new and different metrics on which ESG index products rely compared to traditional passive funds.

To obtain market-worthy metrics, mutual fund families integrating ESG factors must invest in new personnel and expertise to create the metrics in-house or secure metrics or index information from external providers for a (presumably hefty)[70] price. MSCI, which supplies indexes for more of the ESG index funds in our sample than any other provider, offers a "suite of over 900 equity and fixed income ESG Indexes designed to represent the performance of some of the most prevalent ESG strategies [] to help institutional investors more effectively benchmark ESG investment performance, issue index-based investment products, as well as manage, measure and report on ESG mandates."[71] The Vanguard FTSE Social Index Fund, the largest passive ESG fund with quadruple the assets under management ($4 billion) of any other fund in our sample, relies on the FTSE4Good US Select Index, a market-capitalization weighted U.S. equity index that, as noted above, excludes "weapons, tobacco, gambling, alcohol, adult entertainment, and nuclear power" stocks.[72] The index is produced by FTSE Russell, a leading global provider of indexes that developed its first FTSE4Good Index products in 2001 and now offers numerous suites of ESG indexes, across various strategies and asset classes.[73] As does MSCI, FTSE

[69] *See* Morningstar, *supra* note 1, 27; *see also* Morningstar, *supra* note 20, at 1, 13, 18 (reporting findings that sustainable index funds in the U.S. and Europe are more expensive than standard index products).
[70] A 2017 report by Investment Week cite index fees ranging from £22,000-150,000 for the licensing fees and use of data. *See* Tom Eckett and Anna Fedorova, *Managers Reconsider Use of Index Providers Amid "Eye-Watering" Costs*, INVESTMENT WEEK UK, June 8, 2018, at https://www.investmentweek.co.uk/investment-week/news/3011594/managers-reconsider-use-of-index-providers-amid-eye-watering-costs.
[71] MSCI, ESC Integration, at https://www.msci.com/esg-integration; *see also* MSCI, *MSCI ESG Multi-Asset Class Analytics*, 2018 at 4, https://www.msci.com/documents/1296102/11039838/MSCI+ESG+Analytics+Brochure.pdf/e54eb02f-1c09-f394-3768-ec7a776f9973 (claiming MSCI is "the world's largest provider of ESG research and data"); MSCI, *MSCI ESG SCREENED INDEXES: An Off-the-Shelf Approach to ESG Screens*, 2019, at 4 https://www.msci.com/documents/1296102/1636401/MSCI-ESG-Screened-Indexes-Brochure.pdf/ff64b0bc-f06e-298b-f84b-95814f193ed4 (boasting that "over $150Bn in institutional, retail and ETF assets [are] benchmarked to MSCI ESG Indexes").
[72] Vanguard FTSE Soc. Index Fund, Summary Prospectus (Form 497K) (Dec. 3, 2018).
[73] *See* FTSE Russell, *FTSE4Good Index Series Overview*, 1, at https://www.ftse.com/products/downloads/FTSE4Good-brochure.pdf?_ga=2.193271214.2070678876.1550678839-407133334.1550678839 (describing origination and development of FTSE4Good Index); FTSE Russell, *FTSE ESG*

Russell also offers ESG benchmarking and metrics products in addition to these proprietary indexes.

At least with regard to some ESG products, fees diverge from market norms. This imposes a burden on investors to investigate fees and decide whether the blend of potential financial and non-financial returns from ESG investments – which is itself difficult to discern and assess – is sufficient to compensate them for higher costs.

3. Portfolio Holdings

Here we examine the portfolio companies in which ESG funds invest. The range of portfolio company holdings is consistent with range of investment styles (US vs. international; specific industry/sector vs. whole market, etc.) and the range of ESG commitment reflected in investment strategies. That disclaimer aside, the holdings, reported in Appendix II may surprise even skeptics.

To explore portfolio holdings, we review the top holdings, as measured by percent of fund assets invested in a company. [74] For consistency and manageability, we capped all reported holdings at the top 10 portfolio companies. While this is a small subset of holdings for a relatively small sample of funds, the information is still too diffuse and granular to get a sense of what companies are included in ESG funds. To focus our discussion, we researched each portfolio company and assigned it one of the following broad categories:

- **Financial services**: capital providers to individuals and businesses, insurance companies, credit card companies, and large financial institutions such as Intercontinental Exchange, Inc.
- **Technology and tech infrastructure companies**: companies that make integrated technology software, hardware, or products including companies such as Apple, Alphabet (Google's investment arm), Microsoft, Vodafone, AT&T, etc.
- **Consumer products and services:** companies making goods or providing goods (including retail) for individual consumption and use such as Clorox, Hanes, Dollar General, Starbucks, Amazon, Alibaba, PepsiCo Inc., Wal-Mart, etc.
- **Pharmaceuticals and health**: companies manufacturing over the counter and prescription medicine for humans and animals, medical device companies, and pharmacies such as Eli Lilly, Pfizer Inc., United Health Group, Inc., and CVS Health Corp.
- **Other**: companies focused on business operations, logistics, small component parts, the automobile, railroad, and energy industries, etc.

There are some companies for which the category assignment is reasonably debatable, such as 3M Co, which is assigned as a consumer product despite its wide range of operations. The category assignments reflect our predilection for post-it notes rather than a balance sheet or operations analysis, and are intended to condense disparate information into a digestible,

Index Series, at https://www.ftse.com/products/indices/esg (linking to information on the various ESG index series available from the firm).

[74] We report the top 10 holdings of each fund in our sample, as reported in the fall of 2018. Holdings are listed in Appendix II, *infra*. Raw data is on file with authors.

although imperfect, snapshot of the portfolio holdings for purposes of illustration, not causal analysis. The categories also reflect, in part, our interest in household names, which appeared repeatedly across both the four industry categories and the "other" category, in which clear examples of household name companies such as Walt Disney and Nissan Motor Co. Ltd. were also common.

The following three charts report the distribution of top 10 portfolio company holdings in our broad categories across our three samples of funds.

Chart 1

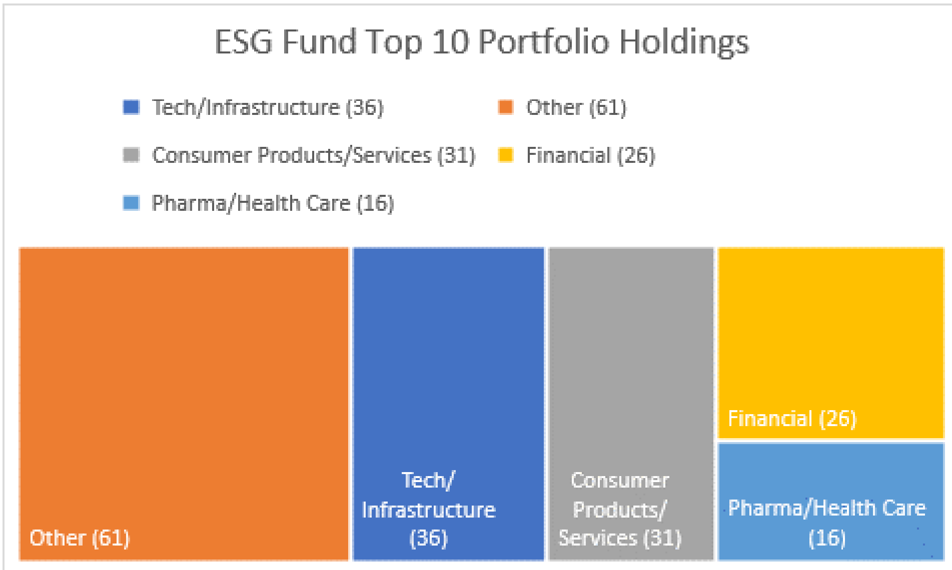


Chart 2

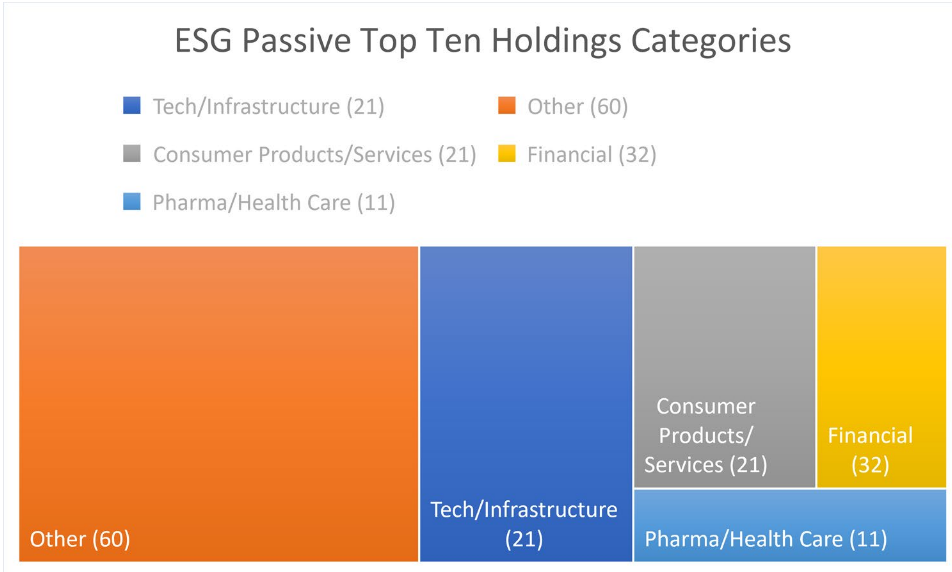
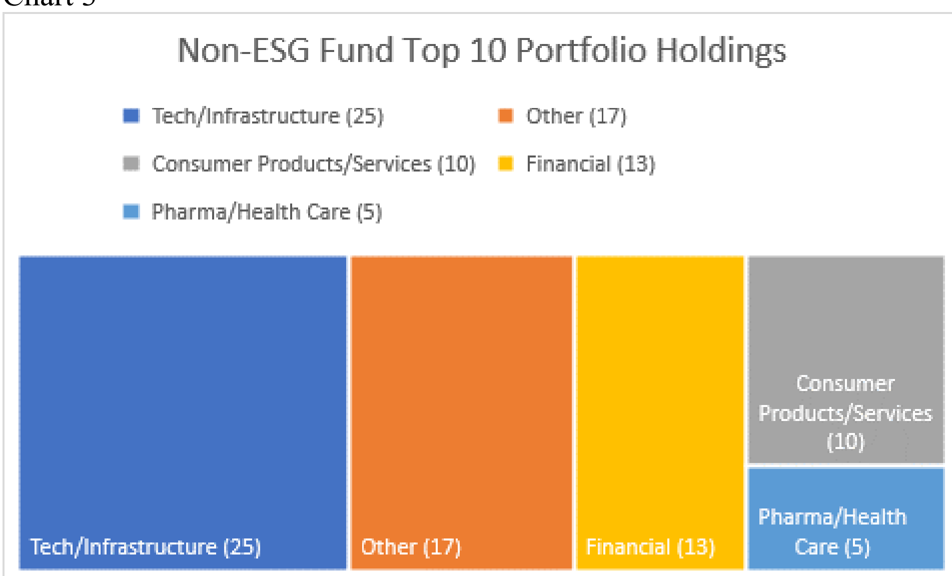


Chart 3



This albeit rough view of portfolio holdings gives us a sense of what markets/sectors these funds invest in, and can also help us to compare ESG fund portfolio construction compared with that of non-ESG funds. Although our ESG Funds and ESG Passive Funds samples reflect a wide range of ESG "commitments" and investment styles (international, domestic, growth, large cap, etc.), assigning each portfolio company to one of our broad categories yields similar industry distributions for both ESG samples. In each, the "other" category captures the most firms, followed by technology, consumer products, financial and health care companies in descending order.

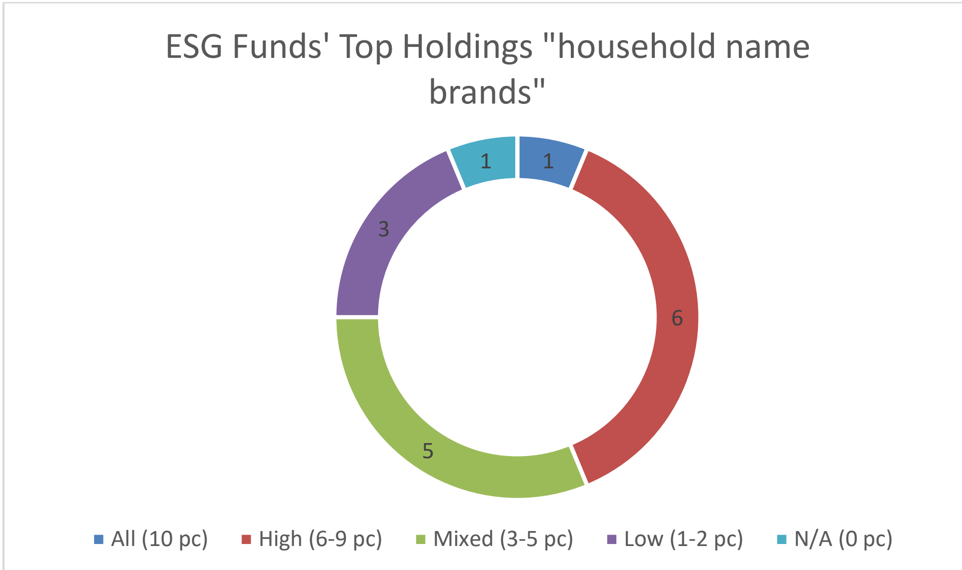
The non-ESG Comparison Funds distribution across our broad categories is also similar to our ESG fund findings,[75] but with a few notable differences. Most important is the divergent composition of the "other" category in ESG and non-ESG funds. This category captures the largest share of top ten portfolio holdings in both our ESG Funds and ESG Passive Funds samples, and the second largest in our non-ESG Comparison Funds sample. As a catchall by design, it is important to unpack the range of firms included in this category to understand our findings. In reviewing the constituent firms assigned to the "other" category across our samples, one observation stands out. For non-ESG funds, the "other" category includes a concentration of traditional energy industry players (11 out of 17 companies). In contrast, traditional energy companies are conspicuously absent from the top ten portfolio holdings of the ESG Funds and ESG Passive Funds we studied. If nothing else, ESG investments on aggregate appear to provide very differential exposure to the traditional energy sector than their non-ESG competitors.

The other differences across the samples are less dramatic, but still worthy of discussion. Some are likely driven largely by the group of ESG funds that concentrate on a particular ESG theme or sector. For example, in the ESG Passive Funds sample, the "other" category is largely comprised (61%) of portfolio companies held by sector/thematic ESG funds focused on water, clean energy, etc.,[76] and not held by Non-ESG comparison funds. This large component of the "other" category may impact the differing prevalence of our categories across the ESG and non-ESG samples. "Other" companies also rank highest in both the ESG Funds and ESG Passive Funds samples, while for non-ESG Funds, technology and financial firms dominate. That said, consumer products/services companies too rank higher in the ESG and ESG Passive Funds' portfolios than in those of our non-ESG Comparison Funds. Our sample included no funds built around an explicit consumer products/services theme, but it is possible the especially significant pressure consumer-facing firms face to engage in corporate social responsibility efforts lead them to be overrepresented among ESG fund portfolios.[77]

Our review of portfolio holdings across all three samples also revealed a strikingly consistent reliance on household name brand companies.[78] We observed a high occurrence of household name brands within the ESG Funds sample. Indeed, the TIAA-CREF Social Choice Equity fund is entirely comprised of household name brands. Six other funds also include six or more household name companies among their top ten portfolio holdings. Household names likewise figure prominently in ESG Passive Funds, constituting more than half of the ESG Passive Funds' top ten holdings. Non-ESG Comparison funds are similar. In fact, roughly half of all funds across our three samples have six or more household name brand companies in their top ten holdings, and many consist exclusively of household name brands. Charts 4-5 below report the representation of household name companies among the top ten portfolio holdings of funds in our ESG and non-ESG funds.

[75] There are fewer observations with the Non-ESG funds, but we care about the proportions.
[76] There are no observable patterns driving the composition of the "other" category in our ESG Funds sample, although it also includes thematic funds.
[77] *See* N. Craig Smith, *Consumers as Drivers of Corporate Social Responsibility*, 281, 297-98 *in* THE OXFORD HANDBOOK ON SOCIAL RESPONSIBILITY (Andrew Crane et al. eds. 2008) (arguing that consumers are likely less important drivers of CSR among business-to-business firms).
[78] We defined household name brand in light of our subjective evaluation of a company's status. As noted above, we researched each portfolio company, and in that way possibly skewed our perception.

Charts 4-5



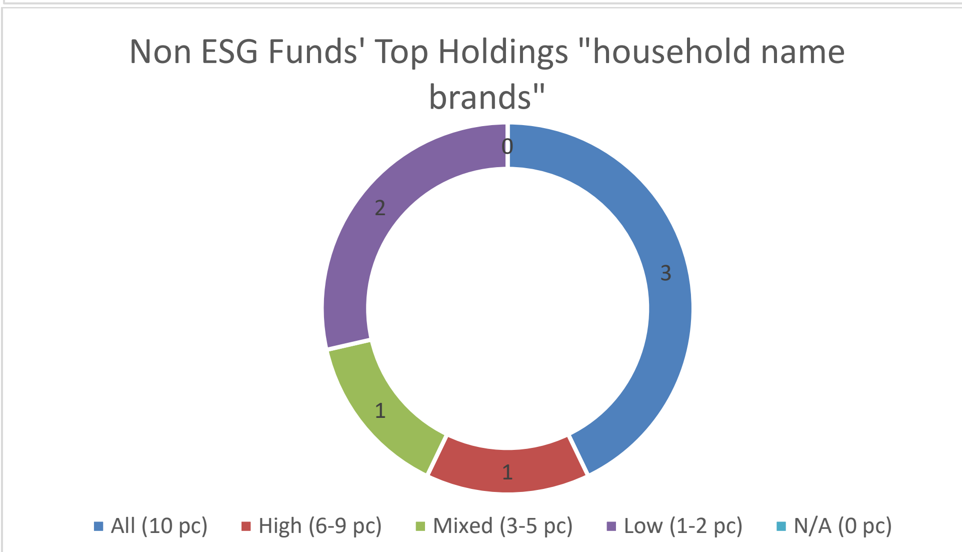


Table 3 provides readers with some instructive examples drawn from our household name brand analysis. It reports the household name companies in each category described above (aside from "other") appearing among the top ten holdings of funds in our ESG Passive Funds sample. Numbers indicate totals; sample firms are listed in the second row, noting companies held by multiple funds. For readers seeking still greater detail, Appendix II lists the top 10 portfolio company holdings for our entire sample: ESG Funds, ESG Passive Funds, and Non-ESG Comparison Funds.

Table 3: Review of Top 10 "Household Name" holdings of ESG Passive Funds Sample			
15 Banking & Finance	32 Technology & Infrastructure	21 Consumer Goods/Services	11Pharma/Health Care
6 Banks (3 Bank of America) 3 JP Morgan 4 Credit Cards (Mastercard-2; Visa - 2) 2 Citigroup Blackrock	4 Apple Inc. 7 Alphabet Inc.[79] 5 Microsoft 3 Facebook 3 Intel 2 Telecom (1 AT&T; 1 Verizon)	3 Amazon.com 4 Proctor & Gamble 2 Johnson & Johnson 1 Walmart 1 Alibaba 2 Soda (1 Pepsi; 1 Coke)	Proctor Gamble Merck & Co 2 Pfizer Roche 2 UnitedHealth Care

We make no normative judgment about the inclusion of household name brands in a fund as a good indicator of ESG commitment or not, nor of the underlying merits of these portfolio companies' performance on E, S or G metrics. Our observation instead is that, outside of thematic ESG funds such as those focusing on clean energy or water, [80] there is little to distinguish between ESG branded funds and non-ESG branded funds with regard to recognizable quality of their top portfolio companies. A simple specialist/generalist dichotomy may help explain the varied focus on name brand portfolio companies. Of the funds that have mixed or low recognition, they are primarily sector based ESG funds and international or emerging market-focused funds. The same is true of Non-ESG fund holdings.

In this section and as further documented in Appendix II, we observe mainstream investments and overlapping investments in particular portfolio companies such as Apple, Alphabet, Amazon, Bank of America, Facebook, and Microsoft, by funds in all three sample groups. These observations alone are not damning as to ESG commitment; we make no claim as to the ESG performance of the portfolio companies. We note the prevalence of mainstream investments in light of the range of disclosed ESG criteria and investment strategies. An investor looking to invest in a "good" ESG fund, will struggle to distinguish between products based on the disclosures and on the top holdings when the ESG criteria are hard to discern and the holdings concentrated in mainstream companies. Investors are responsible for understanding both the risk and the opportunity of any investment. Our observations raise questions about ESG market efficiency, however, when the information required to distinguish and assess various investment products is diffuse, disaggregated and hard to interpret. Information asymmetry of this kind impedes ESG labels from carrying substantive information to investors, relegating its value again to branding and market signaling rather than investor education.

[79] The iShares MSCI ACWI Low Carbon Target ETF held 2 different classes of Alphabet stock among its top 10 holdings.

[80] Passive ESG funds with a thematic focus, such as Calvert Global Water and Guggenheim Solar ETF funds, are comprised exclusively of companies outside of the mainstream. As noted earlier, all of these funds' portfolio companies also fall into the "other" category, reflecting the overlap between the industry categories and the name brand distinction.

4. Voting

Voting patterns are another way to unpack the range of ESG options from which investors can choose. Voting is particularly important in passive funds for which purchases and sales are constrained by the need to track an underlying index. While shareholder engagement comprises informal attempts to influence portfolio company management, advancing shareholder proposals, and voting on both shareholder proposals and other matters raised by management, not all of these are transparent and frequently relevant to ESG investing. We therefore focused on votes on shareholder proposals, many of which address ESG issues,[81] and for which mutual fund voting records are publicly available (although not easily unearthed). A review of the most recent voting records[82] disclosed by funds in each of our three sample groups on ESG-related shareholder proposals generated mixed results.

Some ESG funds, particularly those offered by specialized ESG fund creators, voted quite consistently in favor of shareholder proposals geared toward enhancing portfolio company ESG performance. For example, the Mid-Cap fund offered by Parnassus Investments, a firm that declares on its landing web page that "[e]very investment we make must meet rigorous fundamental and environmental, social and governance (ESG) criteria,"[83] voted in favor of a proposal to assess the feasibility of including sustainability as a performance measure for senior executive compensation at Alphabet/Google. It likewise opposed management across its various holdings, voting in favor of proposals on gender pay equity, adoption of a board diversity policy, and reporting on political spending, forced labor in the supply chain, and greenhouse gas emissions. The PAX MSCI EAFE ESG Leaders Index Fund, a passive product offered by ESG-specialist Pax World Funds,[84] also consistently voted in favor of climate change and gender/diversity-focused proposals as well as proposals to curb corporate political donations, opposing management's position many times over.

Of course, even niche players do not vote in favor of every ESG proposal. Neuberger Berman's[85] Socially Responsible Fund voted in favor of an ESG reporting proposal, multiple

[81] *See, e.g.*, ISS Analytics, Robert Kalb, David Kokell, Rachel Hedrick, Kathy Belyeu, & Kosmas Papadopoulos, *A Preliminary Review of the 2018 US Proxy Season*, July 20, 2018, 4-6 at https://www.isscorporatesolutions.com/file/documents/ics_a_preliminary_review_of_the_2018_us_proxy_season.pdf?elqTrackId=8bd378d423324ecdb189187cc8f09cb1&elq=e1fa6417035a49dea20d5c16f66c81d5&elqaid=969&elqat=1&elqCampaignId= (reviewing the 2018 proxy season, including ESG proposals as major components).

[82] The voting records are taken from Forms N-PX filed with the SEC in 2018, reporting funds' votes cast during the 2018 proxy season. We focused on votes in the top holdings assuming that funds may not have resources to devote to monitoring all proxy issues at all companies in which the fund invests, but also assuming that proxy resources should be devoted to monitoring votes at companies topping a funds' holding list. In addition to examining all votes at top portfolio companies, we analyzed each fund's reported votes on three indictors of ESG issues as noted in Table 4.

[83] Parnassus Investments, *Principles and Performance*, at https://www.parnassus.com/.

[84] *See* Pax World Funds, *About*, at https://paxworld.com/about/ ("[W] we offer a diverse lineup of investment strategies focused on the investment risks and opportunities associated with the transition to a more sustainable global economy.")

[85] The Neuberger Berman states that "[m]aterial environmental, social and governance factors [are] integrated across [its investment] platform." Neuberger Berman, *Who We Are: Our Firm*, at https://www.nb.com/pages/public/en-us/who-we-are.aspx.

lobbying reporting proposals, and gender pay gap risk reporting, but it did not support all of a series of environmental proposals at Kroger. The Fund opposed management and voted for proposals on renewable energy and deforestation and the supply chain, but supported management and voted against a proposal to report on environmental impacts of the company's continued use of non-recyclable brand packaging. Amana funds likewise did not universally support ESG proposals. Its Growth Investor Fund split its votes on gender diversity and pay equity proposals and voted against a proposal to eliminate greenhouse gas emissions; the Amana Income Investor Fund voted against reporting on sustainability metrics in performance-based compensation.

The votes posted by only two funds across our ESG and ESG Index samples regularly clash with expectations that these funds would favor shareholder proposals calling on portfolio companies to address ESG issues and performance. These surprising voting records were posted by funds offered by large, generalist fund complexes. Vanguard's FTSE Social Index fund voted against a proposal recommending climate change reporting, against six proposals on employee diversity reports and policies, against seventeen proposals to report political spending and against five gender pay equity proposals. The Hartford Schroders Emerging Market Equity Fund was also quite negative on ESG issues. It voted against two proposals on climate change, posted a mix of yes, no, and abstention votes on various diversity and gender pay equity proposals, and voted against five proposals to report on political spending.

A simple specialist/generalist dichotomy cannot explain all of the variation in our results, however. On the one hand, the three iShares ETFs in our sample posted very positive votes on ESG proposals. These funds are managed by passive investing giant BlackRock, yet time and again these funds voted against management and in favor of shareholder proposals on climate change, gender pay/diversity, political spending and other issues. On the other hand, longstanding sustainable investing specialist Calvert[86] posted a mixed record on ESG issues. Calvert opposed management and voted in favor of several proposals for reports on gender pay and diversity across its holdings. Its Equity A fund supported greenhouse gas emission reporting and its US Large Cap Core Responsible Index Fund supported both the Alphabet/Google proposal to include sustainability as a performance measure in executive compensation and a proposal to establish a human rights board committee at Apple. Yet, the Calvert US Large Cap Core Responsible Fund also voted against four climate change proposals.

Table 4 reports 2018 vote records by funds in our three samples on three types of shareholder proposals that raise environmental, social and governance issues. Note that it tabulates fund votes only on climate change (environmental), gender pay (social), and political spending (governance) proposals. Of course, the sample funds confronted and voted on many other types of ESG proposals beyond the types Table 4 reports, but confining the Table to these three types of issues provides the reader with an accessible snapshot of our results. Various other votes are highlighted in the discussion above and the analysis of potential explanations for the results which follows the Table.

[86] *See* Calvert, *About Us*, at https://www.calvert.com/ (claiming "Calvert Research and Management is a global leader in Responsible Investing" and explaining that "[t]he company traces its roots to … the first fund family to launch a mutual fund to avoid investment in companies doing business in apartheid-era South Africa").

Table 4: Voting Records				
Sample Group	Fund	Fund Votes		
		Climate Change	Gender Pay/ Diversity	Political Spending[87]
Passive ESG	Vanguard FTSE Social Index	1 against	5 against	17 against
	Calvert US Large Cap Core Resp Index I	4 against	5 for	16 for
	iShares MSCI KLD 400 Social ETF	1 for	9 for	11 for
	PowerShares Water Resources ETF[88]	0 proposals	0 proposals	0 proposals
	PAX MSCI EAFE ESG Leaders Index Instl	3 for	8 for	12 for
	iShares MSCI USA ESG Select ETF	1 for	9 for	11 for
	Guggenheim S&P Global Water	0 proposals	2 for	1 for
	iShares MSCI ACWI Low Carbon Target ETF	split, 1-1[89]	split, 11-1	17 for
	Calvert Global Water A	0 proposals	1 for	3 for
	Guggenheim Solar ETF	0 proposals	split, 11-1	0 proposals
	Green Century MSCI International Index Fund - Institution	0 proposals	9 for	0 proposals
	Praxis Growth Index Fund	0 proposals	6 for	12 for
	Praxis International Index	2 against	0 proposals	0 proposals
	Praxis Value Index	1 for	6 for	9 for
ESG	Pax Global Environmental Markets Instl	3 for	9 for	7 for
	Morgan Stanley Inst Global Opp I	0 proposals	0 proposals	0 proposals
	Calvert Emerging Markets Equity I	0 proposals	0 proposals	0 proposals
	RBC Emerging Markets Equity I	0 proposals	0 proposals	0 proposals
	AB Sustainable Global Thematic A	0 proposals	1 for	3 for
	Amana Income Investor	0 proposals	0 proposals	split 4-1[90]
	Domini Impact International Equity Inv	0 proposals	5 for	3 for

[87] Many of the funds in our sample voted on management proposals to authorize political spending, per European regulations. As these were not shareholder proposals, we do not report votes on them in Table 4.
[88] Several funds in our sample faced no relevant votes on our selected environmental, social and governance issues during our sample period. Indeed, some faced no ESG-related proposals at all. Funds without reportable votes were primarily those dedicated to emerging market companies.
[89] Split votes are reported in the format for-against unless the fund abstained, in which case votes are reported in the format for-against-abstention.
[90] The negative vote opposed a proposal to require cost-benefit analysis of political spending.

	Eventide Gilead N	0 proposals	2 for	0 proposals
	Neuberger Berman Socially Rspns Inv	1 for	1 for	3 for
	Parnassus Mid-Cap	0 proposals	8 for	2 for
	Hartford Schroders Emerging Mkts Eq I	2 against	split 2-1-4	5 against
	Amana Growth Investor	0 proposals	split, 1-1	2 for
	Calvert Equity A	2 for	0 proposals	2 for
	TIAA-CREF Social Choice Eq Instl[91]	0 proposals	0 proposals	0 proposals
	Parnassus Endeavor Investor	0 proposals	3 for	1 for
	JPMorgan Emerging Markets Equity A	0 proposals	0 proposals	0 proposals
	Parnassus Core Equity Investor	0 proposals	5 for	1 for
Non-ESG	Morgan Stanley Global Core Portfolio	0 proposals	split 1-2	4 for
	iShares Core S&P 500 ETF	10 against	split 2-7	14 against
	Neuberger Berman Large Cap Value Fund	1 for	split 6-2	split 2-2
	TIAA-CREF Growth & Income Fund	0 proposals	1 for	split 2-3-5
	Vanguard Equity Income Fund Investor Shares	0 proposals	split 8-3	18 against
	JP Morgan Emerging Markets	0 proposals	0 proposals	0 proposals

There are numerous explanations for why ESG funds in our sample do not uniformly support shareholder proposals aimed to enhance portfolio company ESG performance. Not every fund in our sample adopts an ESG orientation *per se*. For example, we include the Amana funds in our sample based on their AUM, returns and Morningstar sustainability ratings, but Amana's philosophy is more aptly described as values-aligned and faith-based. It explains that "[t]he Amana Funds limit the securities they purchase to those consistent with Islamic principles." The voting record of Praxis Growth Index Fund, whose sponsor "embrace[s] a wide range of social concerns our Christian faith calls us to consider - as well as traditional, prudent, financial considerations,"[92] too is mixed on proposals raising ESG issues. These faith-based models need not overlap with environmental sustainability concerns and may offer a different vision of social issues to investors, with which their voting records may well align.

Among those funds with a stated ESG goal, these issues still entail challenging and contested questions about what course of action will achieve environmental, social or governance gains. For example, many funds in our samples were required to vote on proposals to adopt or pursue reporting on compliance with the Holy Land Principles. Depending on one's views about the

[91] Votes for TIAA-CREF Social Choice Eq Instl do not appear in the relevant N-PX report.
[92] Praxis Mutual Funds, *Stewardship Investing, Our Core Values*, at https://www.praxismutualfunds.com.

Holy Land Principles, a yes-vote might be seen to further social considerations favoring anti-discrimination efforts or to undermine social considerations by inflaming sectarian conflict. In addition, environmental, social and governance gains can be in conflict with each other, and will not always correlate with financial return. Fund management dedicated to integrating ESG factors into their investment strategies might reasonably dispute the value of individual proposals that on their face appear geared toward enhancing ESG performance.

Even if the underlying issue a proposal raises is clearly one intended to further ESG performance, not all such shareholder proposals will advocate good ideas and our sample does not attempt to discern the quality of shareholder proposals. SEC rules impose numerous limitations on who can make shareholder proposals and their content,[93] and issuers can seek guidance from the SEC staff on whether submitted proposals can be (relatively) safely excluded from management's proxy materials.[94] This process will often weed out proposals that raise improper issues or sow confusion, but a proposal appropriately included on management's proxy can still address an environmental, social or governance issue in a way that a particular ESG fund considers unnecessary, counterproductive, or unwise. Consider the Kroger proposal on non-recyclable packaging that Neuberger Berman's Socially Responsible Fund opposed. The company faced prior shareholder proposals on this same issue and had issued a plan in 2016 to address environmental issues in its packaging by 2020.[95] A fund with strong commitments to ESG might view the company's efforts as sufficient and the proposed reporting obligation to be a distraction. Indeed, although the shareholder proposal failed, Kroger announced in August it planned to phase out plastic bags entirely by 2025.[96] Remember, too, the companies in ESG fund portfolios are often selected for inclusion because of their comparatively high ESG performance. This selection bias likely explains the relative paucity of climate change proposals in our ESG samples. It may also lead ESG fund managers to prefer the ESG plans and prerogatives of portfolio company management to those advocated by shareholder proposals.

Research has also shown that fund families frequently choose to vote all shares owned by their constituent funds consistently, rather than voting holdings on a fund-by-fund basis to accord with investor preferences particular to individual funds.[97] Where deviation from centralized voting

[93] *See* 17 C.F.R. § 240.14a–8 (limiting proposal access to shareholders holding "at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year" and limiting each such shareholder to one proposal per meeting and the length of the proposal to under 500 words).

[94] *See id.* at § 240.14a–8(i), (j) (describing the reasons for which companies may exclude proposals, and the process they must follow to do so, including a requirement that companies planning to exclude proposals notify the Commission of their plans and reasoning).

[95] *See* Kroger, Notice of 2017 Annual Meeting of Shareholders 2017 Proxy Statement and 2016 Annual Report, 53, at http://ir.kroger.com/Cache/1500099541.PDF?O=PDF&T=&Y=&D=&FID=1500099541&iid=4004136.

[96] *See* Heather Haddon, *Kroger Bags Plastic Packaging*, WALL ST. J., Aug. 24, 2018 at B6.

[97] *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 517 (2018) (reporting that "The Big Three closely adhere to their voting guidelines and are thus able to achieve lock-step consistency in voting across funds" in an article arguing that passive funds should not vote their shares); Ann Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: THE TENN. J. BUS. L. 175, 187-89 (2017) (criticizing the practice of fund families voting all funds "as a block" and canvassing potential reforms); Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, __ B.U. L. REV. ___ (forthcoming 2019) (pointing out this practice in work setting out a taxonomy of conflicts it creates); Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Default Rule for Mutual Fund Voting*, 12-14, 33-48 (describing this common practice and arguing both for decentralization of mutual fund voting and to remove the default practice of mutual fund voting for ESG shareholder proposals) (manuscript on file with author).

decisions occurs, it is primarily to enable divergent votes by active funds. Cost pressure and other efficiency concerns and the desire to maximize a fund family's influence with portfolio companies and in the market may motivate this kind of batch voting. But it will often lead to undermining investor expectations of ESG funds.[98] ESG proposals can be expensive to implement. A non-specialist fund family overall may view the potential financial return on ESG gains as insufficient to justify these extra expenses in order to achieve ESG gains, even if mangers and investors of its ESG funds would differ.

Centralized voting practices like these could explain the many surprising Vanguard FTSE Social Index votes against climate change, employee diversity, political spending and gender pay equity reporting proposals. The no-votes by this passive ESG fund are matched by virtually identical voting by the Vanguard Equity Income Fund in our non-ESG sample. Still, centralized voting is clearly not a universal practice. The iShares MSCI KLD 400 Social ETF fund voted against management and in favor of proposals to report on the gender pay gap, lobbying payments, board diversity, and global content management at Alphabet, resolutions the iShares Core S&P 500 ETF opposed.

Funds may also be using engagement strategies other than shareholder proposal votes to pursue their ESG goals. Particularly for large players like the passive Big Three,[99] interventions at the board or executive level may be viewed by fund managers as more important or effective ways to generate improved ESG performance at portfolio companies. This kind of influence, however, will remain opaque to investors and other stakeholders.

The most worrisome explanation, of course, is that some ESG funds sponsors and managers are not as committed to the pursuit of ESG performance as their branding suggests. Funds can be quite comfortable that they will meet any regulatory obligations by establishing a share-voting policy consistent with their clients' best interests, disclosing the policy to their clients, and reporting their votes annually to the SEC.[100] No specific voting content is required. A faithless ESG fund sponsor or manager thus has little to fear from a shareholder proposal vote that undermines ESG goals. Investors expecting their ESG fund managers to assiduously pursue environmental, social and governance performance – whether because they believe this performance will improve financial returns or because they care about these factors for non-financial reasons – can review these votes if they are especially diligent.[101] Few are likely to do

[98] As the literature noted *supra* note 97 has articulated, centralized voting by fund families will virtually always undermine the preferences of some of their investors. *See, e.g.*, Lipton, *supra* note 97, at 189-92.

[99] Often referred to as the "Big Three," BlackRock, Vanguard and State Street now dominate U.S. passive investing, managing over 90% of AUM. *See* Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 3, at 303-04.

[100] *See* SEC Release No. 8188 (S.E.C. Release No.), Release No. 25922, Release No. 47304, Release No. 33-8188, Release No. 34-47304, Release No. IC - 25922, 2003 WL 215451 17 CFR Parts 239, 249, 270, and 274, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Jan. 31, 2003) and SEC Release No. 2106 (S.E.C. Release No.), Release No. IA - 2106, 79 S.E.C. Docket 1673, 2003 WL 215467, 17 CFR Part 275, *Proxy Voting by Investment Advisors* (announcing the disclosure regulation and discussing mutual fund voting more generally); *see also* generally Lipton, *supra* note 97, at 183-87 (discussing the history and development of these requirements); Griffith, *supra* note 97, at 10-12 (relating the history and noting that while SEC rules – unlike ERISA regulation – do not issue a directive to vote every share, "many fund advisors feel legally obligated to vote").

[101] *See* Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 235-36 (2018) (describing the voluminous nature of this reporting and summarizing the problem as "there is currently no way for mutual fund investors to gain

so, though, especially across the long list of portfolio companies contained in a fund and over time. Even for those investors willing to engage in this effort, their only recourse in the event of a shareholder proposal vote with which they disagree will be to sell their holdings in the fund.

A mismatch between ESG investor expectations and ESG fund practices would be of particular concern in the passive context. In an active fund, fund managers can use portfolio composition to voice its ESG preferences even if it does not use voting on shareholder proposals to do so.[102] Passive funds have far less ability to exercise voice through exit in this way. Our sample provides some cause for optimism on this score, as it does not reveal notable differences in voting activity between active and passive funds. If anything, passive funds appear slightly more inclined to support ESG proposals. That said, our sample is illustrative rather than comprehensive, and its fundamental finding is one of variation. Whether actively- or passively-managed, the fact that a fund practices ESG investing gives investors no assurance of how it will vote its shares.

5. Unique Passive Risks: Tracking Errors

Tracking error, the final fund attribute our study reviews, is unique to index investing. Passive funds constructed against an index necessarily fall short of replicating that index exactly. Tracking error measures this divergence between a fund's performance and the performance of the index that the fund is tracking.[103] Tracking error results from various causes, including transaction and rebalancing costs, uninvested cash ("drag"), differing dividend reinvestment practices, securities lending, omitted dividend taxes from the index, sampling errors or divergent techniques, variable swap spreads, variable total expense ratios, fund operational risks, and choosing the right benchmark index.[104] Average tracking error[105] for our ESG Passive sample is 1.67, whereas the average ETF tracking error is 0.59%.[106]

All indexed funds face risks associated with indexing itself, including errors in data, computation and indexing methodology. IShares funds disclose the following standard language: "Errors in index data, index computations or the construction of the Underlying Index in accordance with its methodology may occur from time to time and may not be identified and corrected by the Index Provider for a period of time or at all, which may have an adverse impact on the Fund and its shareholders."[107] While these errors exist with standard index funds, the risks are likely

a comprehensive view of the voting of the mutual funds in which they invest or may wish to invest"). Our own efforts confirm the burden and barriers associated with attempts to do so.

[102] The authors thank Sean Griffith for this insight.

[103] *See e.g.*, iShares MSCI KLD 400 Social ETF (Form 497K) (Aug. 31, 2018). Tracking error "measures the quality of index replication, i.e. how well a fund manager replicates the performance of a specific index." Morningstar, *On the Right Track: Measuring Tracking Efficiency in ETFs* (Feb 2013), at 5, available at https://webcache.googleusercontent.com/search?q=cache:vUKPvb2TFG4J:https://media.morningstar.com/uk/MEDIA/Research_Paper/Morningstar_Report_Measuring_Tracking_Efficiency_in_ETFs_February_2013.pdf+&cd=1&hl=en&ct=clnk&gl=us (hereinafter MS Tracking Report).

[104] *See* MS Tracking Report, *supra* note 103, at 5-8.

[105] *See infra* note 110. The above reported ranges were averaged for a single tracking error and that estimated annualized errors are used in the calculations; average excludes funds for which there was no reported tracking error.

[106] *See* Lara Crigger, *The Top 7 Socially Responsible ETFs,* ETF.COM, Mar. 1, 2017, *available at* https://www.etf.com/publications/etfr/top-7-socially-responsible-etfs.

[107] iShares MSCI USA ESG Select ETF (Form 497K) (Aug. 31, 2018).

amplified with indexed ESG funds, especially compared to a standard S&P 500 index fund.[108] ESG index methodology is opaque as to the criteria, weights, and balance. There is also greater index asset valuation variation with ESG indexes, driven by a particular index's tracking flavor compared with standard financial performance measures in traditional indexes.

Table 5 reports tracking errors in our sample of passive ESG funds. Obtaining tracking errors was a challenge and thus the following is illustrative of the range of tracking errors, rather than a strict comparison of absolutes. Further, calculating tracking errors, in general, is a process itself that can be rife with errors given the volume of data, misaligned data, and calculation errors.[109] Please see the associated footnotes for additional information on the figures presented.[110]

Table 5: Tracking Errors

Fund	Tracking Error
Vanguard FTSE Social Index Inv.	1
Calvert US Large Cap Core Rspn Idx I	1.41-1.69[111]
iShares MSCI KLD 400 Social ETF	1.65
PowerShares Water Resources ETF	1.2[112]
PAX MSCI EAFE ESG Leaders Index Instl	2.49-2.57[113]
iShares MSCI USA ESG Select ETF	-
Guggenheim S&P Global Water ETF	2.02[114]
iShares MSCI ACWI Low Carbon Target ETF	-
Calvert Global Water A	2.77[115]
Guggenheim Solar ETF	2.05[116]
Green Century MSCI International Index Fund - Institution	-
Praxis Growth Index Fund A	0.67
Praxis International Index A	-
Praxis Value Index A	1.26

High tracking error does not necessarily mean poor relative financial performance and vice versa with low tracking errors.[117] Yet, "[t]here is usually a trade-off between ESG performance and

[108] *See* Morningstar, *supra* note 20, at 22-23.
[109] *See* MS Tracking Report, *supra* note 103, at 10.
[110] Challenges to obtaining tracking errors included different years reporting the tracking errors (2017-2018) and different time periods of reported tracking error ranging from monthly (annualized to create estimated annual) errors, 1, 3 and 5 year errors. Unlike other information reported in this article, we were not able to obtain (or verify) tracking errors from SEC filings directly, but rather rely exclusively on third party presentations of the data, often from state retirement plan documents, internal fund reports, and other sources.
[111] Variation reflects a 3- and 5-year reported tracking error.
[112] Estimated annualized tracking error determined from reported monthly tracking error of 0.12.
[113] Three-year reported tracking error; variation depends upon class.
[114] Estimated annualized tracking error determined from reported monthly tracking error of 0.34.
[115] Five-year reported tracking error.
[116] Estimated annualized tracking error determined from reported monthly tracking error of .35.
[117] *See* MS Tracking Report, *supra* note 103, at 3. Further, for the ETF funds, tracking error is an incomplete measure; tracking error alone does not capture "the actual magnitude" of under or over performance. *Id.* at 9. Tracking difference is "the annualized difference between a fund's actual return and its benchmark return over a specific period of time." *Id.* Low tracking difference signals that the ETF is matchings its stated index. *Id.*

tracking error."[118] Within our limited review of ESG Passive funds, 10 funds disclosed specific investment risks associated with indexed investing and tracking errors.[119] The risk disclosures varied in content and complexity from boilerplate disclosures[120] to a comprehensive mini treatise on tracking errors at 410 words provided by a Guggenheim fund, S&P Global Water ETF, a sector-focused index fund.[121]

Examples of disclosed ESG tracking error include asset, pricing, transaction, and objective differences between the index and fund. For example, a fund may hold different assets from the underlying index because of a representative sampling approach, limited availability of the security in the amount needed to match the index, uninvested cash for liquidity, or even tax motivations.[122] Transaction costs and timing are also commonly disclosed and intuitively important contributors to tracking error.[123] The costs associated with rebalancing a portfolio to match the index, brokerage fees, and expense rations as well as size constraints of the fund that force sales in a certain amount when required by the index.[124] Further, pricing differences between fair value and end of the day NAV may also drive different returns between the index (fair value) and the fund (NAV).[125] The use of stewardship and investment screens to alter the indexed portfolio may also contribute to fund performance deviations.[126] Finally, some funds may deviate from an index in a hybrid passive/active strategy and go outside of an index to bolster returns through active investment.[127]

Tracking error, a problem with all indexed investments, may be amplified with ESG Passive funds given the opacity of ESG indexes, variation in index attributes, and market size of ESG

[118] Morningstar, *supra* note 20, at 21, *available at* https://www.morningstar.com/lp/passive-esg-landscape?cid=RED_RES0002; *see also id.* at 22-23 (explaining that as funds seek greater impact, tracking error rises compared to the broader market).
[119] Notes on file with author.
[120] "Asset Class Risk—The securities in the Fund's portfolio may underperform the returns of other securities or indices that track other industries, markets, asset classes or sectors." Guggenheim S&P Global Water Index ETF (Form 497K) (Dec. 29, 2017).
[121] *Id*.
[122] *See*, *e.g.*, iShares MSCI KLD 400 Social ETF (Form 497K) (Aug. 31, 2018) (describing asset differences); *see also* Guggenheim Solar ETF (Form 497K) (Dec. 29, 2017) (providing a comprehensive discussion of tracking errors).
[123] "Tracking error also may result because the Fund incurs fees and expenses, while the Underlying Index does not." iShares MSCI ACWI Low Carbon Target ETF (Form 497K) (Nov. 29, 2018).
[124] "Factors such as Fund expenses, imperfect correlation between the Fund's investments and the Index, rounding of share prices, changes to the composition of the Index, regulatory policies, high portfolio turnover rate and the use of leverage all contribute to tracking error." Calvert Global Water (Form 497K) (June 15, 2018).
[125] "To the extent the Fund calculates its NAV based on fair value prices and the value of the Index is based on the securities' closing prices (i.e., the value of the Index is not based on fair value prices), the Fund's ability to track the Index may be adversely affected" iShares MSCI KLD 400 Social ETF (Form 497K) (Aug. 31, 2018).
[126] "Application of Stewardship Investing screens may contribute to tracking error." Praxis Growth Index Fund A (Form 497K) (April 30, 2018).
[127] *See* PRI, *Passive and Enhanced Passive Strategies*, at https://www.unpri.org/listed-equity/esg-integration-in-passive-and-enhanced-passive-strategies/15.article (describing "enhanced passive" ESG investing as "using the index and its constituent weights as the core of the portfolio, and engaging in restricted active strategies, including divesting certain securities, adjusting the weights of constituents and trading derivatives").

companies.[128] Investors bear the actual costs of high tracking errors, plus the added burden of evaluating tracking error risks without transparency.

6. Summary

Reviewing the investment strategy disclosures, fees, portfolio holdings, and voting practices of our sample funds reinforces concerns that ESG investing, and passive ESG in particular, may have difficulty delivering on its tremendous promise. The price of ESG investment products, while decreasing in response to competition, remains high. Although evidence is mounting that better financial returns are associated with considering ESG factors in making investments, high fees can quickly eliminate marginal improvements in financial performance. ESG investing in practice also includes investment products with a very broad range of investment strategies, with often little detail on the contours of a given fund's ESG practices and commitments. Even vague definitions can suffice to meet funds' securities law disclosure obligations, but leave investors without a clear understanding of how ESG investing will be practiced by a particular fund and make it difficult to compare across offerings.

Investigating holdings and voting patterns slightly clarifies this murky picture, with specialist funds and fund providers emerging as more often offering distinct – though not necessarily superior – ESG investment products. Funds targeting particular industries or sustainability themes offer highly tailored, specialized portfolios that do not overlap with other funds and is outside of the focus on mainstream investments in household name companies shared by both ESG and non-ESG funds. In contrast, broad-based ESG and non-ESG funds appear to invest in largely similar portfolios. Specialist fund providers often, though certainly not always, appear to use voting on shareholder proposals to bolster their ESG goals, and generalist players post an eclectic mix of results. Perhaps ironically, the consistent finding of our study is one of variation. The funds diverge so widely on our various metrics that it will be extremely difficult for an investor to know what she is getting when she invests in an ESG fund.

Passive ESG largely replicates these general concerns, but also introduces new ones. ESG investors who choose index funds will generally save on expense ratios when compared to active ESG funds. Still, fees for ESG index funds are higher than industry averages, raising the specter of cost overwhelming any additional gains. The problems with vague disclosures about ESG investment strategies and portfolio holdings that align with non-ESG funds and wide-ranging voting patterns appear in active and passive ESG funds alike. The confounding element of tracking error, however, is unique to the passive context. Some level of tracking error is an unavoidable feature of passive strategies; it represents deviation from the underlying index and need not undermine the financial performance of a fund. In ESG Index funds, however, investors will find it difficult to achieve both the low tracking error typical of broadly diversified funds and strong ESG performance.

The passive ESG trend also compounds the already high level of opacity in ESG investing. Tracking an index adds another – very private – layer to a fund's ESG strategy. Index purveyors

[128] For example, smaller capitalization companies introduce higher potential transaction costs associated with market depth and contribute to price volatility when a fund must buy or sell shares to maintain index exposure. Anne Tucker & Holly van den Toorn, *Will Swing Pricing Save Sedentary Shareholders*?, 1 COL. BUS. L. REV. 130, 140 (2018).

argue they are offering fund providers the deep expertise needed to evaluate ESG factors, topics on which investment fund experience is shallow. But proprietary indexes designed by private firms like MSCI make it ever more difficult for investors to understand and assess the particular version of ESG a fund pursues.

Beyond concerns about delivering on investors' expectations from ESG funds is skepticism that funds can deliver on improved portfolio firm behavior, especially around environmental and social practices. Fund complexes and their metric and index providers have incentives to emphasize ESG practices most easily tracked, linked to firm profits, and applicable across firms – and particularly governance as opposed to environmental and social practices.

II. DEMAND

Despite the significant variation and opacity in the ESG investment market that the literature describes, and our data confirm, investors are flocking to it. But investor demand for ESG products is far from monolithic. Individual investors have different preferences and requirements than do institutional investors, even though institutions often serve as intermediaries and aggregators for individual investors' portfolios. There are also many different types of institutional investors, whose interest in ESG investing differs by client base, regulatory regime, geography, and other factors. These variations in investor demand for ESG investment products partly explains the variation in ESG product offerings, as investors bring their own preferences to bear on market developments and their appetites and attitudes influence product development. This Part will explore this diverse set of investors and their roles in the growth of ESG investing.

Individual investor interest in ESG investing is significant and growing.[129] In part, this can be explained by the simple desire to align one's investments with one's values, in the same way individuals want to feel the warm glow of other products and services they consume.[130] The shopper who favors Fair Trade coffee to channel her grocery expenditures to small growers or selects a pink yogurt cup to support breast cancer research may likewise favor ESG investing over a standard approach. It is worth noting that our hypothetical "she" is indeed more likely to be female, and younger than the average investor. Interest in sustainable and ESG investing appears concentrated in women and millennials.[131] While 53% of all respondents in a 2018

[129] *See* Morningstar, *supra* note 1, at 1 (collecting studies indicating growing individual investor interest in sustainable investing).

[130] *See* Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1259-61 (2011) (describing the economic concept of warm glow as "the utility one derives from giving" but noting that companies engaging in corporate social responsibility now frequently sell it).

[131] *See, e.g.*, Carol J. Clouse, *The New Allure of Sustainable Investing*, BARRON'S, June 9, 2018, at https://www.barrons.com/articles/the-new-allure-of-sustainable-investing-1528502401 ("While much of the financial industry's focus on ESG skews toward the young folks, surveys indicate that women's interest in this approach is nearly as high as millennials'."); John Waggoner, *Millennials, Women Drive Assets To ESG Strategies*, INVESTMENT NEWS, Nov. 7, 2017, at https://www.investmentnews.com/article/20171107/FREE/171109942/millennials-women-drive-assets-to-esg-strategies (reporting panelists' comments at an industry event that "Two groups of people – women and Millennials – are responsible for the doubling of ESG assets to $8.1 trillion worldwide since 2014"); Beth Brearley, *ESG and Women Investors: A Meeting of Movements*, INVESTMENT WEEK, Oct. 10, 2018, https://www.investmentweek.co.uk/investment-week/opinion/3063826/a-meeting-of-movements-as-industry-joins-forces (similar).

survey of high net worth individuals stated that the "social and environmental impact of the companies" was important in making investment decisions, 64% of women and 87% of millennials did so.[132]

No matter the demographic, individual investor preferences are often expressed indirectly, through the work of an array of investment intermediaries (some of which are themselves institutional investors, or agents of institutional investors). Brokers, investment advisors, family wealth officers, and pension and retirement plan fiduciaries all channel individuals' money into investment products on behalf of their clients and beneficiaries. These intermediaries' interest in ESG strategies varies considerably depending on the type of investor they represent and the regulatory regime they confront. On the one hand, as will be discussed below, pension and retirement plan fiduciaries' appetite for ESG investments is mixed.[133] On the other, financial advisors' appetite for ESG offerings is significant and growing. A 2018 study of these intermediaries, who counsel individual savers about their investment choices, found 26% currently use or recommend ESG funds to clients and 20% "expect to increase [their] recommendation" of such funds "over the next 12 months."[134] Like virtually every other story in modern investment markets, though, individual investors play only a small part.

The staggering growth of ESG investing is being fueled by uptake from institutional investors.[135] A 2017 State Street global study of institutional investors found 80% use ESG strategies as part of their portfolios, representing a wide range of levels of adoption.[136] Results among US institutional investors were strong as well, with "27% incorporating ESG factors in at least half of their investments."[137] Many of these institutional investors are now committed to the Principles for Responsible Investment,[138] which boasts over 2000 signatories managing over $89.6 trillion in assets.[139] Signatories to this project, supported by the United Nations and

[132] U.S. Trust, *2018 U.S. Trust Insights on Wealth and Worth Survey*, available at https://ustrustaem.fs.ml.com/content/dam/ust/articles/pdf/insights-on-wealth-and-worth-2018/Detailed_Findings.pdf; *see also* Morgan Stanley, *Sustainable Signals: New Data from the Individual Investor*, available at https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf at 2 (reporting 75% of investors are interested in sustainable investing, and 86% of millennials are).
[133] *See infra* text accompanying notes 142-165.
[134] Financial Planning Association & Journal of Financial Planning, *2018 Trends in Investing Survey*, at 4, 6, at https://www.onefpa.org/business-success/Documents/2018%20Trends%20in%20Investing%20Survey%20Report%20-%20FIN.pdf.
[135] *See* Morningstar, *supra* note 1, at 1 (citing USSIF USA Review 2016).
[136] *See* State Street Global Advisors, ESG Institutional Investor Survey: Performing for the Future 6-7 (2017), at https://www.ssga.com/investment-topics/environmental-social-governance/2018/04/esg-institutional-investor-survey.pdf. A Morgan Stanley survey of "public and corporate pensions, endowments, foundations, sovereign wealth entities, insurance companies and other large asset owners worldwide" returned similar results, with "84% of the asset owners surveyed are at least 'actively considering' integrating ESG criteria into their investment process, with nearly half already integrating it across all their investment decisions." Morgan Stanley, *supra* note 132, at 1, 2.
[137] *See* State Street Global Advisors, *supra* note 132, at 7.
[138] *See* PRI, Annual Report 2018, at 25 (identifying the US as "PRI's largest market, with more than 345 signatories managing US$36 trillion"), *available at* https://d8g8t13e9vf2o.cloudfront.net/Uploads/g/f/c/priannualreport_605237.pdf; Morningstar, supra note 1, at 27 (reporting that '[v]irtually all of the largest fund companies in the U.S. are now signatories).
[139] *See* PRI, *supra* note 138, at 5, 6.

developed by a group of institutional investors,[140] pledge to "incorporate ESG issues into investment analysis and decision-making processes" and to engage in active ownership around these issues.[141] Every type of institutional investor can be found amongst the PRI's signatories: sovereign wealth funds, public and private pension funds, insurance companies, foundations and other endowments, and, of course, investment companies. These distinct types of institutional investors play very different roles in ESG investing, to which we now turn.

A. Pioneers, Major Players and Recent Converts

Sovereign wealth funds and U.S. and worldwide public pension funds have been early adopters of ESG investing practices, and today represent the largest investors in this growing market. The Norwegian Government Pension Fund Global is the world's largest sovereign wealth fund and a source of its public pension funding.[142] It has been a pioneer in this area, first focusing on sustainable investment in 2001.[143] The Norwegian fund continued to expand its ESG focus over the ensuing years, in response to government mandates.[144] Today it both excludes firms from its portfolio based on environmental and social goals, and practices engagement on these issues with the firms in which it invests.[145] Regulation also focuses sovereign wealth/public pension funds in other European nations on ESG investment, often by requiring pension funds to report on how they incorporate ESG in their investment strategies.[146]

Since 2016, regional regulation at the European Union level has required member states to allow fiduciaries of occupational retirement funds to consider ESG factors in investment decisions and to mandate that these funds include in their investment policy disclosures how they take ESG issues into account in their investment practices.[147] The EU is currently considering whether to extend these obligations further to require institutional and other asset managers to integrate ESG factors into their investment decisions. This proposal was part of a suite of three proposed by the European Commission to improve capital deployment toward sustainable development.[148] For the ESG integration mandate and other proposals to become EU law, the European Parliament

[140] *See* PRI, *About the PRI*, https://www.unpri.org/about-the-pri.
[141] PRI, *What Are the Principles for Responsible Investment*, https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.
[142] *See* Government.no, *The Government Pension Fund*, at https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/id1441/.
[143] *See* Beate Sjåfjell, Heidi Rapp Nilsen, & Benjamin J. Richardson, *Investing in Sustainability or Feeding on Stranded Assets? The Norwegian Government Pension Fund Global* 52 WAKE FOREST L. REV. 949, 956-61 (2017).
[144] *See id.*
[145] *See id.*
[146] *See* EY, *Investing in a Sustainable Tomorrow: ESG Integration in European Pensions*, at 6 available at https://www.ey.com/Publication/vwLUAssets/ey-investing-in-a-sustainable-tomorrow/$FILE/ey-investing-in-a-sustainable-tomorrow.pdf (summarizing European public pension fund ESG investment and regulation); *see also* Attracta Mooney, *ESG Wake-Up Call for Pension Laggards*, FT.COM, Oct. 14, 2018, at https://www.ft.com/content/a681b422-91a3-11e8-9609-3d3b945e78cf (describing new UK rules that would require pension plan "trustees who disregard the long-term financial risks or opportunities from ESG will have to justify why this does not hurt their investment returns").
[147] *See* Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the Activities and Supervision of Institutions for Occupational Retirement Provision (IORPs), *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32016L2341.
[148] *See* Press Release, Eur. Comm'n, *Sustainable Finance: Making the Financial Sector a Powerful Actor in Fighting Climate Change*, (May 24, 2018) (IP/18/3729), http://europa.eu/rapid/press-release_IP-18-3729_en.htm.

and Council will have to approve them, and consideration by these bodies remains ongoing.[149] Even without a regulatory mandate to do so, however, European institutional investors have been increasing their uptake of ESG investing, and European assets make up a majority of the market.[150]

U.S. assets are not far behind, however, and Stateside public pension funds major players in ESG investment markets.[151] California's CalPERS and CalSTRS funds and the New York State Common Retirement Fund, the three largest US public pension funds, have made explicit commitments to incorporate ESG into their investment decisions. [152] A new California law requiring its funds to report on the climate risk in their portfolios may deepen its funds' commitments. Though these are the three largest and most vocal ESG advocates among public pension funds, funds in many other states take similar approaches. One recent report finds public funds represent 54% of US ESG assets held by institutional investors.[153]

Public pension funds also practice engagement. They vote their shares directly even when they invest through intermediary asset managers that vote on behalf of their other investor clients.[154] They seek informal influence with company leaders. They even take the more unusual step of filing shareholder proposals.[155] New York funds have been leaders in this area. In the past few

[149] *See* European Parliament, Legislative Train Schedule, *available at* http://www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-financial-services/file-sustainable-finance-disclosures-relating-to-investments-and-risks.

[150] *See* Global Sustainable Investment Alliance, *Global Sustainable Investment Review* 7 (2016) (finding 53 percent of the $22.89 trillion in global sustainable investments were in Europe); *see also* Morningstar, *Passive Sustainable Funds: The Global Landscape*, May 2018, at 6, *available at* https://www.morningstar.com/lp/passive-esg-landscape?cid=RED_RES0002 (noting European dominance in passive sustainable investing as well, citing "an almost unbroken stream of positive quarterly net inflows"); Bloomberg Intelligence, *Sustainable Investing Grows on Pensions, Millennials* (April 4, 2018), https://www.bloomberg.com/professional/blog/sustainable-investing-grows-pensions-millennials/ ("Europe leads markets with about half of managed assets considering sustainability criteria, though growth appears to have leveled off (partly affected by methodology changes). Canada and U.S. interest continues to increase, while Japan is rising rapidly on government governance and pension fund efforts.")

[151] *See* Chris Taylor, *Sustainable Investing's Secret Weapon: Public Pensions*, REUTERS.COM, Nov. 12, 2018, at https://www.reuters.com/article/us-money-investment-esg/sustainable-investings-secret-weapon-public-pensions-idUSKCN1NH24M.

[152] *See, e.g.*, Press Release, CalPERS Adopts Environmental, Social, and Governance Strategic Plan, at https://www.calpers.ca.gov/page/newsroom/calpers-news/2016/esg-five-year-strategic-plan (Aug. 15, 2016); CalSTRS, *CalSTRS ESG Investment Policy*, at https://www.calstrs.com/esg-investment-policy ("CalSTRS incorporates PRI and other ESG principles into its investment policies and practices"); N.Y. Office of the State Controller, *Corporate Governance*, at https://www.osc.state.ny.us/pension/corporategovernance.htm (noting the New York Fund's engagement with portfolio companies places "emphasis on environmental, social and governance (ESG) issues"); Press Release, State Comptroller DiNapoli Adds $3 Billion to the State Pension Fund's Sustainable Investment Program, Dec. 7, 2018, https://www.osc.state.ny.us/press/releases/dec18/120718.htm (announcing the New York fund's additional sustainable investment commitments, bringing its total to $10 billion); New York State Common Retirement Fund, ENVIRONMENTAL, SOCIAL AND GOVERNANCE REPORT, March 2017, available at https://www.osc.state.ny.us/reports/esg-report-mar2017.pdf (reporting on the NY Common Retirement Fund's ESG strategy to "Fund has incorporated ESG analysis more formally into all aspects of its investment process"),

[153] *See* US SIF, Report on US Sustainable, Responsible and Impact Investing Trends, Executive Summary (2018) at 4-5, *available at* https://www.ussif.org/files/Trends/Trends%202018%20executive%20summary%20FINAL.pdf.

[154] *See* Griffith, *supra* note 97, at 16 ("certain investors, principally large pension funds, ask for and receive pass-through voting rights when they make mutual fund investments").

[155] *See generally* James R. Copeland, Proxy Monitor, *Special Report: Public Pension Funds' Shareholder-Proposal Activism* (2015), at http://proxymonitor.org/forms/2015Finding3.aspx#notes (examining public pension funds'

proxy seasons, the New York City Comptroller has focused on proxy access, submitting 71 proposals on the topic in the 2017 season alone.[156] The New York State Common Retirement Fund also made 44 proposals, most often addressing climate change, diversity, and political spending.[157]

Public fund pioneers seeded the sustainable investing and ESG markets, and continue to play major roles in this growing sector, but they are not alone. Insurance companies have become a large segment of the ESG investment market, and their demand for ESG investment products is growing. A 2018 global survey of insurers found that well over half of "North American (59%) and European (58%) insurers have already adopted an ESG investment policy," and another quarter or more expected to do so in the next year.[158] Zurich Insurance Group positions ESG integration of its investments as part of achieving its core goals. It explains: "To reduce risk and to help communities. These are among Zurich's aims in providing insurance, and in managing its customers' premiums. Responsible investment promises to achieve both, which has led us to adopt it in theory and in practice."[159] Given insurers' business exposure to environmental and social risks, especially those associated with climate change, it is not surprising to see them focusing on these risks as they invest assets they will need to call upon to pay future claims.[160]

Although tiny in terms of assets under management, some U.S. foundations and other charitable endowments are also increasing their ESG investing. Efforts to align endowment investing with the charitable purposes of an organization is often called mission-related investing. This classification includes not only ESG investing, but also "impact investing," which more often occurs through private and specialized investments and can contemplate intentionally concessionary financial returns in service of generating positive social impact.[161]

shareholder proposal activity and finding "From 2006 to [2015], state and municipal pension funds have sponsored 300 shareholder proposals at Fortune 250 companies. More than two-thirds of these were introduced by the pension funds for the public employees of New York City and State.").

[156] *See* New York City Comptroller, 2017 SHAREOWNER INITIATIVES POST-SEASON REPORT, *available at* https://comptroller.nyc.gov/wp-content/uploads/documents/2017_Shareowner_Initiatives_Postseason_Report.pdf (detailing these efforts, as well as numerous shareholder proposals and other company engagements around gender pay equity, diversity, climate risk and other ESG issues); *see also* DAVID WEBBER, THE RISE OF THE WORKING CLASS SHAREHOLDER 63-74 (2018) (describing the NYC Fund's proxy access project in a work articulating the power and potential of pension funds more generally).

[157] *See* Sullivan & Cromwell, *2018 Proxy Season Review* 4, at https://www.sullcrom.com/files/upload/SC-Publication-2018-Proxy-Season-Review.pdf; *see also* NY Common Retirement Fund, *supra* note 152, at 4-6 (chronicling the Fund's shareholder proposal and other engagement activities over several years).

[158] BlackRock, GLOBAL INSURANCE REPORT 2018, 33, at https://www.blackrock.com/institutions/en-us/literature/whitepaper/global-insurance-report-2018.pdf.

[159] Zurich, *Doing Well and Doing Good: Why Zurich Practices Responsible Investment*, November 2017, at file:///C:/Users/dbrakmanreiser/Downloads/zurich%20responsible%20investment%20position%20statment%202017.pdf.

[160] *See* William T.J. de la Mare, *Locality of Harm: Insurance and Climate Change in the 21st Century*, 20 CONN. INS. L.J. 189, 197-98 (2013) ("The underwriting and investment sides of insurance companies are interlinked in the sense that when investment returns are good, the insurance company may lower its rates to make them more affordable or competitive …. [i]in years when losses are relatively high, the insurer can rely on investment returns to make up for underwriting losses.").

[161] *See* Christopher Geczy, Jessica S. Jeffers, David K. Musto, & Anne M. Tucker, *In Pursuit of Good & Gold: Data Observations of Employee Ownership & Impact Investment*, 40 SEATTLE U. L. REV. 555, 560-63 (2017) (defining impact investment); Susan L. Abbott, Keirsa K. Johnson, and Sean M. Doran, *Impact Investing for Section 501(c)(3)*

Until quite recently, many foundations worried any efforts to pursue social along with financial returns were at odds with their fiduciary obligations and tax law expectations about foundation investment practices. Guidance from the Treasury in 2015 and the revised Uniform Prudent Management of Institutional Funds Act clarified that foundation managers have discretion to invest in line with the charitable purposes of their organizations.[162] This flexibility easily accommodates ESG investing, and indeed far more. The Ford Foundation credited the Treasury clarification as contributing to its decision to shift $1 billion of its $12 billion endowment to mission-related investments;[163] other foundation endowments large and small may follow suit. Impact investing – and especially the investment of endowment assets in products contemplating below-market returns – remains controversial among foundations.[164] Even skeptics, though, recognize the appeal of value of market-rate ESG investment products that can align an endowment's investment portfolio with its charitable mission.[165]

B. Untapped Potential

While retirement savers too may want to align their portfolios to their values, the barriers to ESG investing by private U.S. retirement plan managers impose significant obstacles. ERISA fiduciary law properly focuses investment managers' decision-making on financial returns,[166] as experience has shown the risk of shortfalls in such plans are all too real. Each administration since the Clinton Department of Labor has issued guidance clarifying these obligations for ERISA fiduciaries in the context of sustainable or socially-responsible investments. The tone of these pronouncements has shifted back and forth – with Democratic administrations suggesting more openness and Republican ones expressing more skepticism – up through the Trump administration's announcement in April 2018, though the upshot has remained the same. In the words of the most recent guidance, "ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals."[167]

Organizations, 29 TAX'N EXEMPTS 17, 20 (2018) (distinguishing mission-related investment from other forms of impact investment).

[162] *See* I.R.S. Notice 15-62, IRB 2015-39 (Sept. 28, 2015), https://www.irs.gov/pub/irs-drop/n-15-62.pdf ("When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes."); UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 3(a), (e)(1)(H) (Nat'l Conference of Comm'rs on Unif. State Laws 2006) (allowing fiduciaries to "consider the charitable purposes of the institution" when making investment choices).

[163] *See* Darren Walker, *Unleashing the Power of Endowments: The Next Great Challenge for Philanthropy*, Ford Foundation: Equals Change Blog (Apr. 5, 2017), at https://www.fordfoundation.org/ideas/equals-change-blog/posts/unleashing-the-power-of-endowments-the-next-great-challenge-for-philanthropy .

[164] *See* Mark Gunther, *Doing Good and Doing Well*, CHRON. PHILANTHROPY, Jan. 8, 2019, at 1 (reporting that "despite the hype," relatively few foundations engage in impact investing).

[165] *See*, *e.g.*, Mark Gunther, Hewlett Foundation's Leader Makes a Case Against Impact Investing, Jan. 8, 2019, at (reporting one foundation leader's views against impact investing by foundations, but who still believes ESG investing strategies "are fine as long as they don't sacrifice returns").

[166] *See* ERISA, 29 U.S.C. § 1104 (directing each ERISA fiduciary "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries … for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan").

[167] Department of Labor, Field Assistance Bulletin 2018-01, https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

Social policy considerations are not irrelevant; nor need ERISA fiduciaries be willfully blind to them. If non-financial issues will impact financial returns, plans should consider them as they would any other factors in a prudent analysis of risk and return. However, "[f]iduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision."[168]

Moreover, investments that can achieve social policy goals without sacrificing financial return are permissible.[169] Fiduciaries of ERISA-regulated defined benefit plan, which steward plan assets to ensure specified payouts for recipients,[170] can make ESG investments so long as they provide risk-adjusted market-rate returns. ESG investments may also be made available within ERISA-regulated defined contribution plans, also known as 401(k) or 403(b) plans, in which plan beneficiaries make their own investment choices among a menu of options curated by plan fiduciaries.[171] Current DOL guidance explicitly states that including "a prudently selected, well managed, and properly diversified ESG-themed investment alternative"[172] as one of several amongst which plan participants can choose can be permissible. It also emphasized, however, that such choices would not be appropriate as default investment options, into which savers' funds are placed unless they opt out.

The Department of Labor's various guidance documents in this area have also addressed shareholder engagement. Again, the tone of its pronouncements tends to correlate with the policy preferences of the issuing administration. In its 2016 guidance, the Obama Department of Labor stated that

> [a]n investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved.[173]

It also specifically contemplated engagement on "policies and practices to address environmental or social factors that have an impact on shareholder value" as well as a host of other issues.[174] Guidance from the Trump Department of Labor in 2018, however, explained that this earlier guidance "was not meant to imply that plan fiduciaries … should routinely incur significant plan expenses" to engage in advocacy on shareholder issues.[175]

Despite the flexibility the Department of Labor's guidance gives ERISA plan fiduciaries to consider ESG factors when they impact returns, to include ESG-themed choices in defined

[168] *See id.*
[169] *See id.*
[170] *See* Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 155-56 (2013).
[171] *See id.*
[172] *See* Department of Labor, *supra* note 167.
[173] Department of Labor, Interpretive Bulletin Relating to the Exercise of Shareholder Rights, 29 CFR Part 2509, Dec. 29, 2016, available at https://www.dol.gov/sites/default/files/ebsa/2016-31515.pdf.
[174] *Id.*
[175] Department of Labor, *supra* note 167.

contribution plans, and to practice shareholder engagement when linked to value, in light of the shifting tone of the Department's pronouncements, ERISA fiduciaries understandably remain wary. In this environment, it is not surprising that uptake of ESG investments by private U.S. retirement plans has been limited. A 2018 study found only "16% of [defined contribution] plans offer a dedicated ESG option. Notably, this number masks a large divide among plans: Only 5% of corporate DC plans offer a standalone option, compared to the 43% of public and non-profit plans that do so."[176] Some signs suggest uptake among private pension plans may increase. While only twelve percent of plan sponsors surveyed in 2018 reported incorporating ESG into selection of their fund managers, 29% indicated interest in doing so in the future.[177] Recent reports have also suggested that Wells Fargo and BlackRock were developing target-date ESG funds for the 401(k) market, "betting that a surge in interest in environmental, social or governance investing will carry through to 401(k)s."[178]

The relatively high fees associated with ESG funds can further hamper retirement plan interest. Consider the plight of the CalSavers program. The program is creating a new, publicly-managed fund to provide California private sector workers with a portable retirement savings fund. In an initial request for proposals, the program sought a suite of funds for retirement savers including an ESG option, but it was unable to find a sufficiently low-cost ESG option in this initial process.[179]

Demand from investors is part of what is driving the growth in ESG investment products. Interest among individual investors, particularly women and millennials, is already large and likely to grow. While institutional investors' interest in the space is nearly universal in Europe, the U.S. market is more varied. Public pension funds are already enthusiastic participants and insurance companies and some endowments are recent converts. The blend of regulatory uncertainty and high fees mean U.S. private pension plans are underrepresented in ESG investing. They represent still untapped potential. The final category of institutional investors – fund complexes themselves – are also already big players in the ESG market. The next Part considers their complementary role as suppliers of ESG investment products.

III. UNMASKING ESG SUPPLY SIDE DRIVERS

Supply side forces acting on those entities that develop and sell investment products are also driving the ESG market. These pressures are diverse too. Fund creators compete with each

[176] James Veneruso, Callan, *ESG's "Good Vibrations" – Not Yet for DC Plans*, May 29, 2018, at https://www.callan.com/esg-dc/.
[177] *See* Brad Smith & Kelly Regan, NEPC ESG SURVEY, July 11, 2018, https://cdn2.hubspot.net/hubfs/2529352/files/2018%2007%20NEPC%20ESG%20Survey%20Results%20.pdf?t=1541714687871.
[178] Melissa Karsh & Emily Chasan, *BlackRock, Wells Fargo Are Betting on Ethical Investing Funds for 401(k)s*, June 13, 2018, BLOOMBERG.COM, https://www.bloomberg.com/news/articles/2018-06-13/blackrock-wells-fargo-are-said-to-push-esg-funds-for-401-k-s.
[179] *See* John Hale, *3 Challenges for Getting ESG Funds Into Retirement Plans*, MEDIUM.COM, Sept. 2, 2018 (describing the CalSavers struggle), at https://medium.com/the-esg-advisor/3-challenges-for-getting-esg-funds-into-retirement-plans-1ab62c1101ff; *see also* Arleen Jacobius, *California Secure Choice Goes with Newton for CalSavers ESG Option*, PENSION & INVESTMENTS, Jan. 29, 2019, (reporting CalSavers ultimately secured an ESG fund provider), at https://www.pionline.com/article/20190129/ONLINE/190129852/california-secure-choice-goes-with-newton-for-calsavers-esg-option.

other on fund performance and fees, and each seeks to differentiate its offerings from those of its competitors in a crowded investment management market. They must retain established clients and draw in new ones, and must design products that will generate revenue to support the fund complex's bottom line. ESG investing presents opportunities for fund creators to serve their own interests in each of these ways. It has also generated a huge market opportunity for the providers of ESG indexes and metrics, who are likewise capitalizing on this key moment. This Part considers how fund creators' and index providers' responses to these pressures and opportunities are contributing to the development of ESG investing.

These market forces are largely unbridled because investment law has little to say about the substance of ESG investing.[180] A combination of investor "control" over investment allocations and intermediated fiduciary duties through employer plan sponsorships leaves investment products and retirement investors in a largely unregulated space save for the standard financial disclosures required and claims facilitated by SEC regulations.[181] Fund compliance officers likely disagree when peering from under the web of regulation, but from a consumer standpoint investment products are a low-regulatory environment where market forces dominate. Index providers operate completely outside of regulation, offering private products answerable to no one.[182] When developing ESG investment products, fund complexes and index providers in this low-regulation environment respond to the financial incentives that motivate them: increasing market share (and AUM for fund complexes) and earning fees.

As the evidence shifts to accept that ESG factors influence financial returns, fund families' business models are implicated directly. If funds perform better financially when investments excel on ESG factors, fund complexes can boost assets under management and expand market share by outperforming competitors on ESG integration. To seize this opportunity, funds will develop active funds that consider ESG as they select investments, and in doing so seek to implement the methods of ESG investing that best align with financial return. In their passive fund portfolios, fund creators will pursue ESG indexes and other metrics that likewise align with financial performance. While ESG engagement strategies might help active and passive funds alike to mitigate risk, passive funds' relative lock-in to the firms within a given index increase the importance of engagement for this market segment.

That mounting evidence linking ESG factors and financial returns is shifting the ethos of fund creators can be seen vividly in the efforts of the largest U.S. investment company, BlackRock, to reimagine itself as a force for good. In recent years, the role that the mutual fund giant has said

[180] At the portfolio company level, too, law plays a minor role. Corporate statues are generally silent as to corporate objectives and whether and to what extent corporate fiduciaries should consider sustainability and other social concerns is rarely litigated. *See* Dana Brakman Reiser, *Corporate Law, Corporate Governance and Sustainability in the United States,* 6-9, *in* CAMBRIDGE HANDBOOK ON CORPORATE LAW, CORPORATE GOVERNANCE AND SUSTAINABILITY (Beate Sjåfjell & Christopher M. Bruner, eds. Forthcoming 2019).
[181] As one author has written about separately, federal regulation of retirement plans is piecemeal and trifurcated between the Department of Labor, Internal Revenue Service and SEC leaving everyone, and *no one*, driving retirement plans the way beneficiaries may assume. *See* Tucker, *supra* note 170, at 215-218 (discussing the oversight and structural limitations of ERISA regulations).
[182] *See* Securities and Exchange Commission, *Fast Answers: Market Indices*, (explaining that"[t]he SEC does not regulate the content of these indices" used to compose indexed mutual funds and ETFs), at https://www.sec.gov/fast-answers/answersindiceshtm.html.

ESG factors will play in its investment practices has markedly increased. Perhaps most prominently, BlackRock Chairman and CEO Larry Fink expressed concern in his 2018 letter to CEOs of its investee companies that

> [t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.[183]

Fink pledged BlackRock would use its considerable clout with portfolio companies to demand long-term growth strategies that take sustainability issues into account, at least as they contribute to growth and profitability. Despite mixed responses to the 2018 letter, this year's missive doubles down on the ESG theme. Fink asserted that "profits and purpose are inextricably linked"[184] and implored CEOs to "fulfill their purpose and responsibilities to stakeholders."[185]

Fink's 2019 letter also pointed to the swelling importance of millennials as employees, consumers and investors. As to the latter, he explained, "as wealth shifts and investing preferences change, environmental, social, and governance issues will be increasingly material to corporate valuations."[186] Not all fund complexes will climb out as far on the ESG limb as BlackRock claims to be going. Generational shifts will impact all of them, however. If Fink's predictions are borne out, other fund complexes – whether in or outside of the public eye – will need to ramp up their consideration of and engagement on environmental, social and governance factors to keep their funds' returns competitive and appeal to the investors of the future.

Fielding ESG funds can offer fund complexes benefits beyond the assets invested in ESG funds themselves. Consider retirement plan administrators creating the highly curated investment menu (on average nearly 20 funds)[187] for participants to allocate their retirement savings. Including ESG funds in a fund family facilitates direct investment opportunities in those funds, but it may also garner goodwill about the fund family, facilitating investment in traditional products carried by a fund with both ESG and traditional products. To that end, funds may advertise ESG-related vehicles as a branding and marketing exercise intended to direct fund flows to both ESG and traditional products they offer. For example, in 2018, coinciding with the largest fund flow to passive funds ever, TIAA-CREF launched a new advertising campaign for Nuveen, the firm's ESG investing arm. The campaign was titled "investing by example" and included video content for internet and television and nationwide billboard and print advertising.[188] The campaign focused on the positive ripple effect of investments with the line, "When we invest in a world we're proud to leave behind, it isn't just business as usual. It's

[183] Larry Fink, Letter to CEOs, 2018 at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.
[184] Larry Fink, "Larry Fink's 2019 Letter to CEOs: Purpose & Profit," Jan. 16, 2019, at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (emphasis in original).
[185] *Id.* (emphasis added).
[186] *Id.*
[187] *See, e.g.,* Janice Kay McClendon, *The Death Knell of Traditional Defined Benefit Plans: Avoiding a Race to the 401(k) Bottom*, 80 TEMP. L. REV. 809, 813 (2007) (citing an average of 18 choices in a defined contribution plan menu).
[188] Julie Mansmann, *Impact Takes Centerstage in Nuveen Ad Campaign*, FUND INTELLIGENCE, Sept. 25, 2018, https://fundintelligence.global/sales-marketing/news/impact-takes-centerstage-in-nuveen-campaign/.

investing by example."[189] The campaign contained intentional features to reach baby boomers as well as young investors, for example, it used a band popular with millennials to play a cover of the 1970's band the Carpenters. The ads also harkened back to TIAA-CREF's founder Andrew Carnegie, and linked the legacy investment arm with the new ESG practice.[190]

ESG investing provides fund complexes with a welcome counterbalance to the passive investing trend, and its negative effect on fees. Fund complexes rely for revenues in large part on the higher fees paid for active fund investments.[191] As data emerged showing passive funds consistently outperforming their active counterparts, particularly when returns are considered net of fees, fund flows to passive strategies increased, and active managers have come under pressure to reduce fees or justify them in some way.[192] The costs and challenges of ESG investment can be used to support active management strategies and to justify higher fees in actively- and passively-managed funds alike.

The growing pool of investors demanding alignment of their investments with their values may accept that strong ESG investment performance justifies higher fees. After all, even funds marketed as ESG index products often include some active elements like screening – and associated higher fees.[193] Relatively higher-fee ESG offerings can thus offset lower fees earned on ordinary indexed assets and fund flow favoring passive strategies.[194] In this way, ESG investment products can also be used strategically to respond to the existential threat fund complexes face from the rise of passive investing. We term this concept "fund family balancing" where funds offer fee-earning products to offset outflows from traditional investment vehicles gutted by investors' appetite for passive investment.[195]

The increase in demand for and use of ESG factors in investing also empowers the research firms providing ESG metrics, benchmarking ESG performance, and, most importantly, designing ESG indexes. As noted above, intermediaries that produce and sell these opaque systems, like MSCI and FTSE Russell, already play an outsized role in ESG indexed equity funds. By at least one measure, they also appear to be pursuing widely disparate visions or applications of ESG in their own work. A 2018 study by Schroders found a remarkable "lack of consistency in ESG scores between the main data providers."[196] By quite literally setting the standards for what counts as ESG, index and other ESG metric providers wield tremendous influence over how institutional investors will ESG factors. Moreover, by dint of their power in the investment marketplace,

[189] *Id*.
[190] *See id*.
[191] *See* Fisch et al., *supra* note 32, at 8 & nn. 36-37 (reporting that even passive fund specialists like Vanguard field numerous active funds).
[192] *See* Charles Stein, Annie Massa & Felice Maranz, *Free Fidelity Funds Stoke Price War in Bid to Catch Index Giants*, BLOOMBERG.COM, Aug. 2, 2018 (describing how all of the major mutual fund and ETF providers are engaged in fee reduction to capture investors seeking low-price options), at https://www.bloomberg.com/news/articles/2018-08-01/fidelity-to-offer-index-mutual-funds-with-zero-expense-ratio.
[193] *See, e.g.*, Praxis Growth Index Fund (Form 497K) (April 30, 2018).
[194] *See* Morningstar, supra note 1, at 27-28 (positing that fund creators repurposing actively managed funds experiencing outflows "would not be surprising").
[195] Future work could examine the relationship between fund flows out of actively managed funds and the rise of ESG funds.
[196] *See* Ovidiu Patrascu, *Index-Based ESG Strategies: Key Things to Watch For*, Aug. 2018., at https://www.schroders.com/en/sysglobalassets/digital/insights/2018/thought-leadership/e.s.g.-in-passive-final.pdf.

these very private players will impact the environmental, social and governance goals to which portfolio companies will aspire. To appease their clients and maintain their market dominance, index and metric providers will naturally seek to weight ESG factors that align with financial performance, but these may or may not align with either investor preferences or societal needs in these areas. The private nature of the indexes means none of us will likely ever know.

IV. Analysis and Responses

Enormous amounts of money are flowing into ESG and now ESG index funds, driven by a combination of demand-side and supply-side forces. Whether driven by their individual values, legal requirements, or a vision of ESG factors driving financial return, investors are demanding products that respond to systemic risk, climate change and social inequality. Fund creators' relentless pursuit of tools to better predict financial return, as well as their desire to increase market share and enhance revenues in an industry rocked by the rise of passive investing, are leading them to supply a dizzying array of ESG products. These products in turn are increasingly linked to opaque and unaccountable indexes. In ESG investing's low-regulation environment, these market forces are largely unchecked.

The variety and opacity of ESG funds leaves even a diligent and well-intentioned investor without assurance that an ESG investment, and even more so one in an ESG index fund, can deliver its dual promises of either secure, guilt-free accumulation of wealth or a stable environment and society in which that wealth can ultimately be used. It is beyond the scope of this Article to comprehensively consider the market-based and regulatory strategies for improving ESG products' ability to satisfy investor expectations and harness the investment market to improve environmental and social sustainability. In this Part, however, we briefly sketch some promising alternatives and identify areas for exploration in future research.

The market, already the most powerful force in this low-regulation space, is one promising place to seek improvement in ESG investing. If investors, both institutional and individual, demand more clarity about ESG practices and commitments, fund creators can be expected to respond. On the individual side, we can expect the growing financial weight of women and millennials to continue to increase demand for more and better ESG investing options. Like all individual investors, though, they face coordination problems and information deficits. Therefore, intermediary behavior will be key. Expert investment intermediaries can demand greater clarity and assessment from fund creators, especially if the potential of ERISA markets can be tapped. On the institutional side, a combination of business goals and legal dictates will also increase demands for reliable and transparent ESG investment products. So long as the trend in the data confirming ESG investing's link to financial performance persists, institutional investors will continue to up their demands for real and accountable ESG integration. Disclosure requirements in the EU are already driving ESG innovation and transparency. If this major market mandates its largest players use ESG factors in their investments, they will push fund creators worldwide to offer products that can be shown to comply.

The impact of regulation already being felt in Europe is just one example of how legal intervention can play a positive role in improve ESG investing's ability to deliver on its promises. It seems far-fetched to imagine the US regulators imposing ESG integration mandates on investors. Disclosure requirements, however, could be updated to include information on ESG factors. Much of the discussion around ESG or sustainability disclosure in the U.S. has revolved around issuer obligations.[197] Currently, securities regulation imposes no broad-based requirement for companies to engage in such disclosures,[198] although they do frequently issue voluntary disclosures styled as corporate responsibility or sustainability reports.[199] Organizations like the Global Reporting Initiative[200] and Sustainability Accounting Standards Board[201] offer tools to standardize this voluntary reporting, but at the moment their contents remain diverse and often difficult to compare.[202] The conversation about issuer disclosure is important, but resolving it will not necessarily provide investors with sufficient information. When they invest in funds combining scores of individual issuers, disclosures around the ESG practices of a fund or its associated index will be far more informative. The European experience can help US regulators distill the focus and content of any such disclosure mandates it might impose on investment companies, and future work in this area is warranted.

Another legal intervention to increase the transparency and effectiveness of ESG investing would take advantage of a different set of investment intermediaries: private employers and their retirement plan administrators. As discussed above, operating in the shadow of often dire Department of Labor warnings about non-financial investment considerations, these ERISA fiduciaries currently make relatively little use of ESG investment products. This barrier should be removed or reframed to seize upon the link between ESG performance and financial performance, particularly over the long-term, and its consequent compatibility with retirement savings. In doing so, however, the Department of Labor should prod ERISA fiduciaries to become demanding consumers of ESG products, requiring transparent and consistent disclosures of ESG strategies, and their impact on fees, diversification and tracking error. Fund creators not wanting to miss out on the enormous ERISA-regulated asset market would have significant incentives to respond.

Regulating index providers is yet another route to improving the content, consistency and transparency of ESG investment products. By creating the metrics that power ESG investing, these thoroughly private players wield great public power over markets – and more. One need

[197] *See e.g.*, Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, at 12-20 (forthcoming Geo. L.J. 2019), available at https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3000&context=faculty_scholarship (advocating a new mandatory sustainability discussion and analysis section of issuers' annual disclosures); Roberta Karmel, *Disclosure Reform - The SEC Is Riding off in Two Directions at Once*, 71 BUS. LAW. 781 (2015-2016); *see also* S.E.C. Concept Release, *Business and Financial Disclosure Required by Regulation S-K*, Rel. No. 33-10064, Apr. 13, 2016, at 206-15, *available at* https://www.sec.gov/rules/concept/2016/33-10064.pdf (requesting comments on whether the SEC should mandate sustainability disclosure by issuers).
[198] *See* Fisch, *supra* note 197, at 12-20 (describing the lack of SEC mandates in this area, with discussion of limited disclosure obligations it has imposed around climate change and board diversity).
[199] *See* KPMG, *The Road Ahead: The KPMG Survey of Corporate Responsibility Reporting* 4 (2017) (finding "CR reporting is standard practice for large and mid-cap companies around the world" with three-quarters of companies surveyed engaging in the practice), at https://assets.kpmg/content/dam/kpmg/xx/pdf/2017/10/kpmg-survey-of-corporate-responsibility-reporting-2017.pdf.
[200] *See* Global Reporting Initiative, *About*, at https://www.globalreporting.org/information/about-gri/Pages/default.aspx.
[201] *See* Sustainability Accounting Standards Board, *Standards Overview*, at https://www.sasb.org/standards-overview/.
[202] *See* Fisch, *supra* note 197, at 29-33; Jill M. D'Aquila, *The Current State of Sustainability Reporting: A Work in Progress*, THE CPA JOURNAL (July 2018), *available at* https://www.cpajournal.com/2018/07/30/the-current-state-of-sustainability-reporting/.

only look to the role of the rating agencies in the 2008 financial crisis to be reminded of the tremendous power of seemingly unassuming metric providers.

European regulation has again been at the forefront here, with its European Benchmark Regulation going into force in January 2018. This Regulation creates "a common framework to ensure the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts, or to measure the performance of investment funds in the Union."[203] It was prompted by scandals like LIBOR[204] and concerns about the growing influence and concentration of index providers in the passive investing space more generally, and not with ESG indices in mind. Its authority sweeps broadly, however. Whether it will be effective in constraining index providers, and in what ways, will depend on how it is implemented. But index providers seeking to operate in the EU market (read: virtually all of them and certainly all of the big ones) are watching.

The topic of index regulation looms large on the US regulatory horizon as well. The massive shift of investment assets under management to passive strategies empowers private index providers. They are generating huge profits and the market is consolidating. The longstanding view that index providers are mere publishers, not investment advisors, is ripe for revision. The ESG context, where index providers devise bespoke indexes sometimes for use by a single fund, is an example of the declining utility of the publisher analogy. Review of the idea that a fund's disclosure that it uses a particular index is sufficient without greater elaboration is likewise overdue. The SEC's recent proposed regulations on ETFs did not address these issues or index regulation more generally, but this effort certainly drew its attention to the explosive growth and power of index providers.[205] If and when the SEC sets its sights on index regulation, the particular challenge of making ESG indexes transparent and accountable must be part of the conversation.

CONCLUSION

The promise of ESG investing in general, and passive ESG in particular, is enormous. Despite its astounding recent growth in AUM, the offerings in this essentially unregulated market are endlessly varied and its use of ESG factors is opaque. ESG investment strategies are difficult to parse and impossible to compare, and ESG fees – especially for index funds – are often high. Portfolio holdings and fund voting records vary widely in how much they differ from non-ESG alternatives, and investigating these differences across the field of funds is a monumental task. In the growing ESG index fund market, tracking errors are high and this indicator trades off

[203] *See* Regulation (EU) 2016/1011 on Indices Used as Benchmarks in Financial Instruments and Financial Contracts or to Measure the Performance of Investment Funds, 8 June 2016, art. I, at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.171.01.0001.01.ENG&toc=OJ:L:2016:171:TOC.
[204] *See id.* (noting in the preamble at (1) that "[s]erious cases of manipulation of interest rate benchmarks such as LIBOR and EURIBOR, as well as allegations that energy, oil and foreign exchange benchmarks have been manipulated, demonstrate that benchmarks can be subject to conflicts of interest").
[205] *See* SEC, Proposed Rule: Exchange Traded Funds, Release Nos. 33-10515, June 28, 2018, at 11, at https://www.sec.gov/rules/proposed/2018/33-10515.pdf (discussing ETFs' reliance not only on "broad-based" but also "specialized", "customized or bespoke indexes"); *see also* Speech by Dalia Blass, Director, SEC Division of Investment Management, March 19, 2018, at https://www.sec.gov/news/speech/speech-blass-2018-03-19 (suggesting, in a speech "only for myself and not for the Commission, the Commissioners or the staff," that innovation in the index market may mean it is time to "revisit" these regulatory issues).

against ESG performance. For ESG investors to reliably build savings or wealth in tandem with contributing to social and environmental progress, greater consistency and transparency is required. At the moment, fund creators and index providers are in the driver's seat. As demand for ESG investment products, and their quality, increases, investors may demand that fund creators and index providers make these improvements. Changes to securities disclosure, ERISA law, and index regulation could hasten their implementation.

The degree of difficulty rises when one asks what contributions ESG investing can make to society writ large. The market players in ESG investing are acting in their own self-interest and can be expected to continue to do so. When this self-interest aligns with the interests of society – and especially when environmental and social responsibility aligns with financial return – the rest of us can free ride. But we cannot expect a complete overlap. Even if transparency and consistency in ESG investing improves, it is no panacea. Additional efforts by governments, the private sector and countless individual actors are necessary to make real progress on the systemic challenges facing global society today.

APPENDIX I

Sample Funds

ESG Funds

Pax Global Environmental Mrkts Instl
Morgan Stanley Inst Global Opp
Calvert Emerging Markets Equity I
RBC Emerging Markets Equity I
AB Sustainable Global Thematic A
Amana Income Investor
Domini Impact International Equity Inv
Eventide Gilead N
Neuberger Berman Socially Rspns Inv
Parnassus Mid-Cap
Hartford Schroders Emerging Mkts Eq I
Amana Growth Investor
Calvert Equity A
TIAA-CREF Social Choice Eq Instl
Parnassus Endeavor Investor
JPMorgan Emerging Markets Equity A
Parnassus Core Equity Investor

ESG Passive Funds

Vanguard FTSE Social Index Inv
Calvert US Large Cap Core Rspng Idx I
iShares MSCI KLD 400 Social ETF
PowerShares Water Resources ETF
PAX MSCI EAFE ESG Leaders Index Instl
iShares MSCI USA ESG Select ETF
Guggenheim S&P Global Water ETF
iShares MSCI ACWI Low Carbon Target ETF
Calvert Global Water A
Guggenheim Solar ETF
Green Century MSCI International Index Fund - Institution
Praxis Growth Index Fund A
Praxis International Index A
Praxis Value Index A

Non-ESG Comparison Funds

Morgan Stanley Global Core Portfolio
iShares Core S&P 500 ETF
Neuberger Berman Large Cap Value Fund
TIAA-CREF Growth & Income Fund
Vanguard Equity Income Fund Investor Shares
JP Morgan Emerging Markets

APPENDIX II

Top 10 Portfolio Holdings of Sample Funds

**High household name brand recognition denoted by HNB*

ESG PASSIVE SAMPLE (n= 14)		
Vanguard FTSE Social Index Inv. *HNB*		
Wells Fargo & Co	Cisco Systems Inc	Mastercard Inc A
Procter & Gamble Co	The Home Depot Inc	Walt Disney Co
Intel Corp	Merck & Co Inc	Citigroup Inc
		PepsiCo Inc
Calvert US Large Cap Core Rspn Idx I *HNB*		
Apple Inc	Amazon.com Inc	Visa Inc Class A
Alphabet Inc A	JPMorgan Chase & Co	AT&T Inc
Microsoft Corp	Bank of America Corporation	Pfizer Inc
		Intel Corp
iShares MSCI KLD 400 Social ETF *HNB*		
Microsoft Corp	Alphabet Inc A	Intel Corp
Facebook Inc A	Verizon Communications Inc	Procter & Gamble Co
Alphabet Inc Class C	Cisco Systems Inc	Merck & Co Inc
		Coca-Cola Co
PowerShares Water Resources ETF		
Waters Corp	Xylem Inc/NY	IDEX Corp
Danaher Corp	Toro Co/The	HD Supply Holdings Inc
Roper Technologies Inc	Pentair PLC	AO Smith Corp
		Rexnord Corp
PAX MSCI EAFE ESG Leaders Index Instl *HNB*		
Roche Holding AG Dividend Right Cert. ROG	Commonwealth Bank of AustraliaCBA	Unilever NV DR UNA
GlaxoSmithKline PLC GSK	Basf SE BAS	Siemens AG SIE
SAP SE SAP	Novo Nordisk A/S B NOVO B	Allianz SE ALV
iShares MSCI USA ESG Select ETF *HNB*		
Microsoft	3M	Blackrock
EcoLab Inc	Accenture	Agilent Technologies Inc.
Apple Inc	Alphabet	Northern Trust

		Cor.
		Prologis REIT Inc.
Guggenheim S&P Global Water ETF		
Xylem Inc/NY	Geberit AG	Tetra Tech Inc
Danaher Corp	Pentair PLC	Coway Co Ltd
IDEX Corp	Alfa Laval AB	Aalberts Industries NV
		ANDRITZ AG
iShares MSCI ACWI Low Carbon Target ETF		
Apple Inc.	Johnson & Johnson	JP Morgan
Microsoft	Facebook	Alphabet Inc.
Amazon com Inc	Alphabet Inc. Class A	Pfizer Inc
		Bank of America
Calvert Global Water A		
American Water Works Co Inc	United Utilities Group PLC	Suez
Cia de Saneamento de Minas Gerais-COPASA	Guangdong Investment Ltd	Pennon Group PLC
Veolia Environnement SA	Cia de Saneamento do Parana	Beijing Enterprises Water Group Ltd
		American States Water Co
Guggenheim Solar ETF		
First Solar Inc FSLR	SolarEdge Tech. Inc SEDG	Enphase Energy Inc ENPH
Sunrun Inc RUN	Canadian Solar Inc CSIQ	Hannon Armstrong Sustainable Infrastructure Capital Inc HASI
Scatec Solar ASA SSO	Meyer Burger Technology AG MBTN	SunPower Corp SPWR
Green Century MSCI International Index Fund - Institution		
Kao Corp.	Nintendo Co. Ltd.	RELX PLC
Intesa Sanpaolo S.p.A.	Banco Bilbao Vizcaya Arg. S.A.	Schneider Electric SE
Kering		KDDI Corp.
Canadian Imperial Bank of Comm.		Adidas AG
Praxis Growth Index Fund A *HNB*		
Apple Inc	Alphabet Inc Class C	UnitedHealth Group Inc
Microsoft Corp	Facebook Inc A	The Home Depot

		Inc
Amazon.com Inc	Visa Inc Class A	Alphabet Inc A
		Mastercard Inc A
Praxis International Index A		
Nestle SA	Toyota Motor Corp	HSBC Holdings PLC
Tencent Holdings Ltd	Equinor ASA	Alibaba Group Holding Ltd
Taiwan Semiconductor Manufacturing Co Ltd	Roche Holding AG	Chunghwa Telecom Co Ltd
		AstraZeneca PLC
Praxis Value Index A *HNB*		
Apple Inc	UnitedHealth Group Inc	Walmart Inc
JPMorgan Chase & Co	AT&T Inc	Citigroup Inc
Bank of America Corporation	Johnson & Johnson	DowDuPont Inc
		Procter & Gamble Co
		Walmart Inc

ESG Fund sample (n=17)		
Parnassus Core Equity Investor *HNB*		
Xylem Inc	VF Corp	Sysco Corp
WD-40 Co	Verisk Analytics Inc	Synopsys Inc
Waste Management Inc	United Parcel Service Inc Class B	Starbucks Corp
Walt Disney Co		
JPMorgan Emerging Markets Equity A		
Tencent Holdings Ltd	Housing Development Finance Corp Ltd	Sberbank of Russia PJSC
Alibaba Group Holding Ltd ADR	Samsung Electronics Co Ltd	HDFC Bank Ltd
AIA Group Ltd	Ping An Insurance (Group) Co. of China Ltd H	MercadoLibre Inc
Taiwan Semiconductor Manufacturing Co Ltd ADR		
Parnassus Endeavor Investor *HNB*		
Qualcomm Inc	Micron Technology	Allergan PLC

	Inc	
Mattel Inc	United Parcel Service Inc Class B	Bristol-Myers Squibb Company
CVS Health Corp	Alliance Data Systems Corp	Hanesbrands Inc
Gilead Sciences Inc		
TIAA-CREF Social Choice Eq Instl		*HNB*
Apple Inc	Procter & Gamble Co	Merck & Co Inc
Microsoft Corp	Cisco Systems Inc	Coca-Cola Co
Bank of America Corporation	Intel Corp	PepsiCo Inc
The Home Depot Inc		
Calvert Equity A		*HNB*
Thermo Fisher Scientific Inc	Microsoft Corp	Zoetis Inc Class A
Danaher Corp	Praxair Inc	Mastercard Inc A
Alphabet Inc Class C	Dollar General Corp	Intuit Inc
Visa Inc Class A		
Amana Growth Investor		*HNB*
Adobe Systems Inc	Cisco Systems Inc	Alphabet Inc A
Apple Inc	Amgen Inc	The Estee Lauder Companies Inc Class A
Intuit Inc	Church & Dwight Co Inc	Harris Corp
TJX Companies Inc		
Hartford Schroders Emerging Mkts Eq I		
Tencent Holdings Ltd	China Construction Bank Corp H	China Petroleum & Chemical Corp H Shares
Samsung Electronics Co Ltd	PJSC Lukoil ADR	AIA Group Ltd
Alibaba Group Holding Ltd	Sberbank of Russia PJSC	Naspers Ltd Class N
Taiwan Semiconductor Manufacturing Co Ltd		
Parnassus Mid-Cap		
Motorola Solutions Inc	Hologic Inc	Clorox Co
Fiserv Inc	Teleflex Inc	Iron Mountain Inc
Verisk Analytics Inc	Xylem Inc	MDU Resources Group Inc
First Horizon National Corp		
Neuberger Berman Socially Rspns Inv		*HNB*

Progressive Corp	Aptiv PLC	Intercontinental Exchange Inc
Comcast Corp Class A	Danaher Corp	The Kroger Co
Texas Instruments Inc	Becton, Dickinson and Co	Alphabet Inc A
Advance Auto Parts Inc		
Eventide Gilead		
XPO Logistics Inc	Splunk Inc	Macquarie Infrastructure Corp
Wayfair Inc Class A	HubSpot Inc	Instructure Inc
Ascendis Pharma A/S ADR	Palo Alto Networks Inc	Lam Research Corp
Lowe's Companies Inc		
Domini Impact International Equity Inv		
Sanofi SA	Kering SA	Novartis AG
Nissan Motor Co Ltd	Allianz SE	Koninklijke Ahold Delhaize NV
Central Japan Railway Co	Sandvik AB	AXA SA
Vodafone Group PLC		
Amana Income Investor		*HNB*
Eli Lilly and Co	Parker Hannifin Corp	Canadian National Railway Co
Microsoft Corp	Pfizer Inc	DowDuPont Inc
3M Co	Honeywell International Inc	PPG Industries Inc
Rockwell Automation Inc		
AB Sustainable Global Thematic A		
MSCI Inc	Visa Inc Class A	Infineon Technologies AG
Xylem Inc	UnitedHealth Group Inc	Kingspan Group PLC
Hexcel Corp	Ecolab Inc	American Water Works Co Inc
Housing Development Finance Corp Ltd		
RBC Emerging Markets Equity I		
Naspers Ltd Class N	AIA Group Ltd	Credicorp Ltd
Housing Development Finance Corp Ltd	Unilever PLC	SM Investments Corp
Tata Consultancy Services Ltd	Antofagasta PLC	Shinhan Financial Group Co Ltd

Taiwan Semiconductor Manufacturing Co Ltd		
Calvert Emerging Markets Equity I		
Wal – Mart de Mexico SAB de CV Class V	Techtronic Industries Co Ltd	Shoprite Holdings Ltd
Ultrapar Participacoes SA	Tech Mahindra Ltd	Shenzhen International Holdings Ltd
Tong Yang Industry Co Ltd	Taiwan Semiconductor Manufacturing Co Ltd ADR	Sberbank of Russia PJSC ADR
Tencent Holdings Ltd		
Morgan Stanley Inst Global Opp I		*HNB*
Amazon.com Inc	DSV A/S	Moncler SpA
Mastercard Inc A	TAL Education Group ADR	Visa Inc Class A
Facebook Inc A	Alphabet Inc C	Hermes International SA
Booking Holdings Inc		
Pax Global Environmental Mrkts Instl		
Sealed Air Corp	Suez SA	Ferguson PLC
Siemens AG	Danaher Corp	Praxair Inc
East Japan Railway Co	Ecolab Inc	Aptiv PLC
TE Connectivity Ltd		

Non-ESG SAMPLE (n= 7)		
Morgan Stanley Global Core Portfolio		*HNB*
Tencent Holdings Ltd. ADR	Ryanair Holdings PLC ADR	Comcast Corp. Cl A
JPMorgan Chase & Co.	Mastercard Inc.	Booking Holdings Inc.
Apple Inc.	Taiwan Semiconductor Manufacturing Co. Ltd. ADR	VMware Inc.
Nippon Telegraph & Telephone Corp. ADR		
iShares Core S&P 500 ETF		*HNB*
Apple Inc.	JP Morgan Chase & CO	Alphabet Class A
Microsoft Corp	Berkshire Hathaway	Johnson & Johnson

	Class B	
Amazon Inc.	Alphabet Class C	EXXON Mobil Corp.
Facebook Inc.		
Neuberger Berman Large Cap Value Fund		
American Electric Power Co. Inc.	CME Group Inc. Cl A	Exelon Corp.
Cabot Oil & Gas Corp.	DTE Energy Co.	Exxon Mobil Corp.
Centene Corp.	Equity Residential	First Energy Corp
Chubb Ltd.		
TIAA-CREF Growth & Income Fund		*HNB*
Abbott Laboratories	Apple Inc.	Chevron Corp.
AbbVie Inc.	Bank of America Corp.	Cisco Systems Inc.
Alphabet Inc. Cl C	Boeing Co.	Citigroup Inc.
Amazon.com Inc.		
Vanguard Equity Income Fund Investor Shares		*HNB*
Bristol-Myers Squibb Co.	Coca-Cola Co.	Eli Lilly & Co.
Caterpillar Inc.	Comcast Corp. Cl A	Exxon Mobil Corp.
Chevron Corp.	DowDuPont Inc.	Intel Corp.
Cisco Systems Inc.		
Vanguard 500 S&P Index		*HNB*
Microsoft Corp	Johnson & Johnson	Facebook Inc A
Apple Inc	JPMorgan Chase & Co	Alphabet Inc A
Amazon.com Inc	Alphabet Inc Class C	Exxon Mobil Corp
Berkshire Hathaway Inc B		
JPMorgan Emerging Economies Fund		
Alibaba Group Holding Ltd. ADR	China Merchants Bank Co. Ltd.	Cognizant Technology Solutions Corp.
Baidu Inc. ADR	Chinatrust Financial Holding Co. Ltd.	Fubon Financial Holding Co. Ltd.
Catcher Technology Co. Ltd.	CNOOC Ltd.	Hana Financial Group Inc.
China Construction Bank Corp.		

Putting the "S" in ESG: Measuring Human Rights Performance for Investors

CASEY O'CONNOR AND SARAH LABOWITZ

NYU | STERN

Center for Business and Human Rights

MARCH 2017

About the Center

Launched in March 2013, the NYU Stern Center for Business and Human Rights is the first human rights center based at a business school. Led by Michael Posner and Sarah Labowitz, the Center offers dedicated courses on business and human rights to MBA and undergraduate business students. In different business sectors, it undertakes projects that combine original research, convening stakeholders, and public advocacy. The Center is an independent academic endeavor of NYU Stern. It receives funding from NYU Stern, philanthropic foundations, individuals, and companies.

More information at http://bhr.stern.nyu.edu.

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Foreword

Investors have a special role in shaping and influencing company actions relating to human rights. Since its founding in 2013, the NYU Stern Center for Business and Human Rights has devoted significant attention to this issue, promoting long-term investing, advocating with public pension funds and university endowments to pay greater attention to human rights, and partnering with Robert F. Kennedy Human Rights to develop human rights programming for some of the largest investors in the world.

In April 2016, the Center and Robert F. Kennedy Human Rights co-sponsored a two-day workshop entitled Measuring Human Rights Performance: Metrics that Drive Change. It brought together people from different business sectors with representatives from civil society, ratings agencies, and academia to explore the current gaps in evaluating the human rights performance of large multinational companies. This paper draws inspiration from the ideas generated at that meeting, but is not a record of the workshop.

Investors increasingly recognize that the lack of reliable, accessible information about the human rights track records of individual companies hinders their ability to manage medium- to long-term risks and advance social objectives in an investment context. While much of this report focuses on the shortcomings of current efforts, we recognize the significant conceptual and operational hurdles and costs that make the assessment of human rights performance such a daunting task.

This paper is based on analysis of 12 existing frameworks for assessing "S" – the social component of "environmental, social, and governance" (ESG) investing approaches. The efforts of those behind these frameworks have been a pioneering first step in pushing investors to develop metrics and tools that help improve the human rights performance of companies. We remain committed to collaborating with the dynamic field of ESG professionals to make practical progress in enhancing "S" measurement in the years ahead.

David Wang, Andrew Duncan, APG, Robert F. Kennedy Human Rights, and the NYU Green Grants program generously supported the April 2016 workshop and subsequent preparation of this white paper. Dorothée Baumann-Pauly, the Center's research director, provided expert guidance on indicator coding and analysis. Gabriel Ng, Nicole Kenney, Nate Stein, Ijeamaka Obasi, Tara Wadhwa, and April Gu did the painstaking work of indicator coding. The paper benefited from thoughtful suggestions offered by Will Millberg, Amol Mehra, Debora Spar, Kilian Moote, Josh Zoffer, Auret van Heerden, and Justine Nolan. Mike Posner's sharp editorial eye helped bring the project to completion, and Kerry Kennedy was a guiding light throughout. Luke Taylor copy edited the report and Samantha Kupferman and Natalie Butz of West End Strategy Team provided communications guidance.

Contents

Executive Summary

Protestors in Irvine, CA boycott Taco Bell for underpaying the farm workers who supply its tomatoes. As individual investors increasingly seek to align their money with their values, financial firms need ways to evaluate the social performance of companies in which they invest. (photo credit: David McNew).

Until recently, sustainable investing was a niche in the broader financial landscape. But today, environmental, social, and governance (ESG) factors are increasingly important to mainstream investors. Large financial firms like Bloomberg, Morgan Stanley, and Goldman Sachs are expanding their ESG product and service offerings. Going forward, women and millennials are poised to manage a greater share of global wealth, and to do so in a way that aligns with their values about fairness, the environment, and human rights.

Some of the largest pools of capital – public pension funds, sovereign wealth funds, and university endowments – also are experimenting with applying ESG criteria as they seek to ensure sustainability across very long time horizons. And in the face of rising economic inequality and mounting evidence of the negative externalities of business practices, financial firms are under pressure to demonstrate that they can deliver value in today's global economy in ways that work for people and communities around the world.

This paper is particularly concerned with the social ("S") performance of companies, which we define as the operational effects of a company on the labor and other human rights of the people and communities it touches. Standards that define these rights are laid out in multiple international instruments, including the Universal Declaration of Human Rights and the Core Conventions of the International Labour Organization.[1] While originally developed for governments, these standards have been extended to the business context and provide a strong foundation in which to ground the scope and meaning of "social" performance.[2]

Over the past three decades, a multi-faceted industry has evolved to offer reporting services on ESG factors to investors and other stakeholders. Investors should be able to rely on the ESG industry to provide data that helps them identify strong performers and assess risk. When it comes to evaluating companies on their toxic waste emissions ("E") or vulnerability to fraud and corruption ("G"), investors now have tools to assist them. But our analysis of 12 leading ESG frameworks shows that the ESG industry is still falling short of this objective when it comes to "S".

We conclude that there are four fundamental gaps:

1. Social **measurement evaluates what is most convenient**, not what is most meaningful.

2. Current approaches to disclosure are **not likely to yield the information needed** to identify social leaders.

3. The **lack of consistent standards** underpinning social measurement increases costs and creates confusing "noisiness" across the ESG industry.

4. Existing measurement **does not equip investors to respond to rising demand** for socially responsible investing strategies and products.

In short, the ESG industry must improve measurement of social performance. The abundance of ESG measurement and products belies the limited basis on which companies are currently assessed on their social performance, while imposing significant costs on companies and other stakeholders. To date, investors have been too willing to accept data that does little to actually assess the social performance of the companies in which they invest. Many still view "S" as a check-the-box exercise in which investors and companies can appear to comply with rising consumer expectations around sustainability, while avoiding the actual costs of improving performance.

That said, most investors view themselves as good actors, who would deploy capital in a way that benefits society – if they can do so while remaining responsible fiduciaries to their clients and beneficiaries. In the context of heightened scrutiny of the financial industry, this is an important moment to seek greater rigor and efficiency in the ESG industry when it comes to measuring "S". Seeking a new way forward for "S" is an opportunity to rationalize the considerable expense of current ESG strategies, while deepening understanding of the long-term benefits of strong social performance for a company's operations and an investor's portfolio.

We offer four principles for improved measurement of social performance that we hope will spur much-needed action to reform the "S" in the ESG industry:

1. **Measure companies' real-world effects**, not just their efforts.

2. **Diversify the data** – go beyond company disclosure.

3. Establish and **rely upon clear standards** for evaluating "S".

4. **Target investors** as the primary audience.

All stakeholders have a role to play in realizing social measurement that adheres to these principles. We recommend the following next steps:

- *Companies* should redirect internal resources away from reporting information on their commitments and processes to gathering and then disclosing information on the effectiveness of these efforts on the ground, according to common standards. Companies should contribute to the development of these standards for evaluating the most pressing labor and other human rights challenges they face.

- *Investors and consumers* should demand accurate performance-based social measures and data that will allow them to meaningfully assess industry competitors on social performance.

- *Asset owners and managers*—particularly large institutional investors with expansive and diverse portfolios—should examine and articulate the systemic social and human rights risks they see among their investments. On the basis of what they find, investors should engage with the companies they hold, reinforcing the importance they place on aligning themselves with companies that are striving to understand and tackle the difficult social and human rights issues they face throughout their operations. Doing so will help to make the case for patient capital and longer-term investment models.

- *NGOs* should share their expertise with companies and investors to develop social measurement that evaluates company effects on the most pressing labor and other human rights issues they face, including impacts in the supply chain.

- *Governments* should continue to explore regulation that helps to standardize the social information companies disclose and to clarify that public fiduciaries not only can but ought to consider social sustainability in their investment choices. Governments also should incorporate standards for social performance into their own procurement requirements.

- *Creators of measurement frameworks* should prioritize transparency on company impacts, rather than policies and processes. In doing so, they can play an important role in helping to identify and define industry-specific standards against which company performance is evaluated. In addition, more work is needed to interrogate the assumptions that have guided many of the measurement initiatives to date, including: the correlation between the social policies or procedures and social outcomes; the comparability of social risks and challenges among industry peers; and the availability and accuracy of social data generated by various stakeholders.

We believe that investors, if equipped with reliable, accessible information, are in a unique position to identify and reward companies with strong social performance, thereby creating incentives for companies across an industry to upgrade their operations in a way that improves human rights and strengthens societies.

Defining Sustainable Investment

Sustainable investment goes by many names – "socially responsible," "ethical," "sustainable & responsible," "Environmental, Social, and Governance (ESG)," and "impact," among others – but generally follows three broad approaches:

(1) **screening** out companies that violate certain values (such as divesting from coal, tobacco, weapons, or other "sin" stocks) and/or positively screening for companies that uphold values or perform well on ESG factors;

(2) **impact** investing in organizations or projects that have social or environmental aims; and

(3) **integrating** ESG factors into traditional financial analysis.[3]

Once a company is in an investor's portfolio, they may further advance sustainability objectives through engagement with management and shareholder voting. This paper focuses on how labor and other human rights factors are currently defined and measured for use across these approaches.

Part 1: Growth of the ESG Industry

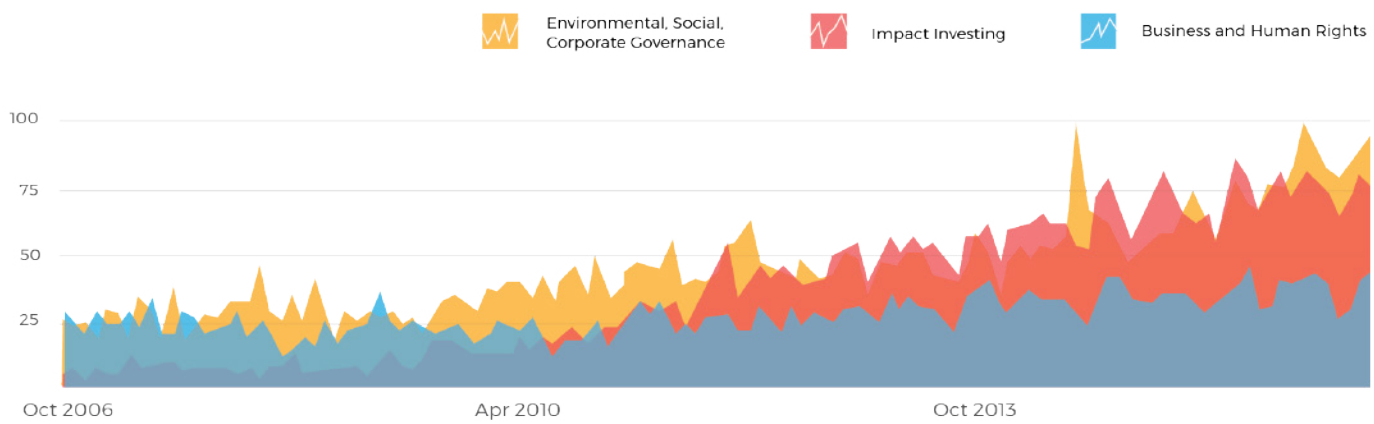


Figure 1: Growth of Google searches on sustainable investing topics and business and human rights (2006-2016). The largest investment firms have established ESG divisions in recent years, as interest and demand grows in this segment of financial services. As Hugh Lawson, Head of ESG and Impact Investing at Goldman Sachs, has said, "ESG has gone, in essence, mainstream."[4]

1.1 Sustainable Investing Goes Mainstream

Interest in sustainable investing and business' social obligations has been steadily rising. While initially focused on screening out companies on the basis of ethical considerations, sustainable investing now comprises a wide-variety of approaches reflecting a diverse set of motivations. Three trends suggest that this is just the beginning and sustainable investing is primed to expand in the coming years: 1) the investment preferences of the rising number of millennial and women investors; 2) growing evidence that investors need to consider longer time horizons; and 3) regulatory measures that encourage or require ESG.

1. **Tomorrow's investors will seek out sustainable investments:** Demand is growing for ESG products, with assets in socially responsible funds rising 76% over the last five years.[5] This trend is likely to continue as millennials and women, both groups that favor sustainable investing, comprise an increasingly large percentage of individual investors.[6] With women projected to control half of all private wealth in the United States by 2020, and millennials projected to inherit $30 trillion over the next 40 years, a considerable pool of capital will be looking for ESG products and strategies.[7]

Millennials are

2x

as likely to both invest in companies or funds that target specific **social/environmental outcomes** and divest because of objectionable corporate activity.

Women are

23%

more likely than men to **seek out sustainable investments** (76% to 62%).

2. **Growing evidence that investors need to consider longer time horizons:** Leaders at the highest levels of the financial sector are starting to publicly acknowledge the downsides of short-term investing. Larry Fink of BlackRock recently argued that short-term investing strategies risk "maximizing near-term profit at the expense of long-term value." [8] These short-term approaches often lead to a range of negative social outcomes, including favoring the immediate interests of capital over labor.[9] Workers who have felt left behind by the global economy are expressing their dissatisfaction with the financial sector in the rising tide of populism around the world. Ray Dalio of Bridgewater – the world's largest hedge fund – calls this trend "the number one economic issue that market participants should be watching, more important than central banks."[10]

   At the same time, a steady stream of studies extol the benefits of both longer-term investment horizons and strong sustainability practices for corporate financial performance. This suggests that ESG considerations have the potential to enhance returns, in addition to contributing to more stable societies and markets.[11]

3. **Countries around the world are adopting ESG regulation:** According to the United Nations Principles for Responsible Investing (UNPRI), 72% of countries they examined had some form of regulation mandating company disclosure on sustainability issues.[12] Forty-four percent of countries also had existing or proposed regulations stipulating that pension funds can and, in some cases must, consider ESG factors as a part of their fiduciary responsibilities.[13] (See Figure 2 for examples of pension regulation and policies regarding ESG integration.) Regulation is also increasingly specific with regard to social issues. Approximately 41% of the countries examined in a separate study concerning sustainability regulation had mandatory social reporting instruments.[14] In many cases, stock exchanges and associated regulatory bodies promulgated the requirements, which covered issues such as gender equality and diversity, workplace health and safety, issues of forced or child labor in supply chains, and efforts to combat corruption.[15]

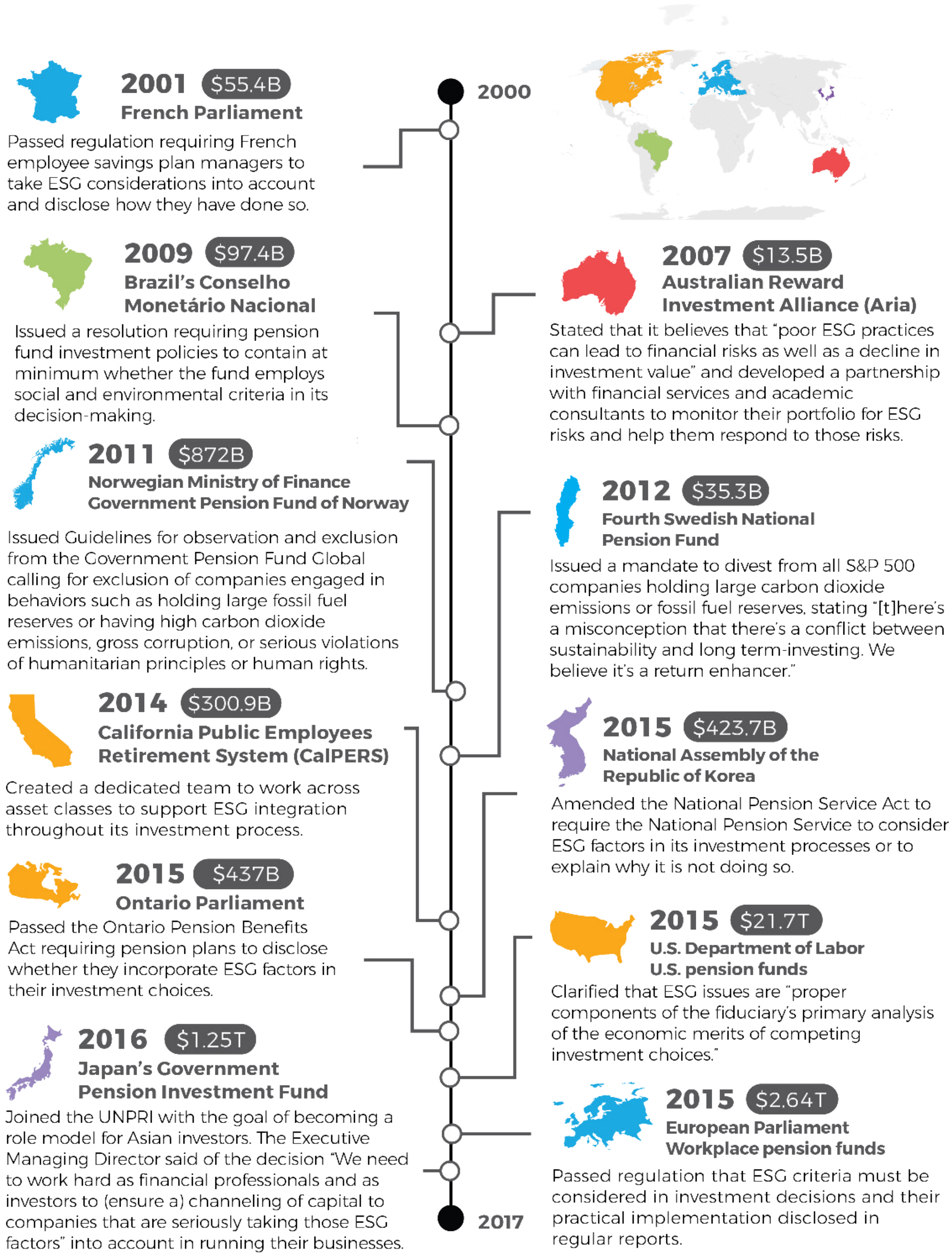


Figure 2: Developments in pension fund regulation and commitment to ESG integration and disclosure. [16]

1.2 The Role for "Social" in Investing

Social factors have not been the focus of early ESG products, particularly those developed for investor use (see Figure 3). Only 14% of "social" ratings products aggregated by the Global Initiative for Sustainability Reporting target an investor audience.[17] This suggests either that investors do not believe these factors are likely to improve investment outcomes (and therefore do not demand social products and services), or that there is something about social factors that make them difficult to package for investor use.

Figure 3: Of the 580 ratings products aggregated by the Global Initiative for Sustainability Reporting, 97% of environmental efforts and 80% of governance efforts target investors as the primary audience.[18] When it comes to social efforts, only 14% similarly targeted investors.[19]

Whether social performance is likely to improve investment outcomes is a question of time horizons. Investors tend to focus on near-term risks and financial returns when determining what information is material to their decisions.[20] Under this approach, investors are likely to consider social performance only when it imposes short-term costs that are easy to calculate. Such costs are most likely to occur when mismanagement of social issues results in damage to brand reputation, lawsuits, fines, workplace shutdowns, or consumer protests.

Investors are less accustomed to accounting for the long-term gains of affirmative social performance, especially if realizing these gains requires absorbing near-term costs. This is problematic because many of the most significant ways in which social performance may improve investment outcomes are only likely to occur in the longer-term. A growing body of research, and CEOs, provides preliminary evidence of such benefits, but more and better data is needed to fully account for the ways in which social performance may impact the strength of an investment.

> *"Sustainability issues have become material concerns for many businesses and investors"*
>
> — Bloomberg, Year In, Year Out: Impact Report Update 2015

Several studies affirm a long-term gains argument, especially in light of the shift in recent decades toward intangible assets (such as brand reputation and human capital) as significant drivers of company value.[21] For instance, studies of employment conditions by scholars at the University of Maastricht and New York University found that firms that treat their workforce poorly suffer a host of negative consequences, including: weaker access to human capital; higher turnover (and associated financial costs of such instability); and decreased trust and innovation.[22] Similarly, a study on the impact of conflict with local communities by the Harvard Kennedy School, Shift, and the University of Queensland found that the greatest cost of conflict is lost opportunities for future projects, expansions, or sales.[23]

Local groups gather in Manila to protest the negative effects of mining practices on their communities including environmental destruction, deception of indigenous peoples, weakening of local autonomy, and lack of transparency and accountability. (photo credit: Jay Directo)

Leading corporate CEOs also emphasize the affirmative reasons they are considering human rights in their business models and operations. Unilever's CEO Paul Polman has said, "[w]hat we firmly believe is that if we focus our company on improving the lives of the world's citizens and come up with genuine sustainable solutions, we are more in sync with consumers and society and ultimately this will result in good shareholder returns." [24] Others argue that sustainability and human rights investments have led to increases in their ability to recruit and retain outstanding employees, enhanced quality control, and improved worker retention throughout their supply chains.[25]

The second challenge for improving "S" is measuring things that are complex, multidimensional, and sometimes intangible. Across all kinds of social measurement, including the long history of measuring governments' social performance (see Appendix 1), experts acknowledge that measuring social outcomes is a unique challenge. Quantifying social phenomena is inherently reductive in a way that measuring revenue is not.[26] But investors are in the business of reducing complexity into comparable metrics for analysis. Measuring customer satisfaction levels, or the value of intangibles such as investments in innovation, brand recognition, or culture, are things companies and investors have been able to do, despite their complexity.[27] With sufficient demand and ingenuity, there is every reason to believe that the challenge of developing sound, easy-to-use measurements for "S" can be overcome.

However, this will require a different approach to the concept of materiality. Too often this term is used to dismiss and marginalize these factors rather than to assess them along the lines of more standard intangible investment considerations. To alter this pattern, investors should work collectively and with other stakeholders to develop a better framework for valuing and incorporating labor and other human rights issues into their routine assessments of company performance.

Lessons from "E"

When looking to improve social measurement, there are lessons to be drawn from the success of "E", while acknowledging that there are some limitations to the comparison. First, "E" demonstrates the importance of standards-based, performance-oriented measurement. For example, the Carbon Disclosure Project (CDP), a widely cited reporting framework used by more than 5,500 companies worldwide, asks respondents to provide total global emissions of carbon dioxide and compares those numbers against prior years.[28] Newsweek's Green Rankings issues an energy productivity score that is calculated using gross company revenue/global energy consumption.[29] These approaches set an industry standard that applies across companies and allows investors and others to compare companies' performance over time and against competitors. As of yet, there are no equivalent measurements for "S".

Investors also reward companies for their environmental performance. A report on Newsweek's Green Rankings found that market values of ranked companies were enhanced in the days following its publication. The study found that "getting one position closer to the top of Newsweek's 'Global 100 Green Rankings' increases the value of an average firm in the list by eleven million dollars." [30]

That said, environmental considerations often result in near-term cost savings, whereas social considerations do not. A prime example of this is Nike's development of Flyknit technology, a single piece of recycled polyester fabric that it introduced in a new line of athletic shoes in 2012. Flyknit can be used for the entire upper portion of the shoe, decreasing material and labor costs associated with older models. The shift reduced environmental waste by 3.5 million pounds, while expanding the company's profit margin by 0.25%.[31] On the other hand, company investments that improve social performance – such as upgrading a facility's safety or regulating hours of work – impose costs, often without an attendant rise in near-term profits. Companies and investors have not yet reckoned with how to accommodate these costs, especially in the context of high-pressure, short-term investing.

Part 2: Typology of Social Measurement

There are now hundreds of initiatives, services, and tools available to measure and communicate companies' performance on labor and other human rights issues, some of which are intended to be useful in an investment context. The proliferation of these efforts reflects broad consensus that labor and other human rights issues should be measured as a part of ESG investing, but little convergence around how to do so.

This paper examines 12 leading measurement frameworks that target an investor audience. In selecting those to evaluate, we first turned to SustainAbility's Rate the Raters survey of investors to identify the tools most commonly used by investors.[32] We then added tools that focus on labor and other human rights issues. The 12 frameworks fit into three general categories:

1. **Company-focused frameworks:** Sustainability and human rights reporting guidelines for companies to inform their public disclosures on social and sustainability practices.

2. **Investor-focused frameworks:** ESG data providers, third-party research services, and ratings and indices designed specifically to aid investment decisions.

3. **Human rights-focused frameworks:** Publicly available ratings and rankings designed by human rights experts to identify which companies are leading on labor and other human rights factors specifically.

In the typology below, we illustrate the different categories of frameworks with additional examples that were not included in our sample but are otherwise prominent in the field.

2.1 Company-focused Frameworks

Company reporting underpins the vast majority of social measurement efforts. But there are few regulatory or standards-based requirements mandating consistency in what companies disclose. As a result, company reporting is highly individualized; the structure and content of what is reported varies between peer companies and even from year to year for the same company. Moreover, companies control what and how to report. They determine what is "material" and therefore should be reported, often without external validation of the accuracy or completeness of their disclosures.

Company reporting frameworks are intended to provide reporting standards to guide company disclosures. Two frameworks dominate this space, the generalist standards of the Global Reporting Initiative and the industry-specific standards issued by the Sustainability Accounting Standards Board. The UN Guiding Principles Reporting Framework, which focuses specifically on human rights, is not yet as widely-discussed.

- Global Reporting Initiative (GRI): GRI issues broad reporting standards for sustainability. After a recent update, it now consists of 36 individual reporting standards. Participating companies are required to incorporate three general standards, and are free to opt-in to additional subject-specific standards if they decide these standards are "material" to their business model.

- Sustainability Accounting Standards Board (SASB): SASB has developed industry-specific standards for company sustainability. It has convened a series of consultative groups comprised of industry, civil society and academic experts over the last several years to develop means for evaluating 79 industries in 10 sectors.

- UN Guiding Principles Reporting Framework (UNGPRF): UNGPRF provides a series of 31 questions to assist companies in communicating how they are integrating human rights considerations into their operations.

Each framework is developed by non-profit organizations following extensive, multi-stakeholder consultation processes. While both GRI and SASB have both garnered considerable attention, neither has emerged as the dominant standard. A recent study found that companies prefer to report using GRI, while investors prefer to consume information via SASB.[33] This is likely because SASB standards were developed specifically to be decision-useful for investors, and are more concise and quantitative in nature.

2.2 Investor-focused Frameworks

The growing interest in ESG investing has resulted in a wide range of products aimed at helping investors incorporate ESG factors into their decisions and offerings. There are now hundreds of sustainability indices and sources of ESG data, many of which build upon one another and on the information disclosed by companies.

As with reporting frameworks, these tools are quite broad. Though some, like the Carbon Disclosure Project, focus exclusively on environmental issues, none are similarly focused exclusively on labor or other human rights issues. Where social considerations are incorporated, they examine a set of loosely defined issues, from health and safety, to labor standards, customer relations, community engagement, philanthropy, employee volunteering, and social investment.

According to the Rate the Raters survey, investors look to third-party data and research providers as among their top sources for ESG information.[34] That said, when rating individual frameworks, only a select few indices, data aggregators, and research providers were used "at least sometimes" by more than 20% of respondents.[35] These were:

- **Bloomberg:** Bloomberg gathers ESG data disclosed by over 11,000 companies and integrates it into its Equities and Bloomberg Intelligence platforms. It also produces targeted analysis and tools, including an ESG scorecard.

- **Dow Jones Sustainability Indices (DJSI):** Provides a large family of indices composed of industry leaders on a variety of sustainability factors. The indices are based on an annual sustainability assessment administered by RobecoSAM and sent to over 3,000 publicly traded companies.

- **Morgan Stanley Capital International (MSCI) ESG research and indices:** Provides ESG ratings on over 6,000 companies, research on ESG strategies and trends, and more than 700 indices designed to support integration, screening, and impact investing approaches.

Initiatives that were used "at least sometimes" by more than 10% of respondents[36] were:

- **Carbon Disclosure Project:** Aggregates company reports and environmental disclosures using the reporting framework described above ("Lessons from 'E'").

- **FTSE4Good:** A series of indices based on FTSE's ESG rating of over 4,000 companies. FTSE's rating relies on 300+ indicators to evaluate ESG exposure and performance.

- **Sustainalytics' Global Access:** Online platform for Sustainalytics' products related to ESG research and ratings, corporate governance research and ratings, controversies, product involvement, and Global Compact compliance.

The majority of these are fee-for-service efforts undertaken by financial institutions and service providers. They have large teams, advanced technology, and access to a wide variety of data sources. This allows these firms to provide regular updates on a large number of companies. But because of the proprietary nature of these services, the methodologies for determining company ratings generally are not publicly available. DJSI is the most transparent, providing a public sample of the questionnaire it uses to assess company sustainability. Bloomberg and FTSE4Good shared their indicators privately with the Center's research team, but at the time of publication, MSCI and Sustainalytics had not yet done so.

Numerous investor-focused consulting groups also offer sustainability research services. In some cases, these may be ESG arms of traditional investment consultants such as Mercer, Cambridge Associates, and Aon Hewett. Others are sustainability-focused consultants. Examples of this later group include:

- **Sustainalytics:** Consultancy that provides sustainability research to companies, investors and investment indices, and civil society groups.

- **SustainAbility:** Consultancy and think tank that offers research and services to help companies and other stakeholders understand key issues and trends, improve engagement, and develop sustainability management strategies.

- **RepRisk:** For-profit data aggregator on ESG risks. Uses a combination of automated and human research of media, stakeholders, and other public sources external to the company to evaluate reputational risks.

These firms offer a range of services, targeting a range of clients. Because they are customized and generally fee-based, they offer very little public information on their exact metrics, indicators, standards, or on the processes they use.

2.3 Human Rights-focused Frameworks

In recent years, a growing number of labor and other human rights experts have created public ratings and rankings that focus specifically on social issues. They aim to highlight leading and lagging companies in a particular industry and/or on a certain social issue. In most cases, they evaluate a small number of companies, using indicators that cover a range of human rights concerns.

Because they are developed by human rights experts in consultation with other stakeholders, these ratings more deeply cover labor or other human rights issues. And, unlike other initiatives, they are transparent about their methodologies and the indicators they use in making their evaluations.

A few relatively small social investment firms like Domini and Calvert rely on these ratings, in part because they have dedicated staffs focusing on human rights as part of ESG investing.[37] By contrast, most mainstream investment firms indicate that their use of external ratings is low.[38]

Prominent examples include:

- **Access to Medicine Index:** Since 2008, it has issued rankings on the efforts of the top 20 research-based pharmaceutical companies to improve access to medicine in developing countries.
- **Enough Project's Company Rankings on Conflict Minerals:** In 2010 and 2012, it publicly ranked 24 electronics companies on their policies, statements, and actions to eliminate conflict minerals from their supply chains in the Democratic Republic of the Congo.
- **Oxfam's Behind the Brands campaign:** In 2013 and 2015, it ranked the largest 10 food and beverage companies across environmental, social, and governance aspects of their agricultural sourcing policies and commitments.
- **Ranking Digital Rights:** Since 2015, it has ranked 16 (soon to be 22) internet and telecommunications companies on their public commitments and policies affecting users' freedom of expression and privacy.
- **KnowTheChain:** Since 2016, it benchmarks 60 large global companies in the information and technology communications, food and beverage, and apparel and footwear sectors on their efforts to address forced labor and human trafficking in their supply chains.
- **Corporate Human Rights Benchmark:** A new initiative, supported by social investors, non-governmental organizations (NGOs) and companies

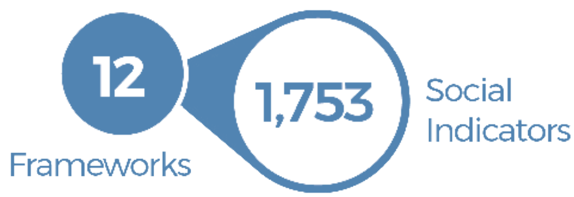
that aims to eventually rank the top 500 globally-listed companies on their human rights related policies, processes, and practices, in addition to responses to issues.

Typically, these efforts rely on very small teams of researchers to gather information about companies from publicly available sources. Several draw exclusively on information provided by companies through their websites, financial reporting, and sustainability reports. Companies are given a chance to give feedback and make corrections and clarifications. In most cases, quantitative scores are augmented with some degree of qualitative analysis, often in the form of a supplemental narrative. Because this is a resource-intensive process, most of these ratings are updated at most every two or more years.

Part 3: The Current State of “S” in ESG

3.1 Analysis Overview

Our analysis of the current state of the ESG industry is based on extensive research into 12 leading measurement frameworks that cover social factors. We first reviewed the methodologies of each framework to determine their aims, sources of data, and operating definitions. A team of researchers then coded 1,753 indicators from the 12 frameworks to gain insight into how “S” is currently measured. We looked specifically at whether indicators measured company efforts to advance social objectives or the effects of those efforts.



Efforts versus Effects

In the below analysis, **“efforts”** include: (1) resource investments, such as funds dedicated to sustainability projects, staff time, or donations; and (2) activities undertaken to advance social objectives. Common examples of efforts are training, community programs, staff assigned to sustainability oversight, policies, and audits. **“Effects”** are the outcomes and longer-term impacts of these efforts. There are noticeably fewer examples of effects in the current landscape of “S” measurement, but they include indicators such as number of rights violations reported during a given period, number of jobs created, or diversity among senior leadership.

A detailed description of the coding methodology and conceptual framework is included in Appendix 2. Examples of specific indicators measuring efforts and effects, as well as trends observed in our sample, are included in Appendix 3.

Sample Selection Criteria

We sought to analyze a group that was representative of the tools investors identified as being useful in understanding ESG performance, in addition to tools that have been developed specifically to measure labor and other human rights issues. Our sample was limited by two practical considerations: (1) to be evaluated, a framework must include at least some socially focused indicators; and (2) we had to have access to the text of the indicators used to measure or evaluate companies.

Our sample includes three company-focused frameworks, three investor-focused frameworks, and six human rights-focused frameworks. For frameworks that included a mixture of environmental, social, and governance indicators, we examined only those that were clearly identified as "social" indicators.[39] In addition, we sought out indicators that addressed a company's supply chain because many of the most significant labor and other human rights challenges companies face occur in this part of their operations.

Company Focused

- Global Reporting Initiative (GRI)
- Sustainability Accounting Standards Board (SASB)
- UN Guiding Principles Reporting Framework

Investor Focused

- Dow Jones Sustainability Index - Metals and Mining
- FTSE ESG Ratings
- Bloomberg Social Indicators

Human Rights Focused

- Access to Medicine Index
- Enough Project's Rankings on Conflict Minerals
- Oxfam's Behind the Brands
- Ranking Digital Rights' Corporate Accountability Index
- Know the Chain - ICT and Food & Beverage Benchmarks
- Corporate Human Rights Benchmark

3.2 Findings

The ESG industry has enjoyed a sustained period of creative experimentation over the last three decades. Existing efforts take a wide variety of approaches, from questionnaires, to calculators, to more qualitative evaluations. They also pursue different strategies in scoping, with some targeting specific issues or industries and others striving for global application. Together they offer a range of benefits in advancing awareness of labor and other human rights issues in business contexts, including: encouraging companies to embed ESG considerations into their corporate cultures; increasing availability of ESG data; enhancing avenues for stakeholder engagement; and improving understanding of priority social issues within specific industries. But, on the whole, current approaches present serious limitations in measuring the social performance for an investment context. Our research yielded five core findings.

Finding 1: Social measurement almost exclusively targets efforts, not effects

Only 8% of the more than 1,700 "S" indicators we examined evaluated the effects of company practices. Rather, a significant majority of indicators (92%) measured company efforts and activities, such as issuing policies or commitments; conducting audits, risk assessments, or training; participating in membership organizations or other collaborations; or engaging stakeholders.

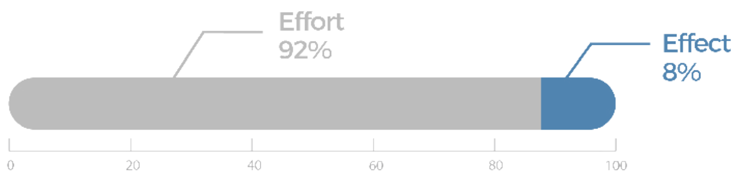


Figure 4: Percentage of indicators measuring company efforts vs. real-world effects across frameworks.

Moreover, social measurement prioritized internal procedures over those that involved external stakeholder participation. Over half of all indicators (58%) evaluated either the governance structures a company has in place for social issues (e.g., roles, management systems, policies, and commitments) or its information gathering and assessment processes (e.g., audits and external assurance, risk or impact assessments, and general data gathering efforts). Less than 20% of indicators examined either stakeholder engagement or remedial mechanisms.

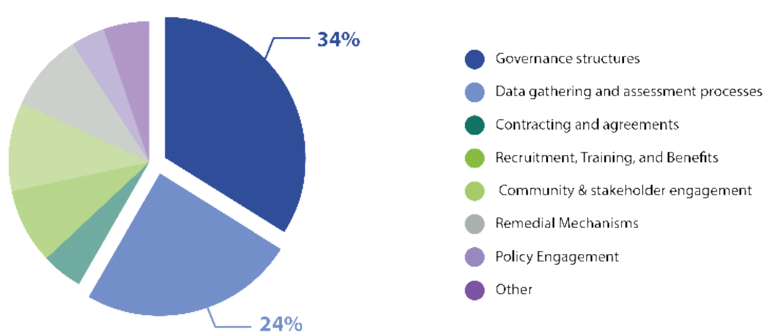


Figure 5: Percentage of indicators measuring governance structures or information gathering and assessment.

This means that, across the board, the ways in which companies are evaluated primarily measure the internal exercises a company is conducting. It is possible that this is relevant in an investment context – perhaps companies that conduct a higher volume of internal procedural exercises are stronger performers than those that do not. But it is also possible that this amounts to a high degree of noise, with significant amounts of data generated about activities that do little to distinguish one company from another. Whether a company's supply chain model results in lapses in factory safety or failure to pay overtime wages is the kind of information that will help investors to distinguish companies that could be long-term risks, as well as those that represent long-term value. But at present, companies have few incentives to report – or be measured against their competitors – on these issues.

While these findings hold true across all three categories of frameworks, the human rights-focused frameworks were the most likely to be limited to measuring efforts (98% efforts). In fact, three out of six human rights-focused frameworks – Behind the Brands, KnowTheChain, and the Enough Project – exclusively measured efforts. One possible explanation for this is that these frameworks rely heavily on publicly disclosed company data as the basis for evaluation.

Investor-focused frameworks were slightly more likely to focus on effects, with Bloomberg having the highest percentage of indicators evaluating effects (51%) of any framework in our analysis. The increased focus on effects among investor frameworks may be due to the likelihood that these groups have access to a wider range of data given the expectations and incentives for companies to disclose sensitive information to existing and potential investors.

Finally, the three company-focused frameworks – SASB, GRI, and the UN Guiding Principles Reporting Framework – were collectively the most likely to include indicators that measure effects, with SASB performing the best of this group (34%). Since these frameworks are designed for company use, they assume full access to company information, suggesting that, at present, measurement of social effects is aided by access to company data.

Figure 6: Percentage of indicators measuring company efforts vs. real-world effects by category.

Absent regulation or agreed upon standards, companies have significant latitude across all three kinds of frameworks in determining the scope of social measurement through the information they choose to disclose. Companies understandably are likely to highlight the efforts they make, often through their corporate social responsibility or communications departments, rather than the higher-cost, higher-risk analysis of the effectiveness of those efforts.

Finding 2: "S" is defined in a multitude of (often vague or limited) ways, making it difficult to draw conclusions about company performance

In our review of methodologies, we found no consistent set of standards underpinning "S" among ESG frameworks. When examined in aggregate, the 12 frameworks most often measured social issues vaguely or with respect to a small set of labor concerns. The highest number of "S" indicators (35%) examined social issues generally, using vague terms such as "social," "human rights," or "ESG" without greater definition. Another 20% focused on a limited set of common labor issues such as occupational health and safety, freedom of association, compensation and benefits, or diversity and equal opportunity.

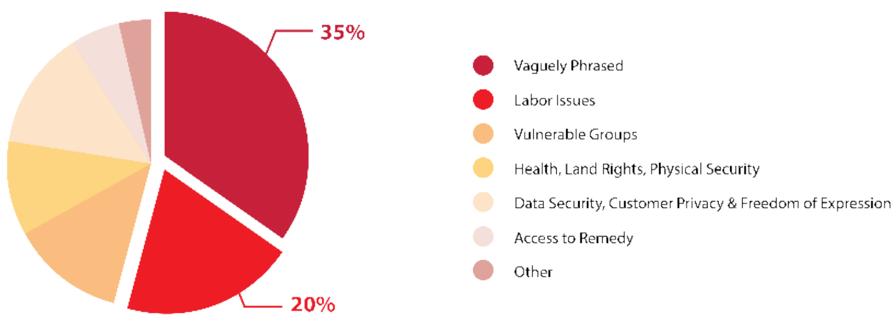


Figure 7: Percentage of indicators measuring vaguely phrased social issues or labor rights across frameworks.

This was most pronounced in investor-driven frameworks (Dow Jones, FTSE, and Bloomberg), where 84% of indicators focused either on vague ESG language or a limited set of labor issues. Investors' reliance on a vague or limited definition of "S" means that they are not equipped to capture the full picture of social considerations in their investing approaches.

Human rights-focused frameworks, in aggregate, covered a greater diversity and balance of social issues. These frameworks tend to focus on a specific industry, allowing them to target the most relevant issues, as opposed to generalist approaches. For example, Ranking Digital Rights and Access to Medicine each target three to four of the highest priority issues for the information and communications technology sector and the pharmaceutical sector, respectively. They include no indicators that use vague or generalist language.

Figure 8: Percentage of indicators measuring vaguely phrased social issues or labor rights by category.

As the ESG industry has proliferated, the lack of unifying standards across frameworks has led to a wide variety of individualized approaches that is confusing and unnecessarily complex. Given this "noisiness," understanding what exactly a company's social score reflects requires an investor to spend considerable time reading and analyzing the details of each framework's methodology. In addition, the tendency to rely on vaguely phrased indicators leaves investors and other users of this information to assign their own meaning and provides little basis for comparison across companies in the same sector.

Finding 3: Lack of clarity in measuring "S" increases costs for investors and companies

In addition to causing confusion, our sample also revealed just how costly the lack of a shared definition for "social" can be. The proliferation of frameworks without a consistent set of underlying premises means that companies must generate many different kinds of data, in formats specific to each framework to which they report. This requires companies to understand the landscape of frameworks, make judgments about which ones merit participation, fill out multiple questionnaires, and respond to requests for additional information, all while preparing their own annual sustainability reports.

The costs of this are substantial. For instance, a food and beverage company seeking to respond only to the 12 frameworks covered by our study would need to provide information on more than 700 different indicators. SASB similarly reports that one S&P 500 company complained of developing responses to more than 650 requests from ratings groups in a single year.[40] The process took several months and involved over 75 people.[41]

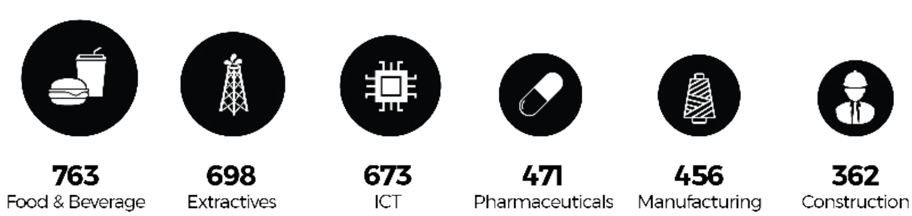


Figure 9: Number of indicators that a company reporting against these 12 frameworks would need to respond to (by industry).

For the frameworks, sorting through all of the company-reported information results in significant additional costs. Measurement projects can cost millions of dollars annually. For instance, the Access to Medicine Index, conducted every other year, reports that it costs approximately $1.6 million to produce,[42] while SASB and GRI report annual expenses of more than $8.2 million and $9.8 million respectively.[43] An ESG data client at one of the human rights rankings reports that each individual indicator purchased from an ESG service provider such as Sustainalytics can cost $50 or more.[44] This means that an initiative seeking to evaluate 100 companies on the basis of 100 indicators would face costs of $500,000 in data alone, on top of personnel and other management expenses.

Finding 4: Supply chains merit special focus, but are largely missing from evaluations of "S"

For many global companies, the most challenging labor and other human rights issues are likely to occur in their supply chain.[45] And yet, when we examined frameworks that covered a mix of environmental, social, and governance issues, we were surprised to find very few references to the supply chain among the "social" indicators. To determine whether the supply chain was not measured at all or simply not considered social in nature, we searched environmental and governance indicators for references to supply chains. We found that the majority of frameworks did include some supply chain issues, but categorized them as governance, rather than social concerns. Even once we incorporated these into our analysis, only 39% of measurement covered companies' supply chains.

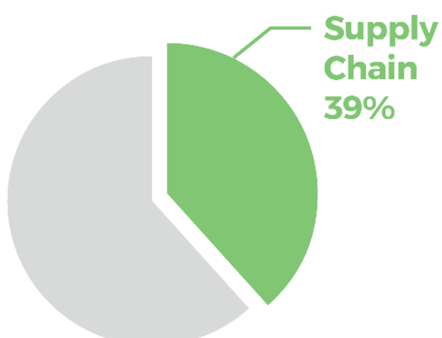


Figure 10: Percentage of indicators measuring the supply chain across all frameworks.

Within this limited landscape, industry-specific frameworks were more likely to encompass the supply chain. The two investor-focused frameworks that targeted specific industries – Dow Jones and FTSE – were four times more likely to cover the supply chain than Bloomberg's indicators, which apply to all companies regardless of industry (approximately 22% versus 5%). This suggests that industry-specific measurement can cover a company's operations in greater depth and, in doing so, provide a more accurate view of social performance.

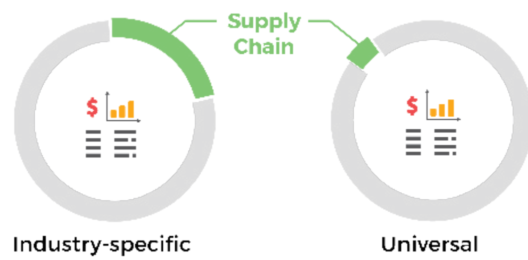


Figure 11: Percentage of indicators measuring the supply chain in industry-specific investor-focused frameworks (Dow Jones and FTSE) versus universal investor-focused frameworks (Bloomberg).

The SASB company-focused framework is a notable exception. Though SASB exclusively uses industry specific measurement, this did not translate into improved coverage of labor and other human rights issues in supply chains among the six industry standards we studied. This was most evident in the engineering and construction services sector, which included no recommended supply chain measures, despite well-documented challenges with labor recruitment practices in the construction industry.[46] Similarly, threats to the land and labor rights of vulnerable populations (e.g., women, children, and migrants) that are common in the food and beverage industry were not reflected in SASB's recommended indicators for food retailers and distributors.[47] This is striking when compared to Oxfam's Behind the Brands ranking of food and beverage companies, in which these same issues account for over 40% of all measures used.

Instead, the majority of SASB indicators in our analysis focused either on social issues that impact the customer directly (e.g., data security and customer privacy or customer health and product safety), on labor issues in the company's core work-force, or on "human rights," "social," or "ESG" issues and policies generally without further definition.

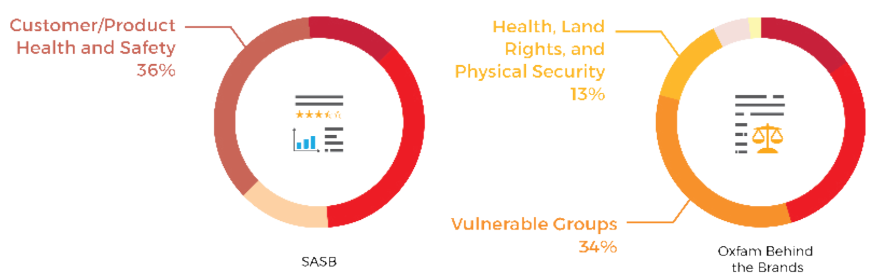


Figure 12: Issues evaluated by SASB versus Oxfam for Food and Beverage Companies.

Finding 5: In the current ESG landscape, transparency too often functions as a substitute for more meaningful measurement of performance

Nearly half of all indicators in our sample (46%) targeted greater company-disclosure of information. Transparency is desirable for many different kinds of stakeholders and perhaps unsurprisingly, all frameworks reward companies for being transparent. Transparency is desirable in a social context for its potential to drive improved outcomes for vulnerable people and communities. But with respect to social measurement, transparency is too often treated as an end unto itself; companies are rewarded simply for the act of disclosing, rather than delivering particular outcomes.

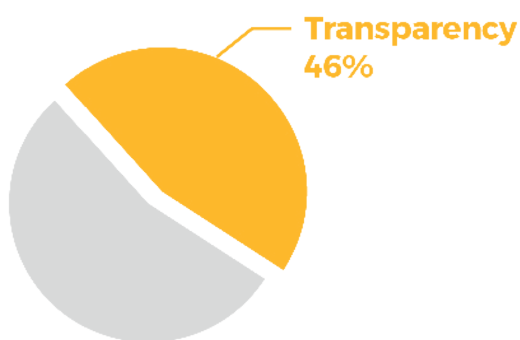


Figure 13: Percentage of indicators across all frameworks that targeted greater transparency.

Across different kinds of frameworks, transparency-for-transparency's-sake compounds other weaknesses of existing social measurement approaches. First, transparency measures focus disproportionately on effort, rather than effects. In our sample, 98% of transparency-focused indicators targeted company efforts rather than effects.

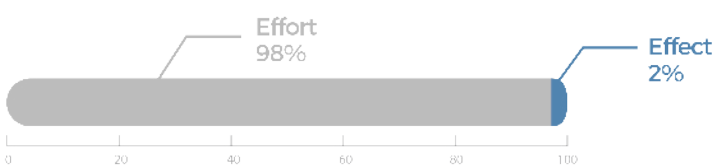


Figure 14: Percentage of indicators targeting transparency that measured efforts versus effects.

Second, even when transparency-focused measurement rewarded disclosure of information that speaks to a company's effects, the absence of standards-based approaches means that it is unclear whether what is disclosed is positive or negative. For example, the Ranking Digital Rights framework includes the follow indicator:

> *P4.1 For each type of user information the company collects, does the company clearly disclose whether it shares that user information?*

It is not clear from this indicator when and with whom a company ought to share user information. When measurement remains neutral about what "good" looks like for companies, investors and other stakeholders are either left without an understanding of which companies are leaders, or must apply their own standard to make this determination.

Finally, the pressure for ever-increasing disclosure – especially of policies and procedures – contributes to rising costs. Today, it is standard for companies to issues sustainability reports. Among the largest 250 global companies, the number issuing sustainability reports went from 35% in 1999 to 92% in 2015,[48] with an average length of 98 pages.[49] While the expectation that companies be transparent on social issues is certainly useful, it is not clear that the enormous effort around disclosure is resulting in disclosure of information that is useful to investors and others in evaluating the effects of a company's operations.

3.3 Conclusions

Our analysis leads to four main conclusions:

1. **Social measurement evaluates what is most convenient, not what is most meaningful.** In the current ESG landscape, most measurement focuses on information that companies have ready access to and are willing to disclose. This effectively rewards companies for generating policies and procedures that relate to social issues, not for the outcomes of those efforts.

2. **Current approaches are not likely to yield the information needed to identify social leaders.** Many frameworks reward companies for expanded disclosure of social information. However, too often companies are rewarded for producing and releasing ever more granular data about their policies and procedures. This practice requires companies to produce a significant volume of information, without enough attention to quality or usefulness of that information. Disclosure-for-disclosure's-sake is not delivering significant benefit in evaluating companies' social performance.

3. **The lack of consistent standards underpinning social measurement increases costs and creates confusing "noisiness" across the ESG industry.** The proliferation of frameworks without clear standards for social performance amplifies the cost of ESG evaluation for all stakeholders. Moreover, the lack of standards contributes to the proliferation of data that does not lead to clear conclusions about which companies are performing well, simply because there is no agreed-upon definition of what "good" looks like.

4. **Existing measurement does not equip investors to respond to rising demand for socially responsible investing strategies and products.** "Social" lags behind other elements of ESG in the development of consistent, efficient strategies for measuring company performance in a way that is

useful to investors. Measurement that does target investors tends to omit some of the most pressing human rights issues in a given industry. While there likely would be significant demand from millennial and women investors for financial products that reward social leaders and contribute to a fairer economy, investors are unable to deliver this kind of product in the current environment.

In addition to these general conclusions, we have identified the following strengths and limitations of company-, investor-, and human rights-focused frameworks.

- *Company-focused Frameworks* (GRI, SASB, and the UN Guiding Principles Framework). These are the most likely to measure effects. However, there is no standard reporting format or requirement that applies to all companies using these frameworks, because each company opts in to the measurements of its choice. The quality of reporting through company-focused frameworks therefore is highly variable, and its accuracy is unverified. These frameworks may provide some examples of good indicators but, absent external verification or consistent reporting requirements, are as yet insufficient to deliver deep understanding of companies' social effects.

- *Investor-focused Frameworks* (Dow Jones, FTSE, and Bloomberg). These frameworks rank second among the three kinds of frameworks in measuring effects. They limit the scope of what they aim to measure, which may be a source of strength when attempting to measure outcomes and impacts. However, these frameworks often exclude the most significant human rights issues and aspects of company operations that are most relevant for human rights and labor, most notably the supply chain. Finally, the proprietary nature of investor-focused frameworks means that, while they are the most opaque regarding their methodologies, they have more resources to devote to diversifying data sources, including big data.

- *Human Rights-focused Frameworks* (Behind the Brands, Ranking Digital Rights, the Corporate Human Rights Benchmark, KnowTheChain, Access to Medicine Index, and the Enough Project's ranking on conflict minerals). Because these frameworks are developed by experts with a comprehensive understanding of the human rights issues a company is likely to face in its operations, they collectively cover the broadest scope of relevant issues and company operations. However, they are the most restricted to measuring company efforts – their policies, procedures, and governance structures – and are therefore the weakest in assessing actual performance. In addition, the relatively small number of companies they rate makes these frameworks less well suited to the needs of investors seeking to develop diverse portfolios.

Taken together, the combined strengths of existing frameworks suggest that here is an opportunity to begin to close the "S" gap through greater collaboration among industry participants and the development of shared standards. In the next section, we set out four principles and priority next steps to guide the way forward for measuring "S".

Part 4: The Way Forward

4.1 Principles for Measuring "S"

1. Measure companies' real-world effects, not just their efforts

It is often said, "What's measured improves." It's time for the ESG industry to measure the real-world effects of companies on the human rights of the people and communities they touch. This is no easy task – unlike measuring environmental effects, there is great potential to misrepresent social phenomena in the attempt to simplify what is inherently complex.[50] A company's impact is the most meaningful aspect of performance to measure, but impacts occur on long time horizons and almost surely result from numerous intersecting institutions, policies, and practices. Linking social impacts to a specific policy, investment, or practice is challenging.

That said, it should be possible to identify and measure a few key features of companies that are good social performers. Companies that treat their employees well, have diverse and upwardly-mobile workforces, and source from safe and stable supply chains should be rewarded. An investor (and other stakeholders) should be able to ascertain whether a company is achieving these outcomes based on a handful of indicators.

For example, does the company have high supplier turnover? Are there frequent reports of wage and hour violations in supplier factories? Are there frequent reports of accidents in the supply chain? How does one company compare to its competitors? This has little to do with how many trainings or policy commitments a company has made, but with the effects of those activities. It's possible that these indicators may need to be complemented with qualitative analysis that helps to capture context and avoid gaming.

More empirical research is needed to strengthen and inform the development of future indicators in areas such as: the correlation between social performance and financial performance over time; the relationship between development of social policies and delivery of social outcomes; the comparability of social risks among industry peers; and the availability and accuracy of social data generated by various external stakeholders.

2. Diversify the data – go beyond company disclosure

As currently structured, the ESG industry is too dependent on companies' discretion in what they choose to disclose. To be sure, companies must disclose information about their operations if investors and others are to understand their social effects or their risk and value propositions. Companies in the end have the best access to information on the social effects of their operations. A core tension that the ESG industry will have to overcome is how to access meaningful, comparable information generated by companies, while maintaining independence from them.

Advances in government requirements[51] around ESG reporting are a promising way forward to strengthen the comparability and reliability of ESG data, especially if companies face penalties for reporting false information. Regulatory innovations in California, the UK, and France are early examples of governments establishing a baseline for reporting.[52] These should be strengthened to include penalties for false disclosures, and to ensure that companies report meaningful, comparable data. Governments also have an important role to play in establishing standards for company performance as part of their procurement requirements.

Diversifying sources of data that inform ESG assessments will require looking beyond companies themselves to assess companies' performance. There are some early encouraging signs that this already is beginning to happen. In our own research on the apparel supply chain, for example, a shift occurred in 2014 when the government of Bangladesh and local manufacturers' trade associations disclosed factory data at a national level.[53] This data belied what companies had reported themselves about the size of the factory base in Bangladesh and revealed that the apparel supply chain in Bangladesh was about 65% bigger than previously estimated.[54] Stakeholders in the ESG industry should be looking for other innovative ways to capture a fuller picture of "S", potentially using big data, in addition to the news and NGO reporting that already are part of some ESG frameworks.

3. Establish clear standards for evaluating "S"

For ESG measurement to identify and reward social leaders, it must rely on shared standards that enable comparisons of industry competitors using a common framework. Naturally there is a tension between developing standards that are easy to apply and the need to adapt to changing conditions across industries and in the various sociopolitical, legal, and economic environments where companies operate. However, at present, the complete lack of clear social standards has resulted in a "noisiness" that fundamentally compromises the ESG industry's effectiveness and exaggerates its costs.

Industry-specific frameworks that are developed on the basis of established standards and periodically reviewed for relevance by or in collaboration with subject area experts and key stakeholders offer a good way forward. Companies operating in the same industry are likely to face similar risks. Rather than covering the full scope of human rights issues, Industry-specific indicators can focus on the most relevant risks that companies in that industry are likely to face.

While some existing frameworks apply industry-specific approaches, these have not yet resulted in widespread agreement on a shared set of standards. More work is therefore needed to reconcile the myriad approaches that currently exist for defining and measuring social performance. This will include agreeing upon the most important issues to measure, the scope of a company's operations that ought to be considered, as well as what good looks like and how this can be captured by an indicator. In developing standards that are relevant to an investor audience, it will be important to establish a connection between social performance and long-term value. This means developing a standard for high performing companies that manage their operations and their workforces in a sustainable way over the long-term.

4. Target investors as the primary audience

Companies are accountable to their investors for best use of their capital. This relationship empowers investors to influence companies to adopt business practices that result in greater respect for human rights. However, when it comes to "S", very few existing efforts target investors as their primary audience. As a result, there is a dearth of measurements that offer investors assessments of companies on labor and other human rights standards that are packaged for their easy use. The development of social measures that identify the strongest social performers would enable investors to reward true human rights leaders. It also would lay the groundwork for making the link between social performance, long-term stability, and economic benefit.

This means engaging investors in the development of standards and new methods of collecting and interpreting information. Some of the biggest firms have established in-house units to assess ESG, in part because the broader ESG industry is not serving their interests in assessing ESG risks. As in other areas of financial services, they are turning to advanced technical tools to assess these risks.[55] Going forward, the ESG industry should identify best practices from the in-house experience of large investment firms (to the extent that these methodologies are not proprietary) and seek to encourage greater availability of data in the areas that are most helpful for distinguishing leaders and laggards on "S" factors.

4.2 Recommendations to Key Stakeholders

All stakeholders have a role to play in realizing social measurement that adheres to these principles. We recommend the following next steps:

- *Companies* should redirect internal resources away from reporting information on their commitments and processes to gathering and then disclosing information on the effectiveness of these efforts on the ground, according to common standards. Companies should contribute to the development of these standards for evaluating the most pressing labor and other human rights challenges they face.

- *Investors and consumers* should demand accurate performance-based social measures and data that will allow them to meaningfully assess industry competitors on social performance.

- *Asset owners and managers*, particularly large institutional investors with expansive and diverse portfolios, should examine and articulate the systemic social and human rights risks they see among their investments. On the basis of what they find, investors should engage with the companies they hold, reinforcing the importance they place on aligning themselves with companies that are striving to understand and tackle the difficult social and human rights issues they face throughout their operations. Doing so will help to make the case for patient capital and longer-term investment models.

- *NGOs* should share their expertise with companies and investors to develop social measurement that evaluates company effects on the most pressing labor and other human rights issues they face, including impacts in the supply chain.

- *Governments* should continue to explore regulation that helps to standardize the social information companies disclose and to clarify that public fiduciaries not only can but ought to consider social sustainability in their investment choices. Governments also should incorporate standards for social performance into their own procurement requirements.

- *Creators of measurement frameworks* should prioritize transparency on company impacts, rather than policies and processes. In doing so, they can play an important role in helping to identify and define industry-specific standards against which company performance is evaluated. In addition, more work is needed to interrogate the assumptions that have guided many of the measurement initiatives to date, including: the correlation between the social policies or procedures and social outcomes; the comparability of social risks and challenges among industry peers; and the availability and accuracy of social data generated by various stakeholders.

Appendix 1. The Rise of Social Measurement

Though social factors are least developed in the investment context, governments and civil society groups have long used social indicators to understand and improve social issues. As early as 1810, social reform groups in Philadelphia used detention data to advocate for prison reform, while in Europe, indicators were used to help understand the causes of epidemics in industrial cities.[56] The modern approach to social measurement and reporting arose out of the social indicator movement of the United States in the 1960s.[57]

The Social Indicator Movement (1960s)

In 1946 Congress established the Council of Economic Advisors (CEA), reflecting a post-depression and post-war focus on economic factors.[58] But critics argued that economic measurement alone was not providing an adequate understanding of the country's development. Increasingly, policy makers called for well-defined social metrics and a national-level advisory function analogous to the CEA to help achieve the country's economic and social goals.[59]

In 1966, NASA developed social indicators to better understand the social impacts of the space program.[60] The project highlighted the need for social indicator systems to measure and evaluate progress toward national goals and to predict social events and crises.[61] It also spurred a range of other social indicator initiatives, books, and articles in the 1970s, including the first indicators aimed at understanding citizens' views of their wellbeing.[62]

Other nations and multinational organizations began similar efforts, which contributed to the emergence of a global social measurement movement.[63] However, by the early 1980s, the movement had stalled in the United States.[64] Though Congress put forward legislation proposing a Council of Social Advisors, it was never adopted. Other efforts to develop comprehensive social indicators similarly struggled under political pressures.[65]

Expansion of Social Indicators (1980s – 2000s)

Beginning in the 1980s, a number of new efforts emerged that sought to understand and compare the governance, social, and environmental conditions of countries. These built on efforts by the United Nations to establish statistics departments that began in the 1950s.[66] By the late 1980s, multinational organizations' use of indicators had picked up dramatically.[67] During this period, the Organization for Economic Cooperation and Development, the World Bank, the World Health Organization, and various United Nations agencies all developed measurement frameworks, and in some cases ratings systems that assessed country performance against social indicators.[68]

In 2002, President George W. Bush established the Millennium Challenge Corporation (MCC), which evaluates potential US aid recipients on the basis of both economic and political commitments and past performance.[69] It drew on existing multinational and NGO ratings and rankings, which gave many of these initiatives greater weight.[70]

Figure 15: Example indicators used by international frameworks to evaluate social outcomes:

Indicator(s)	Desired Outcome	Measurement Initiative
Did established and reputable national and/or international election monitoring organizations judge the most recent elections for head of government to be free and fair?	Free elections	Freedom in the World
On a scale of 0-100, how corrupt are the country's public sectors?	Lack of corruption	Corruption Perception Index
Household income, financial wealth, employment levels, earnings, rooms per person, basic sanitation, perceived health, working hours, time off.	Well-being	How's Life? OECD annual report on comparative well-being
Under 5 mortality rate by rural/urban residence.	Equal healthcare	World Health Statistics 2016: Monitoring health for the SDGs

Criticisms of Social Indicators

These and other country rankings on social performance have been studied extensively and subject to considerable criticism. The most common criticism centers on the inherently reductive nature of rankings and their potential to misrepresent social phenomena in the attempt to simplify what is inherently complex.[71] The heavy reliance on quantitative proxies exacerbates these concerns.

Critics refer to what they term a "performance paradox," where weak correlation between performance indicators and actual performance creates problematic incentives.[72] This most commonly occurs when there is too great a focus on procedural indicators, or when objectives or goals are unclear or difficult to measure, as is often the case with social measurements.[73]

The result can be:

- **Tunnel vision** – where performance measurement focuses on what is easily quantifiable, not most meaningful.

- **Measure fixation** – where the person or entity under evaluation focuses effort on maximizing performance against the metric rather than achieving the underlying objectives.
- **Ossification** – where the person or entity under evaluation prefers known paths that will maximize performance against established measures to creative and innovative approaches and solutions.[74]

Despite these challenges, social indicators, rankings, and ratings are here to stay. As Nobel Laureate Amartya Sen observed, people will always seek out "crude but convenient" measures.[75] The core challenge for any social measurement is how to improve the accuracy and reliability of such indicators, while ensuring that they are simple, credible, and straightforward, and most importantly drive the desired changes in behavior.

Lessons from Measuring States: Monitoring vs. Evaluation

One of the biggest challenges in measuring social performance is distinguishing between effort and effect.[76] States and regional unions including the United States and the European Union, as well as multinational bodies, like the United Nations and the World Bank, commonly use monitoring and evaluation frameworks to define and assess different aspects of performance.[77] Under this model, "monitoring" focuses on inputs, activities, and the immediate outputs they yield; while "evaluation," focuses on the broader impact and effectiveness of a program or set of actions.[78]

Monitoring focuses on effort and is achieved through three types of indicators:

- **Input** – resources invested, including financial contributions, human resources, and intellectual or physical capital.
- **Activity** – actions taken, including creation of policies, procedures and, commitments; establishment and oversight of structures, mechanisms, and institutions; as well as trainings and stakeholder engagement efforts.
- **Output** – immediate results of activities, often looking for evidence that products or services are used by the intended beneficiaries, e.g., number of people trained or audited, users of remedial mechanisms, users of handbooks or guidelines, etc.

Evaluation of effect requires two additional indicator styles:

- **Outcome** – focus on the short- and medium-term results of outputs on society. This might include the number of rights violations or employment rates.
- **Impact** – measure longer-term and larger-scale changes, e.g., increases or decreases in social stability or crises or the rate and distribution of economic growth. Impacts are often the effect of numerous intersecting outcomes over time.

Impacts are the most meaningful aspect of performance to measure. But they also are the most difficult, due to their long-term nature and the fact that they result from numerous intersecting institutions, policies, and practices. Linking impact to a specific policy, investment, or practice is challenging and sometimes not possible. Outcomes, on the other hand, can be more closely traced to specific activities and outputs. For this reason, they can be very helpful in evaluating the consequences of specific programs, efforts, or actions.

We have applied this framework in examining the strengths and weaknesses of company-focused measurements. (See Appendix 2 for further discussion of our methodology.)

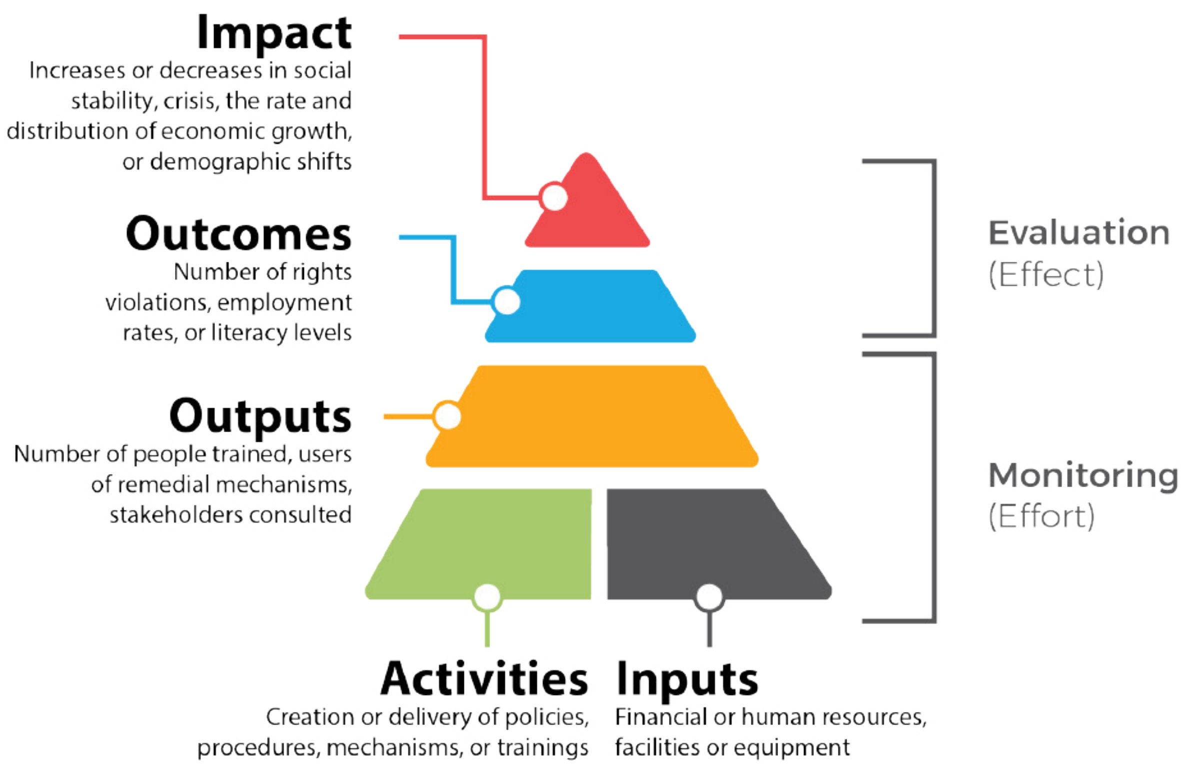


Figure 16: Overview of Monitoring and Evaluation Framework

Appendix 2. Methodology

To better understand how companies' social sustainability performance is currently measured, we conducted a two-phase study. We first reviewed academic literature and media sources on social measurement, sustainable investing, and trends in the ESG industry, as well as the materials and methodologies for leading measurement efforts. On the basis of this review, we generated a central hypothesis: that social measurement tends to focus on company efforts rather than effects. To test this hypothesis, we then identified and systematically coded 12 prominent measurement frameworks according to a standard monitoring and evaluation framework (see Appendix 1 for more details). We selected this framework for two reasons: (1) it is structured to help separate indicators that focus on efforts (monitoring) from those that focus on effect (evaluation); and (2) it is commonly used by governments to measure social factors. We additionally examined the scope of issues, procedures, and operations that social indicators measure to further understand how "social" is currently defined in practice.

Scope and selection criteria

In selecting the frameworks for analysis, we sought a group that was representative of the most useful measurement tools available for investors seeking to understand social performance. To achieve this aim, we prioritized frameworks that either investors have indicated they use most often (i.e., company reporting, Bloomberg, DJSI) or are most likely to rigorously evaluate sustainability and human rights performance (i.e., those developed by sustainability and human rights experts).

In addition to these criteria, our sample was limited by two practical considerations: (1) all frameworks needed to include at least some socially-focused indicators; and (2) we had to have access to the text of the indicators used to measure or evaluate companies. As a result of these additional considerations efforts like the Carbon Disclosure Project and MSCI, though popular with investors, are not included in the study (due to an environmental focus in the first case and unavailability of indicators in the second).

Frameworks selected

After applying our selection criteria and adjusting for practical considerations, we selected the following frameworks to code:

<u>Company-Focused</u>

1. **Global Reporting Initiative** (GRI):

    - General Disclosures (102), Management Approach (103), and all social reporting standards (401-419)

2. **Sustainability Accounting Standards Board** (SASB):

   - Apparel, Accessories & Footwear; Oil & Gas Exploration and Production; Food Retailers & Distributors; Engineering & Construction Services; Pharmaceuticals; and Internet Media & Services[79]

3. **UN Guiding Principles Reporting Framework** (UNGPRF)

Investor-Focused

4. **Dow Jones Sustainability Index** (DJSI):

   - Metals and Mining Questionnaire

5. **FTSE – ESG Ratings**

6. **Bloomberg's social indicators**

Human Rights-Focused

7. **Access to Medicine Index**

8. **Enough Project's Rankings on Conflict Minerals**

9. **Oxfam's Behind the Brands**:

   - Farmers, Land, Women, and Workers

10. **Ranking Digital Rights' Corporate Accountability Index**

11. **KnowTheChain**:[80]

   - ICT and Food and Beverages Benchmarks

12. **Corporate Human Rights Benchmark**

For frameworks that included a mixture of environmental, social, and governance indicators, we examined only the indicators that were clearly advanced as "social" indicators. These were either indicators that were included in a dedicated "social" section or that explicitly referenced "social" in their text. In addition, we sought out indicators that focused on the management of and effects found in a company's supply chain. We included this group because many of the most significant and difficult human rights challenges companies face occur in this part of their operations.

Coding Process

Once we defined the sample, coders entered indicators for all frameworks into a spreadsheet and assigned a value for each of the factors described in the below chart. Indicators that included many component parts were split across multiple rows, with a code to indicate that they were one part of a larger indicator. Coders erred on the side of not splitting indicators if possible, doing so only when different components required different codes. Throughout our analysis, the text captured on a single row, whether a component or a full original indicator, will be referred to as an "indicator."

Figure 17: Coding structure and definitions

Factor	Answer Choices	Purpose	Instructions Provided
Paper Category	1, 2, 3	Enables analysis of different measurement categories' strengths and weaknesses.	Frameworks were each assigned a code prior to allocating them among the coders. The codes were assigned according to the measurement categories described in Part 3.1 of this paper, with 1 corresponding to reporting frameworks, 2 to investor-driven frameworks, and 3 to expert ratings and rankings.
Framework Name	Drop-down list	Enables analysis of each framework's specific characteristics.	Coders were provided a drop-down list of the names of frameworks selected for the sample and instructed to choose the one from which the indicator came.
Global or Industry-Specific	G, IS	Enables evaluation of the strengths and weakness of global versus industry-specific approaches to measurement.	Coders were told to examine the introductory materials of the framework in question to determine whether it applied to all companies or only specific industries. IS was selected whenever the indicator applied only to specific industries, even if it applied to multiple specific industries. Some frameworks included both general and industry-specific indicators. In such cases, an indicator was assumed to be general unless it expressly stated that it was to be applied only to companies in certain industries or sectors.

Factor	Answer Choices	Purpose	Instructions Provided
Industry code	ICT, Pharma., F&B, Manuf., Extr., Const., or Multi.	Enables assessment of the issues commonly measured for different industries and which industries have the most rigorous measurement.	When indicators were identified as industry-specific, coders were instructed to select the corresponding industry code: • ICT - Information and Communication Technologies • Pharma. - Pharmaceuticals • F&B - Food and Beverage • Manuf. - Manufacturing • Extr. - Extractives • Const. - Construction • Multi. - Multiple industries
Materiality or Saliency-Driven	Y, N	Helps to distinguish between indicators that will apply to all companies and those which only apply after the company or a third party determines the issue to be relevant.	Coders were again told to read all introductory materials and explanatory notes to determine whether a materiality or saliency determination[81] was necessary before the indicator would apply. In addition, indicators were coded Y if the framework expressly stated that the indicator was based on a materiality assessment.
Measurement Category	Social, Social Capital, Human Rights, Human Capital, Governance, Economic, Issue-specific, Unspecified	Enables examination of the different definitions of human rights and social issues implicit in existing measurement frameworks.	Coders were told to identify in which of the provided conceptual categories the framework expressly placed the indicator (i.e., to select “human rights” the framework must place the indicator in a “human rights” section or otherwise in some way clearly indicate that the indicator is considered to cover human rights). “Issue-specific” was used only if the indicator did not fit in one of the other categories and the framework clearly identified a specific human right or social issue around which it was organized (e.g., forced labor). “Unspecified” was theoretically to be used if no other answer choice applied, but there were no instances of this in our sample.

Factor	Answer Choices	Purpose	Instructions Provided
Heading(s)	Free form	Helps to provide the structural and conceptual context necessary to understand a given indicator.	This field was used to capture the full nest of concepts in which an indicator sat. Generally, this included a section heading and sub-heading, however, in some cases there were multiple layers of sub-headings. Coders were instructed to copy the text verbatim from the framework's original text and structure.
Score	1, 2, 3, X, or blank	Helps to capture the weight different indicators received in a company's final evaluation. Enables analysis of which issues have the greatest impact on a company's overall evaluation.	Coders were instructed to assign a 1, 2, or 3 to correspond with the score attributed to that indicator by its native framework. For frameworks where it was clear that an indicator was scored but the scoring system was highly variable or the scoring approach was unclear, coders were instructed to put an "X". For indicators that were clearly not scored, coders were instructed to leave the field blank.
Indicator Type	Contextual, Input, Activity, Output, Outcome	This is the core aspect of the coding exercise. Helps to determine what portion of existing measurement is focused on monitoring effort versus evaluating results.	Coders were instructed to assign types according to the definitions provided in Appendix 3. Where they felt the indicator could be one of two types, they were instructed to list both and these cases were reviewed together as a batch to improve consistency and refine the definitions. (See coding process below for more details).
Substantive Issue Measured	Drop-down list	Enables analysis of the kinds of issues covered by different categories, frameworks, and indicator types.	Coders were instructed to pick the substantive issue that the indicator measured from a predefined drop-down list. [82] Where an indicator measured multiple issues, coders were instructed to favor the more specific issue, unless the general issue was clearly the more dominant issue. Coders were also instructed to note if they felt the indicator would be better coded by an issue that was not reflected in the drop-down list. These suggestions were reviewed between the first and second round of coding to identify missing issue trends (see coding process below for more details).

Factor	Answer Choices	Purpose	Instructions Provided
Procedural Issue Measured	Drop-down list	*As above.*	*As above.*
Supply Chain Flag	X or blank	Enables analysis on the operational scope of different categories and frameworks.	Coders were instructed to place an "X" in this field if the indicator covered a company's supply chain.
Transparency /Disclosure Flag	X or blank	Enables evaluation of the role transparency plays in current measurement.	Coders were instructed to place an "X" in this field if the indicator measured and rewarded transparency or disclosure regardless of the content that is disclosed.

The coding process was again split into two phases. In phase 1, a minimum of two coders were assigned to review and evaluate each indicator. As a part of this preliminary review, coders kept notes regarding choices they found difficult or unclear based on the definitions provided. We then evaluated the results for inter-coder reliability and discovered that there was considerable disagreement on the indicator type and the issues measured.

In phase 2, we reviewed the coders' notes and suggestions for additional issues and adjusted the definitions to help resolve discrepancies. As a result of this process, we added one additional indicator type termed "contextual," which was used for indicators that covered basic organizational information or basic risk information that but merely provided context to the other indicators in the framework. (See Appendix 3 for the fully adjusted definitions of each indicator type, along with trends and examples from our dataset). The complete substantive and procedural issues lists are provided in the table below. One coder then reviewed and adjusted all indicators according to the expanded definitions and lists. As the coder completed this second round, common and/or boundary indicators were added to the definitions to further ensure consistency. Each indicator type and issue was then reviewed as a group to confirm uniformity across frameworks.

Figure 18: List of Substantive Issues and Clarifications Provided to Coders

Substantive Issues	Examples/Clarifications
General	
ESG General	
Social General	
Human Rights General	
Fair Labor Practives General	Only used if more specific labor right did not apply or if the indicator was intended to cover labor rights comprehensively
Freedom of Association and Collective Bargaining	
Occupational Health and Safety	
Compensation and Benefits	
Diversity and Equal Opportunity	Covers women's and minority rights in the company's direct workforce
Forced or Compulsory Labor	
Vulnerable Groups General	Only used if more specific vulnerable group did not apply or if the indicator was intended to cover vulnerable groups comprehensively
Women's Rights	Covers women's rights in the supply chain and among external stakeholders

Substantive Issues	Examples/Clarifications
Women's Rights	Covers women's rights in the supply chain and among external stakeholders
Rights of Indigenous Peoples	
Children's Rights	
Land Rights General	
Security and Conflict	
Health, Water, and Sanitation	
Data Security and Customer Privacy	
Freedom of Expression	
Access to Remedy	
Corruption/Bribery/ Payment Transparency	
Customer/Product Health and Safety	

Figure 19: List of Procedural Issues and Clarifications Provided to Coders

Procedural Issues	Examples/Clarifications
Policies and Commitments	Includes distribution and translation of policies and also systemic judgment calls or aspirations (e.g., a policy of respecting women's rights)
Leadership Involvement	CEO/board involvement, statements, etc.
Governance Structure	General management/oversight structures or processes, internal auditing, approach to implementation of policies (e.g., notification practices)
Definitions and Scoping	
Data Collection and Mapping	
Audits and External Assurance	
Risk and Impact Assess-ment	
Contracting and Agreements	Ethical clauses, supplier requirements, purchasing practices including sourcing preferences/avoidance
Social and Human Rights Training	
Recruitment and Development	Training that is broader than social or human rights would be included in this category
Compensation and Benefits	Use of compensation and benefits to achieve objectives, either because objective is higher wages or to advance human rights/social objectives through financial and performance incentives built into compensation structures
Employee Engagement	

Procedural Issues	Examples/Clarifications
Memberships and Collaborations	
Stakeholder Engagement	
Local Development /Philanthropy	Includes all philanthropy whether directed at local communities or not as well as things like product donation
Action Plans and Corrective Actions	
Complaints Mechanisms	Includes both whistleblowing and grievance mechanisms
Fines, Settlements, Violations	Includes compensation for judgments rendered against company and/or verified violations of international or external codes of conduct
Marketing and Labeling	
Public Policy	Efforts to influence laws, social policies, or norms
Ratings Performance	Indicators that evaluate the company's performance on some form of rating system or framework
Technological Solutions	
Other	Indicators in that were classified as other fell into two broad categories: 1. Aspirational statements with no indication of approach to achieving them: e.g., company respects women's rights. 2. Disclosures regarding the process and rationale for handling customer data. This was not coded as policy or governance structure because in this case such a disclosure would speak directly to the user's right to privacy.

Appendix 3. Indicator Types – Definitions, Trends, and Examples

As described in the report, 92% of the indicators in our sample measured company efforts and 8% measured effects. The below chart provides more detailed definitions of the indicator types associated with these two categories, as well as trends and examples for each type. For the purpose of coding, we broke **"efforts"** into four types that correspond with the monitoring and evaluation framework described in Appendix 1: contextual, input, activity, and output. We broke **"effects"** into the two remaining monitoring and evaluation types: outcomes and impacts. Figure X provides the breakdown of indicators in our sample according indicator type.

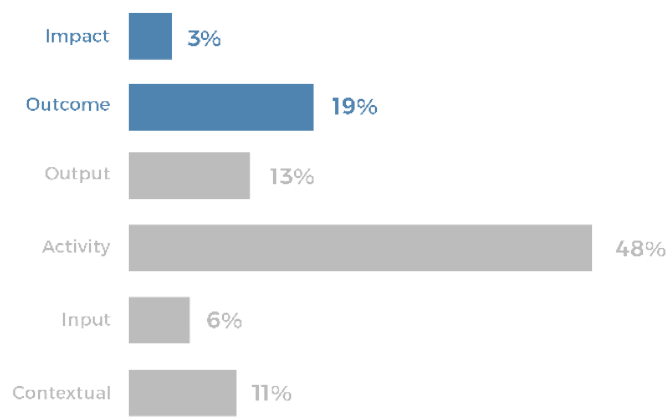


Figure 20: Percentage of Each Indicator Type in our Sample

Type	Definition	Trends in Sample	Example 1	Example 2	Example 3
Contextual	Elicit basic demographic information about companies and facts that are relevant to risk levels in the company's operations. Answers are neither positive nor negative but simply give context to other indicators.	Most common in reporting frameworks. Tended to focus on: • the scope of reporting; • a company's size/ scope of operations; • general risks faced due to industry or geography; and • basic information about board structures, etc.	**GRI 102-4:** Location of operations: a. Number of countries where the organization operates, and the names of countries where it has significant operations and/or that are relevant to the topics covered in the report.	**SASB NR0101-13:** (1) Proved and (2) probable reserves in or near indigenous land.	**SASB TC0401-07(a):** Number of government or law enforcement requests for customer information

Type	Definition	Trends in Sample	Example 1	Example 2	Example 3
Input	Measure the resources a company is investing. Investments may cover a variety of contribution types, including: financial, human resource, intellectual property and/or physical capital. The existence of incentives schemes and avenues for communicating grievances/ whistleblowing (absent any information on their operation, use, or effectiveness) are considered inputs.	Most common in investor-driven frameworks. • Tended to focus on: • the staffing and systems put in place to manage ESG issues; • financial investments in ESG programs or objectives (e.g., community programs, R&D investments, training programs); • leadership involvement in ESG issues; and • financial incentives related to ESG aims.	**KnowTheChain (ICT) 1.3:** The company has a committee, team, program or officer responsible for the implementation of its supply chain policies and standards relevant to human trafficking and forced labor.	**Access to Medicine C.III.1:** The portion of financial R&D investment dedicated to diseases of relevance to the Index out of the company's total R&D expenditures.	**Bloomberg:** Amount of money spent by the company on community-building activities, in millions.
Activity	Measure the actions a company takes in furtherance of its social or human rights objectives. Activities can range from the creation of polices and commitments, to the governance processes and procedures in place to implement those policies, to more specific and bounded actions like training, stakeholder engagements, or policy lobbying.	Most common type across all frameworks and also the most diverse in substance and style. On the weaker end, indicators required only the existence of general policies or high-level public commitments. More rigorous indicators included: • specific rights-advancing policy requirements and disclosures; • regular audits and the development of corrective actions plans in response to poor audit findings; • the gathering of information relevant to human rights risks and aims; and • engagement with specific stakeholder groups.	**Enough Project 2. Audit b.** Has the company conducted internal audits of the procurement practices of 3TG suppliers down to the level of refiner, at least within the past year?	**Behind the Brands W4.3.4** Do the company's systems routinely record actual wage values (instead of recording that minimum wage has been paid)?	**Ranking Digital Rights F5.9.** Does the company commit to push back on inappropriate or overbroad requests made by governments?

Type	Definition	Trends in Sample	Example 1	Example 2	Example 3
Output	Measure the proximate results of activities in a way that involves and/or serves third parties. Output indicators generally improve on activity indicators by providing evidence of a process functioning and some insight into possible outcomes through activity analysis/trends. They are distinct from outcomes in that they do not provide sufficient information to evaluate the effect the company is having on people or the world.	Often built on activity indicators adding in requirements for: • trend analyses or lessons learned; • percentage of workers covered by a policy or products certified to a standard; • the disclosure of audit findings; or • input received from stakeholder engagement. Vague statements regarding a company's recognition of rights without clear measures for assessment were also put in this category as a way of splitting the difference between the implied policy these statements represent and the possible outcome they would speak to if meaningfully assessed.	**CHRB D.3.7 Security (in own extractive operations):** The Company also provides evidence that it extends its security assessment(s) and protection measures to cover the security of local communities around its operations where indicated by security assessments, works with community members to improve security and prevent or address any tensions, such as by increasing the proportion of security provided by the local community.	**Access to Medicine:** C.III.5. Product development: movement through the pipeline: The number of candidates relating to diseases within the scope of the Index moving through R&D life cycle from early research phases to more advanced phases.	**UNGPRF A2.5** What lessons has the company learned during the reporting period about achieving respect for human rights, and what has changed as a result?
Outcome	Measure information that speaks to the effect the company is having on people or the world.	Second least common type. Tended to focus on a small number of labor issues, including: • number of people employed; • wage levels; • diversity of workforce and management; and • accident or fatality rates. In addition, a number of outcome indicators evaluated complaints or lawsuits that resulted in fines, settlements, or adverse verdicts for the company.	**SASB HC0101-09(a):** Description of legal and regulatory fines and settlements associated with clinical trials in World Bank Low-income and Lower- middle-income Countries (LICs and LMICs) and UN HDI Medium-High Development Countries (MHDCs) that are not captured by the World Bank's LIC or LMIC rankings. Dollar amount of fines and settlements.	**CHRB D.3.8 Water and sanitation (in own extractive operations):** The Company does not negatively affect access to safe water, in line with the UN Sustainable Development Goals and the UN Global Compact's CEO Water Mandate.	**DJSI:** Percentage of women in management.

Type	Definition	Trends in Sample	Example 1	Example 2	Example 3
Impact	Measure longer-term and larger-scale changes, e.g., increased economic opportunity, increased quality of life, shifting demographics. Provide information on the effect of outcomes over time.	Least common type. The impact indicators simply requested information regarding a company's impacts without much guidance regarding how such impacts should be defined and evaluated.	**GRI 103-1:** Explanation of the material topic and its Boundary: For each material topic, the reporting organization shall report the following information: b. The Boundary for the material topic, which includes a description of: i. where the impacts occur; ii. the organization's involvement with the impacts. For example, whether the organization has caused or contributed to the impacts, or is directly linked to the impacts through its business relationships.	**UNGPRF C3.2** During the reporting period, did any severe impacts occur that were related to a salient issue and, if so, what were they?	*All impact indicators come from these two frameworks and are similar to the two examples provided.*

A Note on the Diversity of Monitoring Indicators

Though our analysis is focused on distinguishing between indicators that measure efforts (monitoring) from those that measure effects (evaluation), it is important to recognize the diversity of monitoring indicators. Stronger input, activity, and output indicators (i.e., those that are specific, reference relevant standards and best practices, and include benchmarks) can reveal meaningful differences in the level of company commitment and follow through on labor and other human rights issues, even if they do not offer insights into whether those efforts are having the intended effect in the wider world.

Some examples of strong monitoring indicators in our sample include:

<u>KnowTheChain ICT:</u>
5.4 (1) The company has a formal procedure that allows suppliers' workers to report a grievance to an impartial entity.

<u>Behind the Brands LA2.1.2.6:</u>
Has the company published an action plan for how it plans to address findings from the [impact] assessment (e.g. time bound steps to address issues)?

<u>CHRB D.2.9.b Working hours (in the supply chain):</u>
The Company includes working hours guidelines, including respect for applicable international standards and national laws and regulations concerning maximum hours and minimum breaks and rest periods, in its contractual arrangements with its suppliers or supplier code of conduct and describes how these practices are taken into account positively in the identification and selection of suppliers OR the Company describes how it works with suppliers to improve their practices in relation to working hours.

<u>Access to Medicine E.III.5. Anti-competitive behavior: Trade policy:</u>
There is evidence that the company employs an intellectual property (IP) strategy that is conducive to access to medicine, operating in accordance with the international consensus on intellectual property standards as it pertains to public health, confirmed by the Doha Declaration.

1. Universal Declaration of Human Rights, GA Res. 217A(III), 10 December 1948 (UDHR); International Covenant on Civil and Political Rights, opened for signature 16 December 1966, 999 UNTS 171 (entered into force 23 March 1976); International Covenant on Economic, Social and Cultural Rights, opened for signature 16 December 1966, 993 UNTS 3 (entered into force 3 January 1976). The eight fundamental conventions of the International Labour Organization can be found at International Labour Organization, Conventions and Recommendations, http://ilo.org/global/standards/introduction-to-international-labour-standards/conventions-and-recommendations/lang--en/index.htm.

2. In 2011, the UN Human Rights Council unanimously endorsed the UN Guiding Principles on Business and Human Rights. These principles codified, among other things, that corporations have a responsibility to respect human rights as laid out in the UDHR and the core human rights and ILO conventions (see above n 1). Human Rights Council, Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework, Report of the Special Representative of the Secretary-General on the issue of Human Rights and Transnational Corporations and Other Business Enterprises, UN Doc A/HRC/17/31 (2011), http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusiness-HR_EN.pdf.

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80. At the time of selection, the third KnowTheChain benchmark for Apparel and Footwear was not yet released.

81. Both materiality and saliency are approaches to determining the relevance of a given issue to a particular business or industry. As described in Part 1.2 of this paper, materiality has historically been understood in terms of whether a given issue impacts a company's near-term financial risk and return characteristics. Saliency is a term used by the UN Guiding Principles Reporting Framework that is intended to look beyond a strict materiality assessment to determine which issues risk "the most severe negative impact" more generally.

82. We developed the preliminary substantive and procedural lists on the basis of a cursory review of the frameworks included in our sample for perceptible issue trends

October 1, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, Northeast
Washington, DC 20549

Dear Mr. Fields:

Enclosed is a petition for a rulemaking on environmental, social, and governance (ESG) disclosure authored by Osler Chair in Business Law Cynthia A. Williams, Osgoode Hall Law School, and Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch, University of Pennsylvania Law School, and signed by investors and associated organizations representing more than $5 trillion in assets under management including the California Public Employees' Retirement System (CalPERS), New York State Comptroller Thomas P. DiNapoli, Illinois State Treasurer Michael W. Frerichs, Connecticut State Treasurer Denise L. Nappier, Oregon State Treasurer Tobias Read, and the U.N. Principles for Responsible Investment.

The enclosed rulemaking petition:

- Calls for the Commission to initiate notice and comment rulemaking to develop a comprehensive framework requiring issuers to disclose identified environmental, social, and governance (ESG) aspects of each public-reporting company's operations;
- Lays out the statutory authority for the SEC to require ESG disclosure;
- Discusses the clear materiality of ESG issues;
- Highlights large asset managers' existing calls for standardized ESG disclosure;
- Discusses the importance of such standardized ESG disclosure for companies and the competitive position of the U.S. capital markets; and
- Points to the existing rulemaking petitions, investor proposals, and stakeholder engagements on human capital management, climate, tax, human rights, gender pay ratios, and political spending, and highlights how these efforts suggest, in aggregate, that it is time for the SEC to bring coherence to this area.

If the Commission or Staff have any questions, or if we can be of assistance in any way, please contact either **Osler Chair in Business Law Cynthia A. Williams**, Osgoode Hall Law School, who can be reached at (416) 736-5545, or by electronic mail at cwilliams@osgoode.yorku.ca; or **Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch**, University of Pennsylvania Law School, who can be reached at (215) 746-3454, or by electronic mail at jfisch@law.upenn.edu.

October 1, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, Northeast
Washington, DC 20549

Dear Mr. Fields,

We respectfully submit this petition for rulemaking pursuant to Rule 192(a) of the Securities and Exchange Commission's (SEC) Rule of Practice.[1]

Today, investors, including retail investors, are demanding and using a wide range of information designed to understand the long-term performance and risk management strategies of public-reporting companies. In response to changing business norms and pressure from investors, most of America's largest public companies are attempting to provide additional information to meet these changing needs and to address worldwide investor preferences and regulatory requirements. Without adequate standards, more and more public companies are voluntarily producing "sustainability reports" designed to explain how they are creating long-term value. There are substantial problems with the nature, timing, and extent of these voluntary disclosures, however. Thus, we respectfully ask the Commission to engage in notice and comment rule-making to develop a comprehensive framework for clearer, more consistent, more complete, and more easily comparable information relevant to companies' long-term risks and performance. Such a framework would better inform investors, and would provide clarity to America's public companies on providing relevant, auditable, and decision-useful information to investors.

Introduction

In 2014, the Commission solicited public comments to its "Disclosure Effectiveness" initiative, which sought to evaluate and potentially reform corporate disclosure requirements. Over 9,835 commenters have responded to that initiative.[2] As part of that initiative, the 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K ("Concept Release")[3] solicited public opinions on the frequency and format of current disclosure, company accounting practices and standards, and the substantive issues about which information should be disclosed. In that Concept Release, the SEC asked a number of questions about whether it should require disclosure of sustainability matters, which it defined as "encompass[ing] a range of topics, including climate change, resource scarcity, corporate social responsibility, and good

[1] Rule 192. Rulemaking: Issuance, Amendment and Repeal of Rules, Rule 192(a), *By Petition*, *available at* https://www.sec.gov/about/rules-of-practice-2016.pdf.

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[3] Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064; 34-77599; File No. S7-06-16, April 16, 2016, *available at* https://www.sec.gov/rules/concept/2016/33-10064.pdf [hereinafter "Concept Release"].

corporate citizenship. These topics are characterized broadly as ESG [Environmental, Social, and Governance] concerns."[4]

The SEC received over 26,500 comments in response to the 2016 Concept Release, making it one of only seven major proposals by the SEC since 2008 to garner more than 25,000 comments.[5] As noted in a report reviewing comments to the Concept Release, "the overwhelming response to the Concept Release seems to reflect an enormous pent up demand by disclosure recipients for more and better disclosure" generally.[6] The Concept Release also provided the first formal opportunity since the mid-1970s for both reporting companies and disclosure recipients to convey their views to the SEC concerning what additional environmental or social information should be disclosed to complement the governance disclosure already required.

An analysis of the comments submitted in response to the Concept Release, a significant majority of which supported better ESG disclosure, can be found in the report referenced in footnote 2. Across the board, commenters noted how they were using those disclosures to understand companies' potential long-term performance and risks. The response to the Concept Release strongly suggests that it is time for the Commission to engage in a rulemaking process to develop a framework for public reporting companies to use to disclose specific, much higher-quality ESG information than is currently being produced pursuant either to voluntary initiatives or current SEC requirements.

We briefly set out six arguments supporting this petition:

(1) The SEC has clear statutory authority to require disclosure of ESG information, and doing so will promote market efficiency, protect the competitive position of American public companies and the U.S. capital markets, and enhance capital formation;

(2) ESG information is material to a broad range of investors today;

(3) Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful;

(4) Companies' voluntary ESG disclosure is episodic, incomplete, incomparable, and inconsistent, and ESG disclosure in required SEC filings is similarly inadequate;

(5) Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure; and

(6) Petitions and stakeholder engagement seeking different kinds of ESG information suggest, in aggregate, that it is time for the SEC to regulate in this area.

[4] *See id.* at 206.
[5] *Id.*
[6] *See* Joint Report, *supra* note 2, at 10.

1. *The SEC has Clear Statutory Authority to Require Disclosure of ESG Information*

As acknowledged by the SEC in its Concept Release, its statutory authority over disclosure is broad. Congress, in both the Securities Act and the Exchange Act, "authorize[d] the Commission to promulgate rules for registrant disclosure 'as necessary or appropriate in the public interest or for the protection of investors.'"[7] In an early defense of its power to require disclosure of corporate governance information such as the committee structure and composition of boards of directors—disclosure now considered standard, but which was controversial when the requirements were first promulgated—the SEC was explicit about the broad scope of its power over disclosure:

> The legislative history of the federal securities laws reflects a recognition that disclosure, by providing corporate owners with meaningful information about the way in which their corporations are managed, may promote the accountability of corporate managers. . . . Accordingly, although the Commission's objective in adopting these rules is to provide additional information relevant to an informed voting decision, it recognizes that disclosure may, depending on determinations made by a company's management, directors and shareholders, influence corporate conduct. This sort of impact is clearly consistent with the basic philosophy of the federal securities laws.[8]

In 1996, Congress added Section 2(b) to the Securities Act of 1933, and Section 23(a)(2) to the Securities and Exchange Act of 1934. These parallel sections provide that:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[9]

These statutory policy goals underscore the SEC's authority to require disclosure of better, more easily comparable, and consistently presented ESG information. Generally, the SEC seeks to protect investors through requirements for issuers to disclose material information at specified times.[10] Thus, the investor protection aspect of the SEC's statutory authority will be discussed in Part Two, below, in conjunction with the discussion of the materiality of ESG information. Here we discuss why requiring issuers to disclose specified ESG information would promote market efficiency, competition, and capital formation.

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[7] Concept Release, *supra* note 3, at 22-23 & fn. 50, *citing* Sections 7, 10, and 19(a) of the Securities Act of 1933, 15 U.S.C. §§ 77g(a)(10), 77j, and 77s(a); and Sections 3(b), 12, 13, 14, 15(d), and 23(a) of the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78c(b), 78l, 78m(a), 78n(a), 78o(d), and 78w(a).

[8] Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 16 Docket 348, 350 (Dec. 6, 1978).

[9] Securities Act of 1933, §2(b), 15 U.S.C.§ 77b(b); Securities and Exchange Act of 1934, § 23(a)(2), 15 U.S.C. §78w(a)(2)(2012).

[10] *See* Concept Release, *supra* note 3, at 23 (stating that "our disclosure rules are intended not only to protect investors but also to facilitate capital formation and maintain fair, orderly and efficient capital markets.").

A. Promoting Efficient Capital Markets

The concept of "efficient capital markets" includes informational efficiency (market mechanisms able to process new information quickly and with broad distribution)[11] and allocative efficiency (distributing capital resources to their highest value use at the lowest cost and risk).[12] Disclosure is obviously relevant to both efficiency goals, the latter being particularly relevant to the discussion of the need for better sustainability disclosure. As Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, said with respect to climate change, with "consistent, comparable, reliable, and clear disclosure" of firms' forward-looking strategies, both "markets and governments" can better manage the transition to a low-carbon future by supporting the allocation of capital to its risk-adjusted highest-value use in that transition.[13] Climate change is not a purely environmental issue, of course: It is also an issue that poses material risks and opportunities to companies in most industries. The Sustainability Accounting Standards Board ("SASB")'s conclusion, developed in conjunction with industry leaders, is that 72 of 79 industries, representing 93% of U.S. capital market valuations, are vulnerable to material financial implications from climate change.[14] The point is that without consistent, comparable, reliable, and complete information, capital markets are constrained in promoting allocational efficiency as many industries embark on the transition to a low-carbon economy. Similarly, other substantial social and economic challenges in the United States, such as increasingly precarious work environments, rising economic inequality, or the security of private information, can be better perceived by investors and assets allocated to high-performance workplaces and firms with better human capital management and cybersecurity arrangements if investors are provided with clear and comparable information about these matters.

Requiring firms to disclose more ESG information is thus consistent with the SEC's authority to promote market efficiency, and within its broad mandate "to promulgate rules for registrant disclosure as necessary or appropriate in the public interest or for the protection of investors."[15]

B. Ensuring the global competitiveness of America's public companies and the U.S. capital markets

The SEC will also be ensuring the competitiveness of U.S. capital markets and America's public companies by requiring more ESG disclosure. Many other developed countries have already promulgated such requirements, shaping the expectations of global investors. A 2016 study by the U.N. PRI (Principles for Responsible Investment) and MSCI (a global data and investment research provider) identified 300 policy initiatives promoting sustainable finance in the world's 50 largest economies, of which 200 were corporate reporting requirements covering

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[11] *See* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK L.REV. 763, 764–65 (1995).
[12] *See* Alicia J. Davis, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1116 (2009) (recognizing that "[p]ublic markets perform a vital economic role, since accurate share prices lead to the efficient allocation of capital.").
[13] Mark Carney, Governor, *Breaking the tragedy of the horizon: Climate change and financial stability,* Bank of England 14 (Sept. 29, 2015), *available at* http://www.BankofEngland.co.uk/publications/Pages/speeches/2015/844.asp#.
[14] Sustainability Accounting Standards Board, *Climate Risk—Technical Bulletin,* SASB Library 2017, *available at* https://library.sasb.org/climate-risk-technical-bulletin/.
[15] Concept Release, *supra* note 3, at 22.

environmental, social, and governance factors.[16] According to a 2015 report by the Initiative for Responsible Investment of the Hauser Institute for Civil Society at the Kennedy School, Harvard University, 23 countries have enacted legislation within the last 15 years to require public companies to issue reports including environmental and/or social information.[17]

In addition to these reporting initiatives, seven stock exchanges require social and/or environmental disclosure as part of their listing requirements: Australia's ASX, Brazil's Bovespa, India's Securities and Exchange Board, the Bursa Malaysia, Oslo's Børs, the Johannesburg Stock Exchange, and the London Stock Exchange.[18]

Moreover, seven countries have enacted policies following those of the U.K. and Sweden, which since 2000 have required public pension funds to disclose the extent to which the fund incorporates social and environmental information into their investment decisions.[19] Regulations such as these support the trend of increasing institutional investor demand for high-quality ESG data, as discussed below. Currently the European Union is developing a taxonomy of environmentally sustainable activities, as well as developing benchmarks for low-carbon investment strategies, and regulatory guidance to improve corporate disclosure of climate-related information.[20] To the extent that US companies fail to disclose information which global investors are being encouraged, and in some cases required, to consider, they will be at a disadvantage in attracting capital from some of the world's largest financial markets. This highlights that US corporate reporting standards will soon become outdated if they are not revised to incorporate global developments regarding the materiality and disclosure of ESG information.

C. Facilitating Capital Formation

Additionally, promulgating a regulatory framework for the disclosure of ESG information would promote capital formation. By providing more information to investors, giving better information about risks and opportunities, and standardizing what is currently an uncoordinated and irregular universe of ESG disclosures, the SEC would act to increase confidence in the capital markets. This confidence may well mobilize sources of capital from investors who are currently unwilling to invest given knowledge gaps or information asymmetries. Particularly retail investors, who are important as long-term investors and investors in small and medium enterprises, may be emboldened by a clearer sense of the social and environmental aspects of

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[16] PRI and MSCI, *Global Guide to Responsible Investment Regulation*, 2016, *available at* https://www.unpri.org/page/responsible-investment-regulation.

[17] *See* Initiative for Responsible Investment, *Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges* (March 12, 2015), *available at* http://hausercenter.org/iri/wp-content/uploads/2011/08/CR-3-12-15.pdf. These countries include Argentina, China, Denmark, the EU, Ecuador, Finland, France, Germany Greece, Hungary, India, Indonesia, Ireland (specific to state-supported financial institutions after the 2008 financial crisis), Italy, Japan, Malaysia, The Netherlands, Norway, South Africa, Spain, Sweden, Taiwan, and the U.K.

[18] *See id.*

[19] *See* Initiative for Responsible Investment report, *supra* note 63. These countries include Australia, Belgium, Canada, France, Germany, Italy, and Japan.

[20] Technical Expert Group on Sustainable Finance (TEG), *State-of-play, July 2018*, *available at* https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en.

companies' activities as a guide to companies' longer-term risks and opportunities.[21] As we highlight below, the value of assets under management based on ESG-influenced guidelines has grown considerably in the past two decades. We ask the SEC to act to facilitate the provision of information to this rapidly growing sector. In so doing, additional capital may become available to support America's enterprises, particularly its smaller and medium-sized enterprises.

2. *ESG Information is Material and Decision Useful*

In advancing its over-arching goals of investor protection and promoting market efficiency, the SEC has relied upon the concept of materiality to determine what information issuers should be required to disclose and in what format.[22] As defined by the U.S. Supreme Court in *TSC v. Northway,* material information is information that a "reasonable shareholder would consider important in deciding how to vote."[23] As the Court said, "[p]ut another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[24] Thus, what is material depends on reasonable investors' perceptions of what information is already available in the market, and how any new or omitted information changes those perceptions of the quality of management, when voting or engaging with management, or the value of a company or its shares, when investing or selling.

In promulgating disclosure regulations under Regulation S-K, the SEC has predominantly, but not exclusively, sought to require the disclosure of information it construes as financially material.[25] Recent investment industry analyses are confirming the financial materiality of much ESG information. For instance, a June, 2017, Bank of America Merrill Lynch study highlighted by the Sustainability Accounting Standards Board found sustainability factors to be "strong indicators of future volatility, earnings risk, price declines, and bankruptcies."[26] Also in June of 2017, Allianz Global Investors produced a research report with similar findings, concluding that the heightened transparency of ESG disclosure lowered companies' cost of capital by reducing the "investment risk premium" that sophisticated investors would require.[27] In September of 2017, Nordea Equity Research published an analytic research report concluding that there is "solid evidence that ESG matters, both for operational and share price performance."[28] Goldman Sachs concluded in April of 2018 that "integrating ESG factors allows for greater insight into

[21] *See* Davis, *supra* note 12, at 116-1120 for evidence on the importance of retail investors to small and medium enterprises, versus institutional investors which predominantly invest in large-capitalization companies; and for evidence of retail investors generally longer holding periods for shares of stock.
[22] Concept Release, *supra* note 3, at 33-34.
[23] 426 U.S. 438, 449 (1976).
[24] *Id.*
[25] *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1264-66 (1999) (discussing SEC's requirements for public companies to disclose certain corporate governance information without a showing of economic materiality).
[26] Bank of American Merrill Lynch, *Equity Strategy Focus Point—ESG Part II: A Deeper Dive* (June 15, 2017), *cited in* Sustainability Accounting Standards Board (SASB), *The State of Disclosure Report 2017* (December 2017).
[27] Allianz Global Investors, *ESG matters, Part 2: Added value or a mere marketing tool?What does ESG mean for investments?*, (June 2017).
[28] Nordea Equity Research, *Strategy & Quant: Cracking the ESG Code*, 5 Sept. 2017, *available at:* https://nordeamarkets.com/wp-content/uploads/2017/09/Strategy-and-quant_executive-summary_050917.pdf.

intangible factors such as culture, operational excellence and risk that can improve investment outcomes."[29]

These industry studies are consistent with, and indeed rely upon, a number of influential academic studies that have analyzed the over 2,000 research studies also showing the economic materiality of ESG information. Two such studies are of particular note. Deutsch Asset & Wealth Management, in conjunction with researchers from the University of Hamburg, analyzed 2,250 individual studies of the relationship between ESG data and corporate financial performance. From this analysis, the researchers concluded that improvements in ESG performance generally lead to improvements in financial performance.[30] A comprehensive review published in 2015 of empirical studies found that 90% of studies show that sound sustainability standards lower firms' cost of capital; 80% of studies show that companies' stock price performance is positively influenced by good sustainability practices; and 88% of studies show that better E, S, or G practices result in better operational performance.[31]

In addition, the SEC has promulgated disclosure requirements for the production of qualitatively material information. For instance, it has required disclosure concerning corporate governance, such as statistics on board members' attendance at meetings, and information on the committee structure of the board of directors, with the stated purpose of encouraging the board to be more active and independent in monitoring management's actions.[32] It has required extensive disclosure of executive compensation, starting in the early 1990s, as a response to public frustration with the levels of executive compensation.[33] Indeed, with respect to illegal actions by members of management or the company, the SEC has established an almost *per se* materiality standard even where the economic consequences of management's illegal actions were trivial.[34] This qualitative approach to the materiality of information concerning the honesty of management or its approach to law compliance, among other matters, was the basis for the SEC's Division of Corporation Finance and the Office of the Chief Accountant to reject

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[29] Goldman Sachs Equity Research, *GS Sustain ESG Series: A Revolution Rising-From Low Chatter to Loud Roar [Redacted]*, 23 April 2018 (analyzing earnings call transcripts, social media, asset manager initiatives, and rising assets under management utilizing ESG screens to conclude that "the ESG Revolution is just beginning, as the logical, empirical and anecdotal evidence for its importance continue to mount.").

[30] Deutsche Asset & Wealth Management, *ESG and Corporate Financial Performance: Mapping the Global Landscape*, December, 2015, *available at* https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf.

[31] *See* Gordon L. Clark, Andreas Feiner & Michael Viehs, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance* (2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281. This report is an excellent resource because it analyzes the empirical literature on the financial effects of sustainability initiatives by type of initiative (E, S or G) and by various financial measures of interest (cost of debt capital; cost of equity capital; operating performance; and effect on stock prices).

[32] *See* Williams, *supra* note 24, at 1265 & fn. 359, *citing* Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 15,384, 16 Docket 348 (Dec. 6, 1978).

[33] *See id.* at 1266 & fn. 363, *citing* Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31,327, 52 SEC Docket 1961 (Nov. 4, 1992).

[34] *See id.* at 1265 & fn. 361, *citing* Division of Corporation Finance's Views and Comments on Disclosure Relating to the Making of Illegal Campaign Contributions by Public Companies and/or their Officers and Directors, Securities Act Release No. 5466, Exchange Act Release No. 10673, 3 SEC Docket 647 (Mar. 19, 1974); *In re* Franchard Corp., 42 S.E.C. 163, 172 (1964) (Cary, Chair)(stating that the integrity of management "is always a material factor.").

quantitative benchmarks as the sole determinant to assess materiality in preparing financial statements.[35]

The Commission has often developed new disclosure requirements in response to increased investor interest in emerging systemic environmental or social risks, such as its 2011 guidance on disclosure of risks related to cybersecurity.[36] We thus conclude that the SEC properly recognizes that there can be material information which is not yet required to be reflected in financial statements but which may be decision-relevant to investors. As stated by Alan Beller, former Director of the Division of Corporation Finance, "[i]n today's rapidly changing business landscape, investors often look beyond financial statement to understand how companies create long-term value. Financial reporting today has not kept pace with both company managers and investors' interest in broader categories of information that are also material to operations and financial performance." [37] The touchstone is the "reasonable investor," and what information the reasonable investor relies upon in voting, investing, and engagement with portfolio companies.

Today, investors with $68.4 trillion of capital are committed to incorporating ESG factors in their investing and voting decisions as part of the U.N. PRI.[38] Institutions, pension funds, sovereign wealth funds, and mutual funds with $95 trillion of invested capital support the Carbon Disclosure Project's ("CDP") annual survey of global companies regarding their greenhouse gas emissions and strategies for addressing climate change.[39] According to a recent Ernst & Young report, "investor interest in non-financial information spans across all sectors," and 61.5% of investors consider non-financial information relevant to their investments overall.[40]

Global assets under management utilizing sustainability screens, ESG factors, and comparable SRI corporate engagement strategies were valued at $22.89 trillion at the start of 2016, comprising 26% of all professionally managed assets globally.[41] Moreover, U.S.-domiciled assets using SRI strategies in 2016 were valued at $8.72 trillion, comprising more than 21% of the assets under professional management in the U.S. in that year.[42] These latter data starkly contrast with the facts when the SEC last considered the issue of expanded social and environmental disclosure in comprehensive fashion, between 1971 and 1975. Then, there were two active "ethical funds" in the United States, which by 1975 collectively held only $18.6 million assets under management, or 0.0005% of mutual fund assets.[43]

The data in the last two paragraphs indicate that substantial assets under management are

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[35] *See* SEC Staff Accounting Bulletin 99-Materiality (Aug. 12, 1999).
[36] Securities & Exchange Comm'n, *Commission Guidance Regarding Disclosure Related to Topic No. 2 Cybersecurity* (Oct. 13, 2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.
[37] Alan Beller, Foreword to SASB's Inaugural Annual State of Disclosure Report, December 1, 2016, *available at* https://www.sasb.org/blog-alan-beller-pens-forward-inaugural-annual-state-disclosure-report.
[38] *See PRI-11 year growth of AO, all signatories (Asset Owners, Investment Managers and service providers) and respective AUM*, Excel sheet available for download at *About the PRI*, U.N. Principles for Responsible Investment, http://www.unpri.org/about.
[39] *Catalyzing business and government action,* Carbon Disclosure project, https://www.cdp.net/en-US/Pages/About-Us.aspx.
[40] *Id.* at 18.
[41] *See* Global Sustainable Investment Alliance, *The Global Sustainable Investment Review 2016* 3, 7-8, *available at* http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIA_Review_2016.pdf.
[42] *Sustainable and Impact Investing in the United States: Overview,* US SIF, http://www.ussif.org/files/Infographics/Overview%20Infographic.pdf (last visited Nov. 9, 2017).
[43] *See* Williams, *supra* note 24, at 1267 (citing SEC data).

using what ESG data is available, clearly demonstrating that investors consider this information material.[44] And yet, as discussed below, leading U.S. asset managers and executives emphasize that the poor quality of ESG data does not meet investors' needs, and support regulatory mandates to require companies to produce better ESG data.

3. *Companies struggle to provide investors with ESG information that is relevant, reliable, and decision-useful*

Over the last twenty-five years, voluntary disclosure of ESG information, and voluntary frameworks for that disclosure, have proliferated to meet the demands for information from investors, consumers, and civil society. The most comprehensive source of data on ESG reporting is that done by KPMG in the Netherlands. KPMG published its first ESG report in 1993, and its most recent report in 2017. In 1993, 12% of the top 100 companies in the OECD countries (excluding Japan) published an environmental or social report.[45] By 2017, 83% of the top 100 companies in the Americas publish a corporate responsibility report, as do 77% of top 100 companies in Europe and 78% in Asia.[46] Of the largest 250 companies globally, reporting rates are 93%.[47] The Global Reporting Initiative's (GRI) voluntary, multi-stakeholder framework for ESG reporting has emerged as the clear global benchmark: 75% of the Global 250 use GRI as the basis for their corporate responsibility reporting.[48] Of particular note, 67% of the Global 250 now have their reports "assured," most often by the major accontancy firms.[49]

Although 75% of the Global 250 use GRI as the basis for reporting, academic studies of reporting according to GRI have found serious problems with the quality of the information being disclosed. One study comparing GRI reports in the automotive industry concluded that "the information . . . is of limited practical use . . .Thus, quantitative data are not always gathered systematically and reported completely, while qualitative information appears unbalanced."[50] Markus Milne, Amanda Ball, and Rob Gray surveyed the existing literature on GRI as a preeminent example of triple bottom line reporting, and concluded in 2013 that "the quality—and especially the *completeness*—of many triple bottom line reports are not high. . . With a few notable exceptions, the reports cover few stakeholders, cherry pick elements of news, and generally ignore the major social issues that arise from corporate activity…."[51] Other studies have observed similar problems, particularly with the lack of comparability of the information

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[44] For further evidence of investors' views on the materiality of ESG data, *see* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, GEO. L. J. (forthcoming 2018), *available at* https://ssrn.com/abstract=3233053.
[45] *See* Ans Kolk, *A Decade of Sustainability Reporting: Developments and Significance*, 3 INT'L J. ENVIR. & SUSTAINABLE DEVELOPMENT 51, 52 Figure 1 (2004). KPMG has changed the format of the report since its original 1993 report, so direct comparisons are not possible between the Global 250 in 1993 and the Global 250 in 2017.
[46] KPMG, The KPMG Survey of CR Reporting 2017, at 11, available *at* https://home.kpmg.com/content/dam/kpmg/campaigns/csr/pdf/CSR_Reporting_2017.pdf.
[47] *Id.*
[48] *See id*. at 28. The Global Reporting Initiative is now in its fourth iteration. It has been developed by, and is used by, thousands of companies, governments, and non-profit entities around the world to report on the economic, environmental, social and governance effects of entities' actions. *See* Global Reporting Initiative, *available at* http://www.globalreporting.org.
[49] *See* KPMG 2017 Report, *supra* note 42, at 26.
[50] Klaus Dingwerth & Margot Eichinger, *Tamed Transparency: How Information Disclosure under the Global Reporting Initiative fails to Empower*, 10:3 GLOBAL ENV. POL. 74, 88 (2010).
[51] Markus J. Milne, Amanda Ball & Rob Gray, *Wither Ecology? The Triple Bottom Line, the Global Reporting Initiative, and the Institutionalization of Corporate Sustainability Reporting,*188 (1) J. BUS. ETHICS 1 (2013).

being reported.[52] These conclusions should not be taken as a criticism of GRI *per se*, or of companies' efforts to provide expanded ESG information. Rather, these conclusions are an indication of the weaknesses of voluntary disclosure: without a regulatory mandate, the information being produced is often incomplete, lacks consistency, and is not comparable between companies. In contrast, when ESG disclosure becomes mandatory, standards become clearer and reporting becomes more consistent and comparable.[53] In analogous circumstances, the SEC has recognized the importance of standardized disclosure frameworks for financial information, expressing concerns about the use of non-GAAP accounting, concluding that information being disclosed without adherence to the standardized disclosure framework of U.S. GAAP may be confusing and even deceptive.[54]

4. *Companies' Voluntary Disclosure is Insufficient to Meet Investors' Needs*

Given these problems with the quality of voluntary ESG disclosure, notwithstanding the efforts of public companies to meet investors' needs, a wide range of capital market participants have come out in favor of required ESG disclosure. In response to the Concept Release, the SEC received comments from asset managers, institutional investors, individual investors, foundation executives, and public pension funds, among others. These users of corporate disclosure "overwhelmingly expressed support" for more required ESG disclosure.[55] BlackRock, the world's largest asset manager, with assets under management of $6.317 trillion as of March 31, 2018, has recognized the strategic value of ESG information:

> Environmental, social, and governance issues are integral to our investment stewardship activities, as the majority of our clients are saving for long-term goals. It is over the long-term that ESG factors – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts. Our risk analysis extends across all sectors and geographies, helping us identify companies lagging behind peers on ESG issues.[56]

And yet, BlackRock asserts that current reporting practices are insufficient for the kinds of in-depth investment analysis that it seeks with its ESG integration, making it "difficult to identify investment decision-useful data." As a result, it has advocated for public policy

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[52] *See* David Levy, Halina S. Brown, & Martin de Jong, *The Contested Politics of Corporate Governance: The Case of the Global Reporting Initiative*, 49 BUS. & SOC'Y 88 (2010); *see also* Carl-Johan Hedberg & Fredrik von Malmborg, *The Global Reporting Initiative and Corporate Sustainability Reporting in Swedish Companies,* 10 CORP. SOC. RESP. & ENVTL. MGMT. 153 (2003).

[53] *See generally,* Jody Grewal, Edward J. Riedl & George Serafeim, *Market Reactions to Mandatory Nonfinancial Disclosure,* at 27 (Harvard Business School Working Paper, No. 16-025, 2015), http://www.ssrn.com/abstract=2657712 (stating that "firms having high ESG disclosure and stronger governance performance will be able to institute the [EU Directive on non-financial reporting] more efficiently and cost-effectively" because the reporting is mandatory, thus creating consistency).

[54] *See* Chair Mary Jo White, *Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility,"* Dec. 9, 2015, *available at* http://www.sec.gov/news/speech/keynote-2015-aicpa-white.html; U.S. Securities and Exchange Commission, *Non-GAAP Financial Measures*, Oct. 17, 2017, *available at* https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[55] Gellasch Joint Report, *supra* note 2, at 17.

[56] *See* BlackRock, *Viewpoint*, *Exploring ESG: A Practitioners Perspective* (June 2016), *available at* http://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf.

changes to require companies to disclose such information, assuming appropriate safe harbors are also provided.[57]

BlackRock is not alone among substantial asset owners and asset managers advocating for better ESG disclosure in required securities filings. As discussed in Section Four, below, the Human Capital Management Coalition, a group of 25 institutional investors representing $2.8 trillion in assets, has submitted a rulemaking petition to the Commission urging the adoption of standards that would require listed companies to disclose information on human capital management policies, practices, and performance.[58] In July 2017, 390 investors representing more than $22 trillion in assets wrote to G20 heads of state, calling on governments to "evolve the financial frameworks required to improve the availability, reliability and comparability of climate-related information."[59]

Bloomberg, another global company that sells capital markets data, has reached conclusions similar to those of BlackRock about the quality of ESG data. Since 2009, Bloomberg has incorporated ESG data into the data that it sells to dealers, brokers, and investors around the world.[60] Even so, its CEO Michael Bloomberg has said this:

> [F]or the most part, the sustainability information that is disclosed by corporations today is not useful for investors or other decision-makers. . . .To help address this issue, I became chair of the Sustainability Accounting Standards Board (SASB) in 2014, and last year [2015], I agreed to build on that work by chairing the new Task Force on Climate-Related Financial Disclosures (TCFD)….The market cannot accurately value companies, and investors cannot efficiently allocate capital, without comparable, reliable and useful data on increasingly relevant climate-related issues….[61]

The Task Force on Climate-Related Financial Disclosure (TCFD) was constituted by the Financial Stability Board, under the auspices of the G20.[62] It has now released its final recommendations for a framework of climate-relevant financial disclosure, focusing on four aspects of a company's operations in respect of climate change: Governance, Strategy, Risk Management, and Metrics & Targets.[63] Among what the TCFD calls its "key recommendations" is that climate-related financial disclosures should be included in required financial filings, thus that this type of reporting should be mandatory.[64]

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[57] *Id.*at 1.

[58] http://uawtrust.org/hcmc.

[59] https://www.ceres.org/news-center/press-releases/over-200-global-investors-urge-g7-stand-paris-agreement-and-drive-its.

[60] *See* Bloomberg, *Impact Report Update 2015* 2, (2015), *available at* http://www.bbhub.io/sustainability/sites/6/2016/04/16_0404_Impact_report.pdf.

[61] *Id.*

[62] The Task Force, chaired by Michael R. Bloomberg, was established by the FSB in December 2015 pursuant to a request from Bank of England Governor Mark Carney "to develop a set of voluntary disclosure recommendations for use by companies in providing information to investors, lenders and insurance underwriters about their climate-related financial risks." *See* https://www.fsb-tcfd.org/news/#.

[63] *See* Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017, at iii, *available at* https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf [hereinafter "Task Force Report"].

[64] *Id.*

Notwithstanding the problems with the quality of voluntarily produced ESG information in the markets, the substantial growth in voluntary sustainability disclosure globally is important for a number of reasons. First, companies are responding to investors who are increasingly aware of the relevance of ESG data to a full evaluation of company strategies, risks, and opportunities. This investor awareness shows the materiality of this information, particularly to shareholders with a long-term orientation. Second, to produce sustainability reports companies have developed internal procedures to collect and evaluate the kinds of information that an SEC framework would likely require, thus showing that costs to companies should not be an impediment. While not all companies have embarked on sustainability reporting, therefore adoption will include some additional costs to some companies, the SEC is well-positioned to provide "on-ramps" or differentiated requirements for smaller companies, as it has done historically. Third, and perhaps most important, twenty-five years of development of voluntary sustainability disclosure has not led to the production of consistent, comparable, highly-reliable ESG information in the market, notwithstanding the voluntary, multi-stakeholder development of a framework for disclosure (GRI) that is being used by 75% of the world's largest companies. SEC leadership providing a mandate for ESG disclosure in the world's largest, and arguably most important, capital market can significantly contribute to solving this problem.

5. ***Commission rulemaking will reduce the current burden on public companies and provide a level playing field for the many American companies engaging in voluntary ESG disclosure***

In addition to benefiting investors, rulemaking regarding ESG disclosure would benefit America's public companies by providing clarity to them about what, when and how to disclose material sustainability information. Today companies are burdened with meeting a range of investor expectations for sustainability information without clear standards about how to do so. A number of promising frameworks have been promulgated over the previous decade or decades, many of which have been mentioned in this petition: GRI, SASB, CDP, and now TCFD being the most prominent. And yet, because there isn't clear guidance and an authoritative standard in the U. S. for all public reporting companies to use, different companies are using different frameworks and multiple mechanisms to disclose sustainability information. Thus, investors are still dissatisfied with the comparability of sustainability information, even between companies in the same industry.[65]

That ESG disclosure requirements could actually reduce burdens on America's public companies was well-stated in the CFA Institute's Comment Letter to the Concept Release:

> Many issuers already provide lengthy sustainability or ESG reports to their investors, so many issuers will not face a new and burdensome cost by collecting, verifying and disclosing ESG information. Costs may be saved if instead of producing large sustainability reports that cover a broad range of sustainability information, issuers can instead focus on only collecting, verifying and disclosing information concerning the factors that are material to them and their investors.[66]

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[65] *See* PwC, *Sustainability Disclosures: Is your company meeting investor expectations?* (July 2015), *cited in* Jean Rogers, SASB Comment Letter to the SEC's April, 2016 Concept Release, July 1, 2016, at 7 fn.20 (79% of investors polled said they were dissatisfied with the comparability of sustainability information between companies).

[66] CFA Institute Comment Letter to the Concept Release, October 6, 2016, at 19. The CFA Institute is a global, not-for-profit professional association of over 137,000 investment analysts, advisers, portfolio managers, and other

Such rulemaking would also act to create a level playing field between companies. Today, sustainability information is being provided by some but not all companies, in formats that differ, using different mechanisms for disclosure (sustainability reports, company websites, SEC filings), and different timing. As recognized in an analysis of sustainability reporting by PwC in 2016, this has created a situation where information is not comparable between companies in the same industry and sector; where "an increasing volume of information is being provided without linkage to a company's core strategy," and where there are no clear standards all companies within the same industry are using.[67] Such standards could well encompass a mix of required elements, based on industry and sector; information about firms' governance of sustainability issues across industries; and principles-based elements to act as a materiality back-stop. By providing clarity to issuers on what sustainability disclosure is required, the SEC would create comparability between firms in the same industry, thus promoting a level playing field between companies. Comparability will allow actual sustainability leaders to be recognized as such, with attendant financial benefits such as increased investment and a lower cost of capital.[68]

6. *Various ESG-related Petitions and Stakeholder Engagements with the SEC Suggest, in Aggregate, that it is Time for the SEC to Act to Bring Coherence to this Area*

In recent years, there have been a number of significant petitions and other investor proposals seeking expanded disclosure of ESG information. These initiatives give evidence of the views of investors and capital markets professionals that more needs to be done to meet investors' needs for consistent, comparable, and high-quality ESG data. Moreover, stakeholders have used additional opportunities created by the SEC to support for broader ESG disclosure. A sampling of such petitions, investor proposals, and stakeholder engagements includes:

<u>Climate Risk Disclosure</u>: In 2007 and 2009, Ceres filed petitions to the SEC calling for better guidance to companies on how to disclose risks and opportunities from climate change. In 2010, the SEC responded by issuing such guidance.[69] Analysis indicates that the guidance has not been successful in producing consistent, comparable, high-quality information concerning climate change risks and opportunities, however.[70] The Framework and Technical Guidance published

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investment professionals in more than 157 countries. On the question of the SEC requiring sustainability disclosure, the CFA Institute concluded that "[i]t is imperative that the SEC develop disclosure requirements that require companies to disclose material sustainability information while allowing issuers the flexibility to disclose that which is germane to their industry/sector . . . " Thus the Institute supported differentiated sustainability disclosure according to industry and sector, along with a general requirement for companies to disclose the corporate governance arrangements for sustainability issues. *Id.*

[67] PwC, *Point of View: Sustainability reporting and disclosure: What does the future look like? (July 2016),* at 1, *available at* . https://www.pwc.com/us/en/cfodirect/publications/point-of-view/sustainability-reporting-disclosure-transparency-future.html.

[68] *See, e.g.,* Clark et al., *supra* note 29 (summarizing empirical literature through 2015, and finding that 90% of studies show lowered cost of capital for firms with sound sustainability practices; 88% of studies show that better E,S, or G practices (the latter specific to sustainability) result in better operational performance; and 80% of studies show stock market out-performance for firms with good sustainability practices.

[69] Commission Guidance Regarding Disclosure Related to Climate Change, Release No. 33-9106; 34-61469; FR-82, Feb. 8, 2010, U.S. SECURITIES AND EXCHANGE COMMISSION, *available at* https://www.sec.gov/rules/interp/2010/33-9106.pdf.

[70] *See, e.g.,* Robert Repetto, *It's Time the SEC Enforced Its Climate Disclosure Rules*, INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT (IISD)(Mar. 23, 2016), *available at* https://www.iisd.org/blog/it-s-time-sec-enforced-its-climate-disclosure-rules.

by the FSB's Task Force on Climate-Related Financial Disclosure (TCFD), mentioned above, would be an industry-developed (operating companies, investors, insurance companies, and accounting) platform for the SEC to use as a starting point in promulgating its own Framework for comprehensive ESG disclosure.

ESG Disclosure: On July 21, 2009, the U.S. Social Investment Forum (USSIF) requested that the SEC promulgate a new, annual requirement for ESG disclosure, modeled on the framework of the Global Reporting Initiative (GRI). GRI sets out a general framework for disclosure of information applicable to all companies, and then industry-specific requirements relevant to the social, environmental, and governance concerns applicable to each specific industry. The USSIF petition also asked the SEC to issue interpretive guidance to clarify that companies are required to disclose short and long-term sustainability risks in the Management Discussion and Analysis section of their 10-K.

Gender pay ratios: On February 1, 2016, Pax Ellevate Management LLC, investment adviser to the Pax Ellevate Global Women's Index Fund submitted a petition to the Commission requesting that it require public companies to disclose gender pay ratios on an annual basis. Petitioners stated that "[w]e believe that pay equity is a useful and material indicator of well-managed, well-governed companies, and conversely, that companies exhibiting significant gender pay disparities may bear disproportionate risk, and that investors therefore may benefit from having such information."[71]

Human Capital Management: On July 6, 2017, the Human Capital Management Coalition, a group of institutional investors with $2.8 trillion in assets, submitted a petition to the Commission requesting that it "adopt new rules, or amend existing rules, to require issuers to disclose information about their human capital management policies, practices and performance."[72] The Coalition seeks this expanded disclosure so that "(1) investors can adequately assess a company's business, risks and prospects; (2) investors can more "efficiently direct capital to its highest value use, thus lowering the cost of capital for well-managed companies; (3) companies can stop responding to a myriad of voluntary questionnaires seeking this information; and (4) investors can pursue long-term investing strategies in order "to stabilize and improve our markets and to effect the efficient allocation of capital."

Human Rights: The human rights policies, practices, and impacts of filers are material to many investors.[73] The SEC has already provided for some human rights disclosure regarding conflict minerals under 17 CFR §240.13p-1, in response to the Dodd-Frank Act, and in certain guidance on disclosure relating to climate change[74] and cyber-security information.[75] General guidance on disclosure of human rights policies, practices, and impacts is lacking, however.

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[71] *See* Pax Ellevate Petition, February 1, 2016, *available at* https://www.sec.gov/rules/petitions/2016/petn4-696.pdf.

[72] *See* Human Capital Management Coalition Petition, July 6, 2017, available *at* https://www.sec.gov/rules/petitions/2017/petn4-711.pdf.

[73] *See, e.g.,* CYNTHIA WILLIAMS ET AL., "KNOWING AND SHOWING" USING U.S. SECURITIES LAWS TO COMPEL HUMAN RIGHTS DISCLOSURE (Oct. 2013) at 16, *available at* http://icar.ngo/wp-content/uploads/2013/10/ICAR-Knowing-and-Showing-Report4.pdf.

[74] Securities & Exchange Comm'n, Commission Guidance Regarding Disclosure Related to Climate Change (Jan. 27, 2010), Release Nos. 33-9106; 34-61469; FR-82, http://www.sec.gov/rules/interp/2010/33-9106.pdf [hereinafter Climate Change Guidance (2010)].

[75] Securities & Exchange Comm'n, Division of Corporate Finance, CF Disclosure Guidance: Topic No. 2 Cybersecurity (2011), http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm [hereinafter Cyber-

In responding to the 2016 Concept Release, a number of stakeholders provided comments on the value of increased disclosure about a number of human rights issues. These comments highlighted the need for better information about the impacts of companies on the human rights of affected communities, but also discussed human rights impacts related to the environment, climate change, human capital, and workforce issues. Over 10,000 commenters raised issues within these different substantive areas.[76] Additionally, in relation to Conflict Minerals rule, when Acting Chairman Piwowar announced the SEC's reconsideration of the rule's implementation in January 2017, the Commission received over 11,500 comments in support of the rule—demonstrating strong stakeholder interest in its continued use.[77]

Political Spending Disclosure: On August 3, 2011, the Committee on Disclosure of Corporate Political Spending (ten academics at leading law schools whose teaching and research focus on corporate and securities law), petitioned the Commission to develop rules to require public companies to "disclose to shareholders the use of corporate resources for political activities."[78] Recognizing that the U.S. Supreme Court in *Citizens United v. FEC,* 130 S. Ct. 876 (2010), noted shareholder mechanisms to hold management to account for its use of corporate funds to support political candidates, the petitioners argued that for that mechanism to work, "shareholders must have information about the company's political speech."[79] To date, this petition has garnered more than 1.2 million comments of support, the most in the agency's history.[80]

Tax Disclosure: In its April 2016 Concept Release the SEC asked about what, if anything, should be changed, updated, included or removed regarding tax disclosure. The Comment Letter submitted by the Financial Accountability and Corporate Transparency (FACT) Coalition emphasized that the role played by international tax strategies and rates on the operations and earnings of many U.S. corporations is important and growing. The letter highlighted the risks to investors created by these at best uncertain and often legally problematic strategies. Given the scope of fines and risks arising from tax jurisdictions around the world, investors need more information to be able to evaluate the scope of tax risks tht the company is running. Moreover, the new tax law in the U.S. moves the U.S. to a territorial tax system, which will open up further uncertainties and risks related to how and where revenues are booked.

The IRS recently finalized a rule to require country-by-country reporting of revenues, profits, taxes paid and certain operations by larger multinational corporations. The European Union has also established new country-by-country reporting requirements for larger firms doing business in any of the member nations. Increasingly, tax authorities have access to this material information, as do company managers, yet investors do not. The growing use of offshore tax

Security Guidance].

76 Gellasch Joint Report, *supra* note 2, at 10.

77 *Comments on the Statement on the Commission's Conflict Minerals Rule,* U.S. SECURITIES AND EXCHANGE COMMISSION, *available at* https://www.sec.gov/comments/statement-013117/statement013117.htm (last visited Jan. 25, 2018).

78 *See* Committee on Disclosure of Corporate Political Spending Petition, August 3, 2011, *available at* https://www.sec.gov/rules/petitions/2011/petn4-637.pdf.

79 *Id.* at 7.

80 *See* Comments on Petition to Require Public Companies to Disclose to Shareholders the Use of Corporate Resources for Political Activities, *available at* https://www.sec.gov/rules/petitions/2017/petn4-711.pdf (viewed November 20, 2017),

strategies, the international response to rein in aggressive tax avoidance, and the potential tax liability for corporations engaged in these practices makes this information material for investors.

These petitions, in conjunction with the large numbers of comments in support of expanded sustainability disclosure in response to the SEC's Concept Release, clearly show that investors and capital market professionals think the time has come for the SEC to act to develop a mandatory rule for clearer, consistent, comparable, high-quality ESG disclosure by all companies subject to SEC public-reporting requirements.

Conclusion

We respectfully request the Commission to promptly initiate rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social, and governance information. If the Commission or Staff have any questions, or if we can be of assistance in any way, please contact either **Osler Chair in Business Law Cynthia A. Williams**, Osgoode Hall Law School, who can be reached at (416) 736-5545, or by electronic mail at cwilliams@osgoode.yorku.ca; or **Saul A. Fox Distinguished Professor of Business Law Jill E. Fisch**, University of Pennsylvania Law School, who can be reached at (215) 746-3454, or by electronic mail at jfisch@law.upenn.edu.

Sincerely,

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WHY YOU SHOULD BE UNSETTLED BY THE BIGGEST AUTOMOTIVE SETTLEMENT IN HISTORY

SARAH DADUSH*

INTRODUCTION†

In September 2015, the world learned that Volkswagen (VW) had rigged millions of its "clean diesel" vehicles with illegal software designed to cheat emissions tests.[1] Tests carried out with the cheat device indicated that the cars were as clean as advertised; however, tests carried out without the cheat device revealed that the cars in fact emitted up to forty times the legal limit of polluting nitrogen oxides.[2] The fraud, which some have taken to calling "Dieselgate," lasted for over seven years.[3] When affected owners learned that their cars were much more toxic than advertised, what were they upset about? Was it that their cars were now worth fewer dollars, or was it that they had been deceived into being bad global citizens when they thought they were being good?

Coverage of Dieselgate strongly suggests that affected car owners experienced both kinds of disappointment—economic and noneconomic—and in heavy doses at that.[4] But

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† Editor's note: This short Essay, prepared specifically for the *University of Colorado Law Review Forum*, introduces topics and ideas addressed at greater length in Professor Dadush's forthcoming article, *Identity Harm*, 89 U. COLO. L. REV. (forthcoming 2018).

1. Amended Partial Consent Decree, *In Re* Volkswagen "Clean Diesel" Mktg., Sales Practices, & Prod. Liab. Litig., MDL No. 2672 CRB (JSC), 2016 WL 6460404, (N.D. Cal. Sept. 30, 2016) (No. 1973-1), at 1–5, https://www.epa.gov/sites/production/files/2016-10/documents/amended20lpartial-cd.pdf [https://perma.cc/G8FT-32U5] [hereinafter First Consent Decree].

2. Guilbert Gates et. al, *How Volkswagen's 'Defeat Devices' Worked*, N.Y. TIMES (Mar. 16, 2017), https://www.nytimes.com/interactive/2015/business/international/vw-diesel-emissions-scandal-explained.html?mcubz=0&_r=0 [https://perma.cc/JMW9-XRYL].

3. *VW Scandal: Company Warned Over Test Cheating Years Ago*, BBC (Sept. 27, 2015), http://www.bbc.com/news/business-34373637 [https://perma.cc/D2EA-FZPF].

4. Jad Mouawad & Christopher Jensen, *The Wrath of Volkswagen Drivers*, N.Y. TIMES (Sept. 21, 2015), http://www.nytimes.com/2015/09/22/business/the-wrath-of-volkswagens-drivers.html [https://perma.cc/J72R-NB82]; Jacob Bogage,

while the first kind of harm is relatively easy to recognize and address, our protective regime is ill-equipped to shield consumers from the second, a type of emotional harm that I refer to as "identity harm." I define identity harm as the anguish experienced by a consumer who learns that her efforts to live in line with her personal values have been undermined by a seller's exaggerated or false promises about their wares. While a range of promises can elicit identity harm (e.g., organic, animal cruelty-free, Kosher, Made in America, etc.), I focus on a particularly important and fast-growing category of promises pertaining to environmental and social sustainability. Here, identity harm arises when a consumer learns that her purchase has rendered her unwittingly complicit in causing injury to another human or the planet.

As explored in my first in a series of articles on this subject,[5] the law's under-recognition of identity harm is problematic, particularly at a time when government agencies such as the Environmental Protection Agency (EPA) are actively retreating from interventionist regulation.[6] As the federal government recedes, consumers need additional tools to hold companies accountable for exaggerated or false claims of sustainability.

Enhanced protections are further warranted given that businesses increasingly incorporate environmental and social sustainability promises into their marketing campaigns specifically to target conscious consumers, who represent a growing share of the purchasing public.[7] Conscious consumers

Volkswagen Agrees to Pay Consumers Biggest Auto Settlement in History, WASH. POST (June 27, 2016), https://www.washingtonpost.com/news/the-switch/wp/2016/06/27/volkswagen-agrees-to-pay-consumers-biggest-auto-settlement-in-history/ [https://perma.cc/JJT7-V7JR].

5. Sarah Dadush, *Identity Harm*, 89 U. COLO. L. REV. (forthcoming 2018).

6. *See, e.g.*, Juan Carlos Rodriguez, *New EPA Chief Pledges to Change Regulatory, Legal Practices*, LAW360 (Feb. 21, 2017, 3:53 PM), https://www.law360.com/articles/893816/new-epa-chief-pledges-to-change-regulatory-legal-practices [https://perma.cc/SQL9-Q4F8] (reporting on Pruitt's commitments to reduce "regulation through litigation," which exactly describes the EPA's handling of Dieselgate, and to promote a "very robust" role for states in implementing environmental laws and diminishing the role of the federal government in climate regulation).

7. *See, e.g.*, Howard Kimeldorf et al., *Consumers with a Conscience: Will They Pay More?,* CONTEXTS, Winter 2006, at 24, 26–27, http://www.npr.org/documents/2013/may/consumer_conscience_study_ME_20130501.pdf [https://perma.cc/UR6C-7HZU] (finding 30 percent of working-class consumers were willing to pay a 20 percent price premium for socks with a "Good Working Conditions" label); *Global Consumers are Willing to Put Their Money Where Their*

care not just about the physical or price attributes of a given good or service, but also its social and environmental impact.[8] They make purchases that reflect their environmental and social values, their personal principles of engagement with the world: their identity.[9]

Dieselgate is the perfect case study to illustrate identity harm since VW's clean diesel advertising campaign was expressly directed at environmentally conscious consumers. Given the campaign's target audience, it is safe to assume that a fair number of those who purchased the Dieselgate vehicles self-identify as conscious (or green).[10] These individuals likely believed VW's claims that the cars were better for the environment than conventional (non-electric) alternatives and that driving one would support, not undermine, their self-identification as conscious consumers.

The realization that one has become unwittingly complicit in harming another being—the planet (its atmosphere, oceans, rivers, animals, etc.) or fellow humans—can be painful, in particular for people who sought to avoid precisely that. It is in such instances that identity harm rears its head. Conceptually, identity harm bears resemblance to the tort of defamation, where one's reputation is publicly sullied by a false statement. The difference is that with identity harm, it is one's conception of oneself—of who one strives to be in the world—that has been distorted as a result of a false or exaggerated sustainability

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Heart is when it Comes to Goods and Services from Companies Committed to Social Responsibility, NIELSEN (June 17, 2014), http://www.nielsen.com/us/en/press-room/2014/global-consumers-are-willing-to-put-their-money-where-their-heart-is.html [https://perma.cc/79W7-UAH6]; FISHWISE, TRAFFICKED II: AN UPDATED SUMMARY OF HUMAN RIGHTS ABUSES IN THE SEAFOOD INDUSTRY 6 (2014), https://www.fishwise.org/images/pdfs/Trafficked_II_FishWise_2014.pdf [https://perma.cc/EB8F-HES8] (revealing that eighty-eight percent of consumers would stop buying a product if it was associated with human rights abuses and seventy percent of consumers would pay a premium for a product certified to be free of human rights abuses).

8. Phillip Haid, *The Myths of Conscious Consumerism*, STRATEGY (Mar. 28, 2016), http://strategyonline.ca/2016/03/28/the-myths-of-conscious-consumerism/ [https://perma.cc/D5JD-GCZM].

9. Josée Johnson, *The Citizen-Consumer Hybrid: Ideological Tensions and the Case of Whole Foods Market*, 37 THEORY & SOC'Y 229, 242 (2007) ("[C]hoice is . . . central to the meaning attached to modern consumption and a modern self who makes autonomous choices expressing a unique identity, and whose sense of freedom is intimately connected to consumer choice.").

10. Press Release, Fed. Trade Comm'n, FTC Charges Volkswagen Deceived Consumers with Its "Clean Diesel" Campaign (Mar. 29 2016), https://www.ftc.gov/news-events/press-releases/2016/03/ftc-charges-volkswagen-deceived-consumers-its-clean-diesel [https://perma.cc/W742-KXH3].

promise: I thought I was being good when in reality I was (unknowingly) being bad.

This Essay proceeds by exposing the unique circumstances that led to the Dieselgate settlement (the Settlement) to show that, even though it did address identity harm, this happened only collaterally, not deliberately. In fact, by "tweaking the facts" just a bit, it becomes apparent just how easily the identity harm caused by Dieselgate could have gone unaddressed, in particular with respect to remedies. The next section offers examples of broken sustainability promises in the social realm—labor and human rights—and explains that, while a growing number of consumers are taking identity harm grievances to court, they are under-equipped to do so effectively. This section further highlights the key characteristics of identity harm. Specifically, identity harm is noneconomic, emotional or psychic, and derivative in the sense that the injury to the consumer stems from an injury that is at least one step removed from the actual purchasing transaction—for example, to another human or the planet. The following section explains why identity harm is legally under-accounted for today and recommends a reparations-centered (rather than compensation-centered) approach for addressing the complaints of aggrieved consumers.

I. THE VW SETTLEMENT REVEALS THE UNDER-RECOGNITION OF IDENTITY HARM

VW installed illegal cheat device software in all of its "clean diesel" vehicles, which had been advertised as green, fuel efficient, and high performing. Had the presence of the cheat device been known, VW would not have been allowed to sell the cars in the United States, both because cheat devices are illegal under the Clean Air Act (CAA) and because the cars themselves were illegally polluting. When the deception was revealed, a flurry of private class action lawsuits were filed, and these private lawsuits were complemented by aggressive action by the EPA (through the Department of Justice) and the Federal Trade Commission (FTC).

To settle the various claims stemming from its deception in the United States, VW agreed to pay approximately $10 billion to the FTC to compensate affected car owners; it also agreed to pay $4.7 billion to the EPA to finance green investments and mitigate the environmental damage caused by Dieselgate.[11] The Settlement, the largest in the history of the auto industry, is being touted as a major victory for consumers.[12] However, the Settlement was the product of such peculiar and difficult-to-reproduce circumstances that its precedential value, especially for conscious consumers, should not be overstated.

The fact that VW was the largest automaker in the world,[13] that its criminal[14] deception affected so many cars (500,000 in the United States alone), and that *both* environmental and consumer law violations were involved,[15] all combined to make the Settlement particularly far-reaching. Furthermore, although the first class action claims were filed within hours after the scandal broke, it was the lawsuits brought by two government agencies—the EPA and FTC—that really put the pressure on VW to reach a large settlement.[16] Governmental intervention signaled that VW's malfeasance could not only strip the Dieselgate cars of market value, but

11. First Consent Decree, *supra* note 1, at 1–5. VW must remove the tainted vehicles from commerce, either physically, by buying them back, or by fixing them to be standards-compliant. *Id.* Car owners therefore have the option to (1) accept a buyback offer based on pre-scandal prices and receive cash payments of up to $10,000; or (2) keep the cars for VW to bring into compliance with environmental standards within two years, if/when it develops the (approved) technology and receive cash payments of up to $10,000. *Id.* Additionally, VW must pay $2.7 billion to a mitigation trust fund and invest $2 billion in the promotion of zero emission vehicles and charging infrastructure. *Id.* at 4–5.

12. Reuters, *How Volkswagen Owners Can Get Compensation from the Emissions Scandal Settlement*, FORTUNE (June 28, 2016), http://fortune.com/2016/06/28/vw-owners-compensation-scandal/ [https://perma.cc/QCP5-MM6E].

13. Bertel Schmitt, *Nice Try VW: Toyota Again Largest Automaker in the World*, FORBES (Jan. 27, 2016), http://www.forbes.com/sites/bertelschmitt/2016/01/27/nice-try-vw-toyota-again-worlds-largest-automaker/#44d787912b65 [https://perma.cc/5TDU-ZVCE].

14. Aruna Viswanatha & Christina Rogers, *VW Engineer Pleads Guilty in Emissions Cheating Scandal*, CNN: MONEY (Sept. 9, 2016), http://money.cnn.com/2016/09/09/news/companies/volkswagen-engineer-emissions-scandal-guilty-plea/index.html [https://perma.cc/ZG27-BQTE].

15. Eur. Parliamentary Research Serv. (EPRS), Briefing on the "Lawsuits Triggered by the Volkswagen Emissions Case" (May 2016), http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/583793/EPRS_BRI(2016)583793_EN.pdf [https://perma.cc/7XRT-ZSTY] (noting that environmental violations included illegal defeat devices that concealed emissions of ten-to-forty times the allowed amount of nitrogen oxides, and that consumer law violations included false advertising claims about environmental-friendliness and high resale values that deceived consumers).

16. Bill Vlasic & Aaron M. Kessler, *It Took E.P.A. Pressure to Get VW to Admit Fault*, N.Y. TIMES (Sept. 21, 2015), http://www.nytimes.com/2015/09/22/business/it-took-epa-pressure-to-get-vw-to-admit-fault.html? [https://perma.cc/FX4B-DTFJ].

also jeopardize the automaker's access to the American market.[17] VW got the message(s) and settled accordingly.

Had Dieselgate involved a domestic company, a less sizeable foreign company, or fewer cars, the authorities might have been less politically motivated to take action. Likewise, had the scandal involved only one type of illegality—consumer or environmental—the outcome of the Settlement likely would have been much less sizable. We do not have environmental and consumer law rules to govern every type of corporate sustainability-related (mis)representation. As such, the fact that Dieselgate was doubly illegal is another crucially important peculiarity that serves to explain the magnitude of the Settlement.

These (combined) peculiarities reveal a number of gaps in our corporate accountability regime, in particular when it comes to broken sustainability promises and greenwashing. Greenwashing happens when a company seeks to boost its sales or its brand by overstating its environmental ambitions and achievements.[18] It is a main source of identity harm, along with "redwashing" or "bluewashing," terms used to describe the overstating of social (e.g., labor and human rights) ambitions and achievements. When "color-washing" happens—and goes unpunished—consumers concerned about the effects of their purchases on the planet and on other humans can experience a special type of emotional anguish that results from having been made unwittingly complicit in causing harm.

For color-washing claims to be properly addressed, the market and the regulators need to hear them, and this is by no means guaranteed. The VW tree fell loudly because of its size (hundreds of thousands of cars), the broad scope of the illegalities involved, and the willingness of the government agencies to listen and dedicate resources to prosecuting a major (foreign) company. Its thump reverberated across both the market for conventional goods—particularly sensitive to changes in resale values—and the market for sustainable goods.[19] However, many broken environmental promises are

17. First Consent Decree, *supra* note 1, at 3–5, 38–40.

18. For analysis of greenwashing and an overview of possible solutions, see Miriam A. Cherry & Judd F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983, 999–1009, 1025–38 (2011).

19. Jack Ewing, *In the U.S., VW Owners Get Cash. In Europe, They Get Plastic Tubes.*, N.Y. TIMES (Aug. 15, 2016), http://www.nytimes.com/2016/08/16/

too small or fall too deep inside the sustainability forest to be heard by the conventional market or by regulators, even if they produce real harm for some consumers.

The point is that the Settlement likely would have been much smaller if the FTC and the EPA had not reacted to VW's deceit as strongly as they did.[20] Indeed, it is interesting to imagine how Dieselgate would have unfolded if the EPA had been headed by a climate change skeptic at the time the scandal broke.[21] The pressure on VW to reach a meaningful settlement would have been greatly diminished if only state attorneys general had responded, let alone if only consumers had responded.

To understand how close the Settlement came to producing a less satisfying outcome, consider the recent complaint filed by those dirty-diesel owners who (re)sold their vehicles *before* the scandal broke. The *Nemet v. Volkswagen Group Of America*[22] complaint refers to the "tens of thousands" of dirty-diesel owners who, because they sold their cars before VW's deception was exposed, received nothing under the Settlement.[23] For these plaintiffs, there was no problem of illegality to speak of; as a result, the resale value of their cars was not adversely affected by VW's deception, even though each mile driven in the car produced exponentially more polluting gases than the drivers had believed. Since they did not incur any economic loss on their resales (beyond ordinary depreciation), one might surmise that this group of Dieselgate victims experienced no harm even though they received "hyper polluting" vehicles instead of what they paid for—clean-diesel vehicles—and even though VW's false environmental promises "secretly turned the

business/international/vw-volkswagen-europe-us-lawsuit-settlement.html [https://perma.cc/X65T-ZE6A]. Currently, VW cannot bring the cars into compliance with national standards without compromising fuel efficiency and performance. *Id.* The cars'—sans settlement—market value therefore dropped. *Id.*

20. This is essentially what is happening in the European Union where car emissions standards are lower than in the United States, which makes it possible to bring the cars into compliance without affecting performance. To the lament and frustration of many car owners in Europe—where class action lawsuits are generally not permitted—regulators have not activated in Europe the way they have in the United States. *Id.*

21. Henry Fountain, *Trump's Climate Contrarian: Myron Ebell Takes on the E.P.A.*, N.Y. TIMES (Nov. 11, 2016), http://www.nytimes.com/2016/11/12/science/myron-ebell-trump-epa.html [https://perma.cc/H6ZJ-GKEV].

22. Nemet v. Volkswagen Grp. Of Am., Inc., No. 3:17-cv-04372 (N.D. Cal. Aug. 2, 2017).

23. Class Action Complaint at 4, *Nemet*, No. 3:17-cv-04372 (N.D. Cal. Aug. 2, 2017).

most environmentally conscious consumers into some of the biggest polluters on the road."[24]

Here lies the crux of the question: Is the fact that the resale value of the dirty-diesels was unaffected by the scandal enough to do away with the question of whether there was any harm at all? From the perspective of the *Nemet* plaintiffs, this question must surely be answered in the negative. To answer in the affirmative would not only be grossly under protective, but also shortsighted and antithetical to one of the driving objectives of consumer protection, which is to foster trust in a fair marketplace. Harm is more nuanced and layered than a simple change in market value. As claimed in *Nemet*, harm arises when consumers realize that they have become unknowingly complicit in a scheme to harm the planet, particularly when they had tried to avoid just that. Otherwise put, consumers can experience identity harm even without economic loss (diminished market value).

A related question pertains to remedies: Should remedies be measured by economic loss or according to another measure? Since they cannot recover lost resale value, the *Nemet* plaintiffs argue that they should receive some depreciation-adjusted share of the clean premium they had originally paid for the cars in order to recover the benefit of their bargain. However, based on the substance of the complaint, perhaps it would be more effective to measure remedies according to the *lost greenness* of the purchase.

This could be done by estimating the number of "dirty" miles driven by the *Nemet* plaintiffs and, based on that figure, calculating the amount of above-what-was-advertised and above-what-was-legally-permitted emissions. The extra emissions could be priced and converted into a measure of total lost greenness that could then be used as the benchmark for damages. Some (significant) share of this money could be placed into a climate fund dedicated to offsetting the emissions produced by the deception.

On this last point—and as another illustration of the Settlement's unsettling features—consider that without the EPA's active involvement, the Settlement likely would not have included the establishment of a climate fund. Yet the fund is a crucial piece of the remedial puzzle for the Dieselgate victims who want to undo the environmental harm they—unwittingly

24. *Id.* at 6.

and unintentionally—contributed to. To summarize, economic loss is not the only dimension along which harm is experienced, just as it is not the only dimension along which remedies should be measured.

II. BROKEN SOCIAL PROMISES MATTER, TOO

Identity harm afflicts the realm of social promises, as well. As examples, consider a "conflict free" diamond engagement ring or a purchase from any of the growing roster of companies that market themselves and their wares (e.g., clothing, coffee, chocolate, minerals, palm oil) as socially sustainable.[25] For the individuals buying such goods, the production backstory likely matters a great deal.[26] Should the sustainability promises that operate in the background of a purchasing decision be revealed to be hollow, buyers can experience an achingly intimate form of disappointment.

Imagine discovering that your "conflict free" engagement ring, a symbol of love and commitment, was in fact sourced from a country marred by diamond-fueled murder, rape, and slavery.[27] Would your experience of the ring be altered? Would your sense of its value change? For some, wearing the ring might elicit deep distress brought on by the constant reminder of one's participation in another's suffering. On a smaller but no less profound scale, learning that the chocolate treat they gave their child was made using forced child labor can make a parent sick to their stomach, literally and figuratively.[28]

25. Marc Bain, *Is H&M Misleading Customers with All Its Talk of Sustainability?* QUARTZ (Apr. 16, 2016), http://qz.com/662031/is-hm-misleading-customers-with-all-its-talk-of-sustainability/ [https://perma.cc/7SYF-3HSN].

26. Douglas Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525, 640–642 (2004) (arguing that "process-information" pertaining to the production backstory of consumer goods should be (1) made more available to consumers and (2) better policed in order to properly protect the "many consumers [who] have come to view themselves as purchasing with their disposable dollars not only products, but also shares of responsibility in the moral and ecological economy that produces them").

27. Jenni Avins, *How to Propose with an Engagement Ring As Rock Solid As Your Ethical Values*, QUARTZ (Apr. 14, 2016), http://qz.com/657236/how-to-propose-with-an-engagement-diamond-as-rock-solid-as-your-ethical-values/ [https://perma.cc/SDJ4-5ND7].

28. Complaint for Violation of Consumer Protection Laws at 1, Dana v. Hershey Co., 180 F. Supp. 3d 652 (N.D. Cal. 2015) (No. 3:15-cv-04453) ("[W]hen . . . food companies fail to disclose the use of child and slave labor in their supply chains to consumers, they are deceived into buying products they would not have otherwise and thereby unwittingly supporting child and slave labor themselves

Indeed, a series of—so far, unsuccessful—class actions have been filed against big chocolate companies such as Hershey, Nestle, and Mars on the grounds that the plaintiff consumers would not have bought the companies' chocolate products had they known that their purchases were supporting forced child labor.[29]

In a similar vein, in *Sud v. Costco Wholesale Corp.*, the company was sued by a consumer because it "unlawfully induce[s] consumers to buy Costco farmed prawn products"[30] the supply chain for which is "tainted by the use of slave labor in Thailand" and contaminated by "documented slavery, human trafficking and other illegal labor abuses."[31] At issue in *Sud* was the fact that Costco—much like the chocolate companies mentioned above—makes various disclosures and public statements that affirmatively represent to consumers that the company "makes efforts to monitor its suppliers to eradicate human rights abuses in its supply chain"[32] and that "it does not tolerate human trafficking and slavery in its supply chain."[33]

In both the chocolate cases and in the Costco case, the plaintiffs failed because they could not establish that the companies had a duty to disclose that their goods were sourced through a tainted supply chain, or that the companies had exclusive knowledge of the labor and human rights problems affecting their supply chains, or that the plaintiffs had actually relied on the sustainability disclosures in making their purchasing decision.

These cases offer just a few examples of how consumers' disappointed expectations of a company's social conduct can lead to identity harm. That these claims are being litigated demonstrates that identity harm is real, that consumers care about corporations keeping their social promises, and, by extension, that consumers want corporations to improve their social performance. Yet, in spite of an upswing in sustainability-related legal claims, consumers are failing because of under-protective interpretations and applications of

through their product purchases.").

29. *Id.*

30. Class Action Complaint at 5, Sud v. Costco Wholesale Corp., 229 F. Supp. 3d. 1075 (N.D. Cal. 2017) (No. 15-cv-03783).

31. *Id.* at 12–13.

32. *Id.* at 18.

33. *Id.* at 19.

consumer law statutes. Identity harm can help equip consumers to wage these legal battles more effectively.

III. WHY WE NEED BETTER PROTECTION FOR IDENTITY HARM AND WHY WE DON'T HAVE IT YET

As things stand, those aggrieved by identity harm have only limited recourse. This is so for several reasons. First, in spite of the growing number of conscious consumers, the market remains generally insensitive to sustainability promises—kept or broken.[34] Market prices represent the value of a good, security, or service for the average (marginal) buyer, rather than for the conscious (infra-marginal) buyer.[35] Thus, unless sustainability promises become more valued by average consumers, the economic loss produced when such promises are broken is likely to be limited.

The problem is that with minimal or no economic loss, the likelihood of market regulation is reduced, as is the likelihood of government intervention *and* the likelihood of success for claims brought directly by consumers against the offending company.[36] As explained above, economic loss is an inadequate and problematic proxy for assessing identity harm,[37] and overreliance on it allows bad corporate practices to proliferate with relative impunity.

A second reason why recourse is limited for aggrieved consumers is that government may be underequipped or unwilling to step in: there may be no law or regulation on point,[38] and even if there is, resource and political constraints may direct attention elsewhere.[39] This again highlights the

34. Cadesby Cooper, *Rule 10b-5 at the Intersection of Greenwash and Green Investment: The Problem of Economic Loss*, 42 B.C. ENVTL. AFF. L. REV. 405, 427–32 (2015) (explaining that ethical investors' disappointment is difficult to redress due to Rule 10b-5 requirements that plaintiffs suffer economic loss attributable to the issuer's misrepresentations).

35. *Id.*

36. Many states require consumers to show that they suffered an ascertainable financial loss and that they relied on the seller's (mis)representation in making their purchase. *See* CAROLYN L. CARTER, NAT'L CONSUMER LAW CTR., CONSUMER PROTECTION IN THE STATES: A 50-STATE REPORT ON UNFAIR AND DECEPTIVE ACTS AND PRACTICES STATUTES, 18–21 (2009), https://www.nclc.org/images/pdf/udap/report_50_states.pdf [https://perma.cc/Z7P6-FPWH].

37. *Infra* Part I.

38. For example, the FTC Guides for the Use of Environmental Marketing Claims (16 CFR 260.1) offer sellers guidance for avoiding deceptive marketing, but there is no equivalent for social claims.

39. CARTER, *supra* note 36, at 18 (explaining that limited state enforcement

peculiarities of the Dieselgate Settlement. It is naïve to expect that the intensity of government agency intervention elicited by VW's wrongdoing will occur in cases where sustainability promises are broken less "loudly"—or where the agencies in charge of protecting the environment and consumers are headed by anti-interventionists.

Third, as illustrated by the fate of the chocolate cases and *Sud* (among others), there are serious consumer law obstacles to identifying an actionable misrepresentation or omission pertaining to sustainability. Consumer law statutes and the case law applying them tend to be demanding with respect to vindicating emotional grievances, especially when it comes to omissions. They can also place onerous demands on consumers with respect to establishing actual reliance on a particular statement at the time of purchase.

Fourth, it may be difficult to show how consumers are harmed by an inaccurate backstory when it is the planet and/or those making the goods that are injured, at least in the traditional sense. Indeed, identity harm is different from, say, the "safety harm" caused by a spontaneously combusting cell phone where users can experience direct personal injury.[40] It is also different from the distress that consumers experience when they learn that the "100% natural" food they ingested in fact contains genetically modified organisms (GMO)—partly because the health risks of consuming GMO foods remain uncertain and partly because these statements address consumers' concerns about their own bodily health.[41] In these scenarios, the primary injured party is the consumer herself. By contrast, with identity harm, the injury is, to a large extent, derivative. Identity harm affects individual consumers, but stems from an injury that is at least one step removed from the

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budgets limit regulatory policing of the marketplace).

40. *See* Eun-Young Jeong, *Samsung to Recall Galaxy Note 7 Smartphone Over Reports of Fires*, WALL. ST. J. (Sept. 2, 2016, 5:35 PM), https://www.wsj.com/articles/samsung-to-recall-galaxy-note-7-smartphone-1472805076 [https://perma.cc/G9VV-PBPM]; Daisuke Wakabayashi et al., *Samsung Halts Galaxy Note 7 Production as Battery Problems Linger*, N.Y. TIMES (Oct. 10, 2016), https://www.nytimes.com/2016/10/11/business/samsung-galaxy-note-fires.html?_r=0 [https://perma.cc/G3R9-G6GV].

41. *See* Michele Simon, *ConAgra Sued Over GMO '100% Natural' Cooking Oils*, FOOD SAFETY NEWS (Aug. 24. 2011), http://www.foodsafetynews.com/2011/08/conagra-sued-over-gmo-100-natural-cooking-oils/#.WKeHvRSnWto [https://perma.cc/JA5R-7DSJ] (describing a class action brought against ConAgra for labeling their Wesson-branded cooking oils as "100% natural" to target health conscious consumers when in fact the oils contain GMOs).

actual purchasing transaction. In the case of broken sustainability promises, the injury is experienced by the planet and/or fellow human beings. But other kinds of broken promises can trigger identity harm, as well.

For example, identity harm can encompass the type of "spiritual harm" that an observant Jewish person might experience upon learning that the food they ingested was falsely marketed as Kosher, or a Muslim might experience upon learning that a meat product they consumed was not in fact Halal, or a Jain might experience upon learning that the food they ordered was incorrectly described as vegetarian.[42] In such instances, the consumer suffers no direct (physical or economic) harm as a result of the transaction, but their faith in their relationship to the divine may be undermined.[43] The "ethical harm" that an animal rights activist might experience upon learning that a product they believed to be "cruelty free" was in fact developed by experimenting on animals can likewise be included under the identity harm umbrella as their injury is derivative of the injury to the animals.

In each of these instances, the injury occurs beyond the transaction and beyond the individual consumer. These examples illustrate how the "defect" of identity-harming products is not necessarily (if at all) economic—the issue is not about the product pricing. Nor is the defect related to the product's physical attributes—consumers are not physically injured by the use of an identity-harming product. Rather, the defect is that the product undermines a consumer's autonomy to make informed choices that will safeguard—not jeopardize—their values or their notion of who they want to be in the world.

The fact that identity harm is non-economic and derivative arguably complicates standing for those seeking to assert it.[44]

42. *See*, Stephen F. Rosenthal, *Food For Thought: Kosher Fraud Laws and the Religion Clauses of the First Amendment,* 65 GEO. WASH. L. REV. 951, 954 (1997) (offering a definition of spiritual harm based on an interview with commentator versed in Jewish law: "The consumption of forbidden foods defiles the holy spirit, and its sanctity is injured. This injury reduces the Jewish capacity to reap the full rewards of Torah and its fathomless depths").

43. The argument for including spiritual harm under the identity harm umbrella is strengthened by recalling that many of the religious rules pertaining to meat consumption are borne of some concern for the well-being of the animal. As such, spiritual identity harm is partially derived from the injuries experienced by animals. I am grateful to Matthew Carey of the *University of Colorado Law Review* for this insight.

44. The Supreme Court's decision in *Spokeo, Inc. v. Robins*, 136 S. Ct. 1540, 1545 (2016), suggests that standing challenges based on the non-concreteness of

More importantly, however, these features highlight a remedies problem. The most common remedy for consumer claims is monetary damages, which are typically limited to purchase price, sometimes enhanced with statutory or punitive damages.[45] However, in order for consumers to be made whole in the wake of a broken sustainability promise, what is needed is for the company to come through on its original promise and to *repair* the social or environmental damage done. Identity harm thus demands injunctive relief.

Injunctive remedies are occasionally employed to repair harm, particularly in cases involving the violation of environmental laws (e.g., the Settlement provides for billions of dollars to be paid into an EPA-administered climate fund)[46] and in cases involving the violation of international human rights laws.[47] In the consumer law context, however, the FTC and state attorneys general tend to steer clear of reparations-oriented remedies. To the extent that injunctive remedies are awarded, it is typically only to enjoin the seller from continuing to engage in the bad practice at issue, not to require them to repair the harm caused by the bad practice.[48] Typical consumer law remedies are therefore unlikely to make aggrieved consumers whole and should be combined with injunctive remedies intended to undo or repair the harm created by the injurious corporate practice at issue. An important additional advantage of developing a reparations-centered rather than compensation-centered remedies framework is that, properly designed,[49] it would reduce the risk of frivolous lawsuits.

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alleged harms are not insurmountable. *See also* Daniel Townsend, *Who Should Define Injuries For Article III Standing?*, 68 STAN. L. REV. ONLINE 76, 80 (2015) ("[N]ot all harms we care about are tangible. Many wrongs we care about do not lead to bodily damage, economic damage, [or] damage to property.").

45. CARTER, *supra* note 36, at 18–21.

46. First Consent Decree, *supra* note 1, at 12–13.

47. Tom Antkowiak, *Remedial Approaches to Human Rights Violations: The Inter-American Court of Human Rights and Beyond*, 46 COLUM. J. TRANSNAT'L L. 351 (2008).

48. *Id.* at 16; 15 U.S.C. §53 (1994); 15 U.S.C §54 (1938); 15 U.S.C §57b (1975).

49. Omri Ben-Shahar & Ariel Porat, *The Restoration Remedy in Private Law: A Novel Approach To Compensation For Emotional Harm* (U. Chi. L. Sch., Coase-Sandor Inst. for L. & Econ., Working Paper No. 819, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3058186 [https://perma.cc/5YK4-9AQ7] (developing a model for restorations-based remedies for emotional harms calibrated to tell apart sincere claimants from fakers).

CONCLUSION

Limited notions of harm do little to deter companies from making and then breaking promises. This hurts consumers, but also society, by breeding distrust of the marketplace and the bodies that are supposed to regulate it. Identity harm completes the picture painted by economic loss, and providing legal recourse for it would empower consumers to be more effective agents of change—leveraging their voices to advance the interests of (often voiceless) third parties.

Identity harm expands our notions of what constitutes actionable consumer harm while also creating openings for the development of new remedies frameworks that look beyond financial compensation to include reparations. Such legal innovation gives rise to difficult questions of what harms to count and how to count them. While challenging, these questions are not novel. We already have mechanisms in place for dealing with intangible harms in the context of medical injuries (e.g., pain and suffering), emotional distress, and defamation. In these areas, the inadequacy of economic loss as a measure of harm is acknowledged, and a degree of subjective experience is recognized.[50] Such protective principles should be harnessed to address the harm produced by companies breaking their sustainability promises, compelling them to do more than simply claim they are making the world a better place.

Though still new, identity harm can enrich the consumer protection toolkit. Rather than create a new cause of action, the idea is to incorporate identity harm into existing consumer law statutes and equip judges to better recognize and address the grievances of consumers who feel that their efforts to live in line with their personal values have been undermined by a seller's empty promises. At a time when the government's protective capacity appears to be shrinking more with each passing day, it is becoming ever-more urgent to arm consumers

50. Robert L. Rabin, *Intangible Damages in American Tort Law: A Roadmap* (Stan. Pub. L., Working Paper No. 2727885, 2016), https://www-cdn.law.stanford.edu/wp-content/uploads/2016/07/R.L.RABIN-SSRN-Rotterdam-Conf-paper-revised-for-ssrn-2727885-Intangible-Damages-in-American-Tort-Law.pdf [https://perma.cc/S8R2-9EYV] (discussing intangible harms); JoEllen Lind, *The End of Trial on Damages? Intangible Losses and Comparability Review*, 51 BUFF. L. REV. 251, 301, 309–14 (2003) (discussing the challenges of comparing intangible harms).

with the legal tools necessary for protecting their freedom to choose *not* to support abusive systems. Identity harm is one such tool.