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Do ESG Mutual Funds Deliver on Their Promises?

Law Working Paper N° 586/2021
June 2021

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We are grateful to ISS, S&P and TruValue for sharing their ESG ratings with us. We thank participants at our pop-up virtual workshop, our presentation at the Investment Company Institute, and the Corporate Law Academic Webinar Series for their many helpful comments and suggestions. Audrey Youn, Logan Hale, and Shannon Brooks provided superb research assistance.

Abstract

Corporations have received growing criticism for their role in climate change, perpetuating racial and gender inequality, and other pressing social issues. In response to these concerns, shareholders are increasingly focusing on environmental, social, and corporate governance (ESG) criteria in selecting investments, and asset managers are responding by offering a growing number of ESG mutual funds. The flow of assets into ESG is one of the most dramatic trends in asset management.

But are these funds giving investors what they promise? This question has attracted the attention of regulators, with the Department of Labor and the Securities and Exchange Commission (SEC) both taking steps to rein in ESG funds. The change in administration has created an opportunity to rethink these steps, but the rapid growth and evolution of the market means regulators are acting without a clear picture of ESG investing.

We fill this gap by offering the most complete empirical overview of ESG mutual funds to date. Combining comprehensive data on mutual funds with proprietary data from the several of the most significant ESG ratings firms, we provide a unique picture of the current ESG environment with an eye to informing regulatory policy. We evaluate a number of criticisms of ESG funds made by academics and policymakers and find them lacking. We find that ESG funds offer their investors increased ESG exposure. They also vote their shares differently from non-ESG funds and are more supportive of ESG principles. Our analysis shows that they do so without increasing costs or reducing returns.

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

Keywords: Mutual funds, ESG mutual funds, Securities regulation, empirical legal studies, environmental, social, and corporate governance, ESG, capital markets, portfolio composition, mutual fund voting, mutual fund fees, disclosure, ERISA, fiduciary duty, Name Rule, 35d-1

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DO ESG MUTUAL FUNDS DELIVER ON THEIR PROMISES?

Quinn Curtis,[*] *Jill Fisch*[**] *& Adriana Z. Robertson*[***]

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Abstract

Corporations have received growing criticism for their role in climate change, perpetuating racial and gender inequality, and other pressing social issues. In response to these concerns, shareholders are increasingly focusing on environmental, social, and corporate governance (ESG) criteria in selecting investments, and asset managers are responding by offering a growing number of ESG mutual funds. The flow of assets into ESG is one of the most dramatic trends in asset management.

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We fill this gap by offering the most complete empirical overview of ESG mutual funds to date. Combining comprehensive data on mutual funds with proprietary data from the several of the most significant ESG ratings firms, we provide a unique picture of the current ESG environment with an eye to informing regulatory policy. We evaluate a number of criticisms of ESG funds made by academics and policymakers and find them lacking. We find that ESG funds offer their investors increased ESG exposure. They also vote their shares differently from non-ESG funds and are more supportive of ESG principles. Our analysis shows that they do so without increasing costs or reducing returns.

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

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Introduction

ESG investing – that is, investing informed by environmental, social and governance criteria or considerations – is growing explosively.[1] Public attention in the U.S. and globally has increasingly focused on ESG issues,[2] and growing percentage of investors consider green investing "a big priority."[3] In one of his first official acts, President Biden rejoined the Paris Climate Agreement,[4] and the Securities & Exchange Commission (SEC) has, for the first time, a designated policy advisor to advance ESG issues.[5]

The growing focus on ESG investing is reflected in the rapidly expanding number of mutual funds that purport to consider ESG factors in their investment and voting decisions, as well as a surge in the volume of assets invested in such funds. Morningstar reports that the number of ESG-focused index funds and the total amount of assets held by such funds have each doubled in the past three years.[6] The COVID-19 pandemic, and the disruptions it has caused to financial markets, have done nothing to slow this rise.[7]

But do these rapidly growing ESG funds deliver what they promise? Do ESG funds offer portfolios with real investment exposure to ESG goals or has the demand for ESG investing led to overpriced, greenwashed funds that are merely marketed as

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[1] *See* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 388 (2020) (explaining that ESG investing "is an umbrella term that refers to an investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices").

[2] *See, e.g.*, Carlo Maximilian Funk & Suzanne Smetana, *The New Normal: ESG Investing in 2021,* etftrends.com, Jan. 9, 2021, https://www.nasdaq.com/articles/the-new-normal%3A-esg-investing-in-2021-2021-01-09 (explaining why global developments are likely to make ESG investing "the new normal").

[3] Michael Martin, *ESG: a trend we can't afford to ignore*, FIN. TIMES, Nov. 26, 2020, https://www.ft.com/content/87a922a1-8d60-4295-a9d8-d2c1ab5d788e.

[4] Nathan Rott, *Biden Moves To Have U.S. Rejoin Climate Accord*, NPR, Jan. 20, 2021, https://www.npr.org/sections/inauguration-day-live-updates/2021/01/20/958923821/biden-moves-to-have-u-s-rejoin-climate-accord

[5] Jim Tyson, *SEC appoints policy advisor to advance new initiatives on ESG*, CFO Dive, Feb. 2 2021, https://www.cfodive.com/news/securities-exchange-commission-esg-Satyam-Khanna-biden/594369/ (reporting Satyam Khanna's appointment in a "newly created role as senior policy advisor for climate and ESG").

[6] Pippa Stevens, *ESG index funds hit $250 billion as pandemic accelerates impact investing boom*, CNBC, Sept. 2, 2020, https://www.cnbc.com/2020/09/02/esg-index-funds-hit-250-billion-as-us-investor-role-in-boom-grows.html.

[7] *See generally* Lubos Pastor & M. Blair Vorsatz, *Mutual Fund Performance and Flows During the COVID-19 Crisis*, NBER Working Paper No. 27551 (Jul. 2020), *available at* https://www.nber.org/system/files/working_papers/w27551/w27551.pdf (finding that ESG funds did well in terms of both performance and fund flows, during the COVID-19 crisis of 2020); Deike Diers & Axel Seemann, *Could Covid-19 Open More Doors for ESG Investing?* Bain & Company (August 26, 2020), https://www.bain.com/insights/could-covid-19-open-more-doors-esg-investing-snap-chart/ (arguing that the COVID-19 crisis is likely to accelerate the trend towards ESG investing).

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ESG to chase the latest investment fad?[8] The answers to these questions have legal implications because mutual funds are extensively regulated by the SEC, and the inclusion of mutual funds in retirement plans is regulated by the Department of Labor (DOL).

In fact, both the SEC and the DOL have recently turned their attention to ESG investing.[9] For the SEC, the central legal question is whether funds that characterize themselves as focused on ESG deliver on that promise – do they invest and vote differently from other mutual funds?[10] For the DOL, the question is whether ESG investing is consistent with the fiduciary duties of retirement plan trustees – do ESG funds deliver sound performance at reasonable cost or do they sacrifice returns to promote social causes? [11] Despite these differing concerns, both SEC and the DOL view the growth of ESG funds as potentially warranting regulatory intervention. Indeed, the DOL has already intervened, adopting a new rule on October 30, 2020 that may deter 401k plans from offering ESG funds.[12] Although to date the SEC has not engaged in formal rulemaking, members of the Commission have expressed

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[8] See, e.g., Tariq Fancy, *Financial world greenwashing the public with deadly distraction in sustainable investing practices*, USA Today, Mar. 16, 2021, https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashingcolumn/6948923002/ (stating that "sustainable investing boils down to little more than marketing hype, PR spin and disingenuous promises from the investment community").

[9] The SEC solicited public comment on whether the use of ESG in mutual fund names is likely to mislead investors. Request for Comment on Fund Names, Release No. IC–33809 (Mar. 2, 2020) (85 FR 13221) (Mar. 6, 2020) ("Request for Comment on Fund Names"). The SEC's Office of Compliance, Inspections and Examinations also identified as a particular interest the "accuracy and adequacy of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria." Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, 2020 Examination Priorities, at 15, www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf. *See also* Department of Labor, Final Rule, Financial Factors in Selecting Plan Investments, Oct. 30, 2020 ("DOL Final Rule") (adopting rule providing that "A fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors"). Although the final rule does not explicitly reference ESG investing, the DOL explained that its purpose in adopting the rule was "to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends." *Id.* at 11.

[10] *See, e.g.*, *Update on progress in ESG Subcommittee*, SEC Asset Management Advisory Committee, Sept. 16, 2020, at 17, https://www.sec.gov/files/update-from-esg-subcommittee-09162020.pdf (identifying "concerns about the potential for "greenwashing" in ESG funds").

[11] *See, e.g.*, Rober R. Gower, *A Pecuniary Focus: Department of Labor Issues Final Rule on Financial Factors in Selecting Plan Investments*, Tucker Huss, Nov. 12, 2020, https://www.truckerhuss.com/2020/11/a-pecuniary-focus-department-of-labor-issues-final-rule-on-financial-factors-in-selecting-plan-investments/ ("Over the last several years, the DOL has expressed increasing concern that a growing emphasis and interest in ESG investing may prompt ERISA plan fiduciaries to make investment decisions for motives other than their fiduciary duty to provide benefits to participants and beneficiaries, and defray reasonable expenses of administering a plan").

[12] DOL Final Rule, *supra* note 9.

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concerns that current disclosure practices by asset managers with respect to their ESG products are insufficient.[13]

Other interventions are on the horizon as well. The reliance of asset managers on third parties, including index providers and rating agencies in evaluating the ESG characteristics of portfolio companies, has led some to call for greater regulation of those providers.[14] The Biden administration is taking steps to review and potentially replace the DOL rule[15] and new leadership at the SEC will likely look to expand corporate disclosures to address ESG issues.[16]

These changes are taking place, however, amid a rapidly evolving ESG landscape that has outpaced the academic literature. Instead, regulators are acting based on a variety of assumptions about how ESG funds operate,[17] often drawn from small-sample studies or anecdotal reports.[18] Even as regulators move, we know relatively

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[13] *See, e.g.*, Elad Roisman, *SEC Commissioner Advocates ESG Disclosure for Asset Managers, Not Issuers*, THE CLS BLUE SKY BLOG, July 10, 2020, https://clsbluesky.law.columbia.edu/2020/07/10/sec-commissioners-advociates-esg-disclosure-for-asset-managers-not-issuers/ ("I do think that retail investors who want "green" or "sustainable" products deserve more clarity and information about the choices they have.").

[14] *See, e.g.*, Dana Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 Cardozo L. Rev. 1921, 2003 (2020) (warning that "The topic of index regulation looms large on the U.S. regulatory horizon"); Elad E. Roisman, Statement at the Meeting of the Asset Management Advisory Committee, Dec. 1, 2020, https://www.sec.gov/news/public-statement/roisman-statement-amac-meeting-120120 (asking Asset Management Subcommittee "to the extent that you are considering recommending that the SEC incorporate certain third parties' disclosure guidelines into our rule set, have you thought about how the SEC should oversee those third parties? Also, should we extend our oversight further, for example, to ESG-index providers and ESG-rating agencies, since so many "ESG" funds and investment products are derivative of their work?").

[15] *See* Tim Quinson, *Biden Administration Considers Reversing Trump's ESG Rule Change,* Bloomberg.com, Jan. 20, 2021, https://www.bloomberg.com/news/articles/2021-01-20/biden-administration-considers-reversing-trump-s-esg-rule-change (reporting that "The so-called ESG rule, or "Financial Factors in Selecting Plan Investments," was the only Department of Labor rule listed for review by President Joe Biden's transition team").

[16] *See* Aaron Nicodemus, *Biden's SEC set to require disclosure of ESG, climate change risk*, COMPLIANCE WEEK, Dec. 3, 2020, https://www.complianceweek.com/regulatory-policy/bidens-sec-set-to-require-disclosure-of-esg-climate-change-risk/29788.article (predicting a Biden Administration SEC will "could require companies to disclose risks related to environmental, social and governance (ESG) issues, which includes addressing risks associated with climate change.").

[17] *See, e.g.*, DOL Final Rule, *supra* note 9 at 8 ("ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective").

[18] For example, in the proposed DOL rule on ESG funds in retirement plans, U.S. Department of Labor, *Financial Matters in Selecting Plan Investments*, 85 Fed. Reg. 39,113 (June 30, 2020), the footnote supporting the claim that "ESG funds often come with higher fees," *id* at 39,115 n. 15, cites an industry whitepaper, which itself cites to a June 2018 news report about the cost of ESG *data* (not funds). The DOL also cites a whitepaper from a conservative think tank which analyzes only 30 ESG funds. *Id. (*citing Wayne Winegarden, *ESG Investing: An Evaluation of the Evidence, Pacific Research Institute* (May 2019), www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf.). For the countervailing claim that "asset-weighted expense ratio for ESG funds has (sic) decreased," the

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little about the market for ESG funds, the investment strategies these funds use, how they vote their proxies, and what they cost. At the same time, regulatory attention has focused on ESG funds as presenting concerns distinctive from other mutual funds. But it is unclear that ESG funds, as a category, present unique regulatory issues.[19] These are all policy-relevant questions that should inform rulemaking.

This article offers the most complete empirical overview of ESG mutual funds to date. Using market-wide data on fund portfolios, voting, fees, and performance, we specifically target the concerns articulated by the SEC and the DOL. We combine detailed information on mutual funds with four proprietary datasets evaluating company-level ESG performance. Using this unique and comprehensive dataset, we explore the practical differences between ESG and non-ESG funds as well as the differences among ESG funds along four dimensions – portfolio composition, voting behavior, costs, and performance. The first two specifically target the SEC's concerns, while the latter two relate to those raised by the DOL. Our goal is to provide an overview of the market as it currently stands for the purpose of informing a regulatory push that has the potential to reshape the ESG landscape.

From the SEC's perspective, the fundamental regulatory question is what investors are *getting* for their "ESG dollars." We confront the question of what ESG funds promise – the information conveyed both by the ESG label and fund disclosure practices. We then ask whether and how these funds deliver on that promise. To answer these questions, we survey the existing market and construct several categories of ESG mutual funds – funds with names that convey an ESG-oriented strategy, funds classified by Morningstar as ESG funds, and funds that purport to consider ESG factors in their investment criteria. We then analyze the portfolio composition and voting behavior of these funds to compare them across multiple dimensions. From the DOL's perspective, the primary concerns are pecuniary: what, if anything are investors *giving up* when they invest in ESG funds? These pecuniary costs can be direct, in the form of fees, or indirect, in the form of lower raw or risk-adjusted returns. We engage with the concerns of both regulators by providing evidence about both what investors are getting and what they are giving up to get it.

Descriptively, we uncover an evolving landscape of ESG funds. Today's ESG funds range from single issue funds that address water conservation or religious values to those that incorporate screening criteria into the construction of a broad-based index. We find extensive disclosures of fund investment strategies – strategies that

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DOL cites only a news report. *Id.* By contrast, we present direct evidence on the fees associated with more than 300 funds.

[19] Although this article's empirical analysis focuses on U.S. investing, we note that the growing importance of ESG investment products raises regulatory concerns globally. *See, e.g.*, *The Regulatory Overlay on ESG Investing*, Morgan Lewis White Paper, Sept. 2020, https://www.morganlewis.com/-/media/files/publication/morgan-lewis-title/white-paper/2020/the-regulatory-overlay-on-esg-investing.pdf (exploring regulatory considerations in the U.S., the United Kingdom, the European Union, and Asia.).

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differ substantially – as well as the extent to which the fund incorporates ESG considerations into voting and engagement. We find, in short, a market that recognizes that ESG means different things to different investors.

Empirically, we find that ESG funds behave differently from other funds. We first evaluate portfolio composition. Using data from four separate rating providers, we calculate what we term a fund's "ESG tilt" — the asset-weighted average of the ESG scores of the fund's portfolio companies. We find that funds that identify themselves as ESG funds hold portfolios that represent a significant ESG tilt. In other words, contrary to the SEC's concern about "greenwashing," ESG funds deliver on their promise to invest differently from other funds, and their holdings are rated more highly with respect to ESG. Because we incorporate ratings from four different providers, our findings offer reassurance that funds are not "gaming" a specific ESG index.

Second, we examine fund voting behavior. Although ESG mutual funds have been criticized for not casting their portfolio-company votes in accordance with their investment profiles,[20] we document clear differences between the voting behavior of ESG and non-ESG funds. Although ESG funds do not automatically support every shareholder proposal related to ESG,[21] they do vote more independently of management compared to other funds when it comes to environmental and social issues. With respect to certain governance issues, such as say on pay, we also find clear differences. In short, ESG funds appear to be considering ESG criteria in voting, as well as investment decisions.

Third, we look at what these differences cost investors. To do so, we investigate the expenses associated with ESG funds and the returns offered by these funds. Contrary to the concern articulated by the DOL, we find no evidence that ESG funds cost more than comparable non-ESG funds, or that they offer inferior performance during our sample period (either raw or risk adjusted). The results persist despite the inclusion of a battery of control variables intended to ensure that we are making "apples-to-apples" comparisons. While these tests are not intended to establish – nor can they establish – whether or not ESG funds are a "good" investment, we find no evidence that they perform *worse* than comparable funds.

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[20] *See, e.g.*, James McRitchie, *Mutual Fund Wars Over Fees AND Proxy Votes*, CorpGov.net, Sept. 3, 2019, https://www.corpgov.net/2019/09/mutual-fund-wars-over-fees-and-proxy-votes/ (reporting that "Morningstar also found ESG funds from BlackRock, Vanguard, Fidelity Investments, TIAA-CREF and others cast a number of votes that appear to conflict with an ESG mandate, especially for funds specifically aimed at the environment.").

[21] We note the absence of any clear benchmark as to the specific percentage of ESG proposals that a fund should support given obvious differences in proposal quality as well as firm-specific variation in the degree to which the actions contemplated by a given shareholder proposal are necessary or appropriate.

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A final empirical contribution of this paper is to address the impact of variation in ESG ratings. As the SEC has noted, there is little consensus on what falls within the definition of ESG or how to weigh various ESG considerations.[22] There are over 600 ESG rating providers, and these providers rely on a range of different sources of data and employ a variety of methodologies to analyze that data.[23] Commentators have highlighted the fact that these differences frequently lead to different ratings.[24] Thus, for example, among automobile manufacturers, Tesla receives a top ESG rating from MCSI and a bottom rating from FTSE.[25] Although we do not directly interrogate differences among providers in this paper, we take the unique approach of incorporating ESG rating data from four different and well-known providers — ISS, S&P, Sustainalytics, and TruValue Labs — to measure the ESG orientation of the mutual fund portfolios that we examine. We find that, although the providers take very different approaches to measuring ESG, the patterns are remarkably stable across providers.

In sum, we provide new data on the role of ESG in mutual fund investing and its effects. Our goal in this article is modest. We do not seek to establish that ESG funds are good with respect to any specific benchmark – good with respect to the myriad possibility of environmental, social and governance objectives or good in the sense that they outperform non-ESG funds. Rather, the goal of this article is to address concerns that ESG funds present distinctive regulatory concerns relative to the mutual fund market as a whole, either because (as the SEC fears) they are not doing what they purport to do or because (as the DOL fears) their economic performance is inferior to non-ESG funds. Either of these concerns, if established, would warrant singling out ESG funds for distinctive regulatory treatment. Our empirical results, however, provide powerful evidence that ESG funds are offering investors something different from traditional funds with respect to both portfolio composition and voting, and that they are doing so without causing investors systematically to sacrifice economic performance.

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[22] SEC Commissioner Elad L. Roisman, *Keynote Speech at the Society for Corporate Governance National Conference*, July 7, 2020, https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020.

[23] *See, e.g.*, Jasmin Malik Chua, *The rise in ESG ratings: What's the score?,* VOGUE BUSINESS, Oct. 28, 2020, https://www.voguebusiness.com/sustainability/the-rise-in-esg-ratings-whats-the-score (explaining variation in methodologies used by ESG rating organizations).

[24] *See, e.g.*, Jacqueline Poh, *Conflicting ESG Ratings Are Confusing Sustainable Investors*, BLOOMBERG, Dec. 11, 2019, https://www.bloomberg.com/news/articles/2019-12-11/conflicting-esg-ratings-are-confusing-sustainable-investors (observing that "There are many ways to score a company on environmental, social, and governance criteria, making the results difficult to compare"). *See also infra* notes 36-40 and accompanying text.

[25] See James Mackintosh, *Is Tesla or Exxon More Sustainable? It Depends Whom You Ask*, WALL. ST. J. Sept. 17, 2018, https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931.

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Our findings describe the current state of the market for ESG funds. We do not purport to evaluate the claims made by ESG funds in the past. It may be that the recent proliferation of ESG products has generated meaningful market discipline. Nonetheless, our findings do not suggest a need for regulatory intervention either to limit investor access to ESG products or to curtail their use by ERISA fiduciaries.

I. Background of ESG and the Growth of ESG Mutual Funds

The Background of ESG

Interest in ESG stems from increasing public, issuer and investor attention to the impact of corporate operations on stakeholders and society more broadly. A range of commentators have criticized corporations for prioritizing shareholders at the expense of employees and customers.[26] The need to address climate change and other environmental issues has taken on heightened urgency and led to a focus on the role that corporations play in carbon emissions and other environmentally damaging activities. Corporations have also faced scrutiny over their role in perpetuating racial and gender discrimination, wealth and wage inequality and exploitation of disadvantaged groups. [27]

The ESG movement generally calls for corporations to incorporate these concerns into their business practices. ESG is a rough label for an amalgamation of voices, interest groups and substantive concerns, and those advocating greater attention to ESG often disagree on the relative importance of the various issues that they identify.[28] The appropriate benchmark for corporate behavior ranges from

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[26] *See, e.g.*, Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote "An Economy That Serves All Americans*," Aug. 19, 2019, available at https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans; Business Roundtable Statement, *The British Academy proposes principles for the age of purposeful business*, Nov. 27, 2019, available at *https://www.thebritishacademy.ac.uk/news/british-academy-proposes-principles-age-purposeful-business; World Economic Forum, Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution*, Dec. 2019, available at http://www.wlrk.com/docs/weforumorgDavosManifesto2020TheUniversalPurposeofaCompanyintheFourthIndustrialRevolution.pdf.

[27] *See, e.g.,* Melissa Repko, et al., *Hashtags won't cut it. Corporate America faces a higher bar in a reckoning on racial inequality*, CNBC, June 12, 2020, https://www.cnbc.com/2020/06/12/action-wanted-corporate-america-faces-a-higher-bar-on-racial-inequality.html (describing pressure faced by corporations to address racial inequality and economic justice).

[28] *See, e.g.*, Thomas Brigandi, Paul Kovarsky & Paul McCaffrey *The Seven Asset Owner Approaches to ESG,* ENTERPRISING INVESTOR, Sept. 5, 2019, https://blogs.cfainstitute.org/investor/2019/09/05/the-seven-asset-owner-approaches-to-esg/ (describing seven different approaches by asset owners to ESG investing).

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demand that corporations at least consider a broader range of stakeholder and societal interests to an exhortation for corporations to "do no harm."[29]

The role of ESG in investing continues to evolve. For some years, investing on the basis of ESG considerations was thought to be a preference predicated on ethical, political, religious or other objectives rather than an investment strategy grounded in financial risk and return.[30] Commentators debated whether corporations could do well by doing good, and the data generated in response to this debate was mixed.[31] More recently, an increasing number of scholars and policymakers claim that sustainable or ESG investing is associated with better economic performance.[32] Max Schanzenbach and Robert Sitkoff observe that investors may have different reasons for ESG investing and differentiate between ESG investing for moral or ethical reasons, which they term "collateral benefits ESG" and ESG investing for risk and return benefits, which they call "risk-return ESG."[33]

One challenge to analyzing the relationship between ESG and economic performance is the absence of a clear definition of ESG. Acting SEC Chair Roisman explains that "there is not consensus on what, exactly, 'ESG' means."[34] Stavros Gadinis and Amelia Miazad note that ESG's "wide scope" encompasses a range of

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[29] *See, e.g.*, Mike Phillips, *How To Tell Your Impact From Your Sustainable Investing — And Avoid Greenwashing*, Bisnow, July 5, 2020, https://www.bisnow.com/london/news/sustainability/how-to-tell-your-impact-from-your-sustainable-investing-and-avoid-greenwashing-105069 ("For the EU, sustainable investment must contribute to environmental objectives in a measurable way or contribute to social objectives, must do no significant harm to any social or environmental objectives, and must follow good governance practices.").

[30] *See, e.g.*, Jess Liu, *ESG Investing Comes of Age*, Morningstar, Feb. 11, 2020, https://www.morningstar.com/features/esg-investing-history (explaining that "What we now refer to as sustainable investing began with religious groups such as Muslims, Quakers, and Methodists who set ethical parameters on their investment portfolios").

[31] *See, e.g.*, Robert G. Eccles, Ioannis Ioannou & George Serafeim, *The Impact of Corporate Sustainability on Organizational Processes and Performance*, 60 Mgmt. Sci. 2381 (2014) (reporting that high sustainability companies outperformed their counterparts in both stock returns and accounting performance); Pieter Jan Trinks & Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 J. Bus. Ethics 193 (2017) (finding that negative screens were frequently correlated with inferior economic performance); Morgan Stanley Institute for Sustainable Investing, Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds, 2019, https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf (studying nearly 11,000 mutual funds and ETFs from 2004 to 2018 and finding "no financial trade-off in the returns of sustainable funds compared to traditional funds."),

[32] *See, e.g.*, Reiser & Tucker, *supra* note 14 at 1934 ("data showing ESG investing need not sacrifice returns - and indeed may increase them - is beginning to mount"); Alex Edmans, GROW THE PIE: HOW GREAT COMPANIES DELIVER BOTH PURPOSE AND PROFIT (Cambridge Press 2020), 3 ("By applying a radically different approach to business, enterprise can create *both* profit for investors and value for society")..

[33] Schanzenbach & Sitkoff, *supra* note 1, at 390-91.

[34] Roisman, *supra* note 22.

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issues from environmental concerns and workplace relationships to "the use of sugar in packaged foods."[35] Both the range of potential issues and the scope of data analysis required to evaluate a corporation's performance with respect to those issues have fueled the development of an array of private standard-setters that gather ESG data and transform that data into company-specific ratings or rankings.[36] Today there are more than 600 ESG rating organizations and rankings worldwide, and the number continues to grow.[37] The sheer multitude of ratings organizations makes any attempt to rank companies "difficult, and more of an art in certain situations than a science."[38]

Moreover, because organizations vary both in the data that they collect and the methodology that they use to incorporate that data, ESG ratings vary substantially among providers.[39] Some providers rely on questionnaires to collect information from issuers, some review issuers' public disclosures and filings, and some rely on third party sources.[40] Commentators have documented substantial variation among ratings and have, as a result, questioned the viability of evaluating an issuer's ESG accurately.[41] SEC Commissioner Hester Peirce notes that "the different ratings available can vary so widely, and provide such bizarre results that it is difficult to see how they can effectively guide investment decisions"[42]

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[35] Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 Vand. L. Rev. 1401, 1414-15 (2020).

[36] Alan R. Elliott, *As ESG Investing Gives 2020 A Sustainable Spin, 50 Best ESG Companies Revealed*, Investor's Business Daily, Oct. 26, 2020, https://www.investors.com/news/esg-investing-puts-sustainable-spin-2020-esg-funds-best-esg-stocks-show/

[37] Nicolas Rabener, *ESG data: Dazed and confused*, ETF Stream, Nov. 30, 2020 (citing report from "the think tank SustainAbility").

[38] Elliott, *supra* note 27. *See also* Hester M. Peirce, Scarlet Letters: Remarks before the American Enterprise Institute, June 18, 2019, https://www.sec.gov/news/speech/speech-peirce-061819 (observing that "[n]ot only is it difficult to define what should be included in ESG, but, once you do, it is difficult to figure out how to measure success or failure")

[39] Indeed, our data analysis relies on ratings from four different providers and, as we detail below, both the underlying data utilized by these providers and the methodologies used to construct their ratings vary significantly.

[40] *See generally* Donnelley Financial Solutions, *The Future of ESG and Sustainability Reporting: What Issuers Need to Know Right Now*, White paper (2018), https://www.dfinsolutions.com/sites/default/files/documents/2019-01/dfin_thought_leadership_whitepaper_ESG_Sustainability_Reporting_0.pdf , at 7-9 (summarizing data used by several major ESG ratings providers).

[41] *See, e.g.*, Florian Berg, Julian Kölbel, & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings* (May 17, 2020). https://ssrn.com/abstract=3438533 (comparing ratings from six prominent agencies and reporting substantial differences); Feifei Li & Ari Polychronopoulos, *What a Difference an ESG Ratings Provider Makes!,* Research Affiliates, Jan. 2020, https://www.researchaffiliates.com/en_us/publications/articles/what-a-difference-an-esg-ratings-provider-makes.html; Jim Hawley, *ESG Ratings and Rankings All over the Map. What Does it Mean?* (2017), https://truvaluelabs.com/wp-content/uploads/2017/12/ESG-Ratings-and-Rankings-All-Over-the-Map.pdf.

[42] Peirce, *supra* note 38.

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The Growth of ESG Mutual Funds

The challenges associated with defining and measuring ESG have not impeded its growth as an investment strategy. The use by mutual funds of ESG criteria in selecting investments and engaging with portfolio companies is one of the hottest investment trends. Over the last four years, investments in the United States in funds using ESG data have almost doubled from $22.9 trillion in 2016 to over $40 trillion in 2020.[43]

ESG investing can incorporate several different strategies. One is investment screening, in which a fund uses ESG data as a component of its investment decisions. Funds may engage in negative or exclusionary screening, in which they exclude certain types of companies – oil, tobacco and gambling companies are common examples – from their portfolio. Alternatively, funds can engage in positive screening in which they limit their portfolios to investments that meet designated ESG criteria. Funds can also incorporate ESG data as part of a more comprehensive analysis of an investment, what some funds term an "integrated" use of ESG criteria. For example, Vanguard's Global ESG Select Stock Fund describes its ESG strategy as "Regularly including ESG factors alongside the traditional investment analysis performed by active fund managers. This strategy doesn't require the fund to rule out any company, industry, or country simply because it's involved in a business activity that may be objectionable to some."[44]

The potential impact of ESG investing on mutual fund investors is increased by the ease with which ESG screening can be incorporated into a passive investment strategy. The amount of money invested through passive or indexed strategies has grown dramatically fueled both by the low costs of indexing and by studies suggesting that active strategies do not consistently outperform indexed strategies over time.[45] The extensive number of ESG rating organizations creates a ready tool for an index-based investment product in which the selection of a mutual fund's portfolio companies is predicated on a rating conferred by an external provider. Thus, for example, four of Vanguard's five current ESG fund offerings are indexed, with their portfolio composition tracking several indices created by FTSE Russell.[46] Indexed mutual funds or ETFs enable funds to offer the cost advantages and scalability associated with a passive investment strategy. At the same time, the sponsor of such

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[43] E*SG Data Integration by Asset Managers: Targeting Alpha, Fiduciary Duty & Portfolio Risk Analysis* (June 2020), Opimas; http://www.opimas.com/research/570/detail/.

[44] Vanguard, ESG investing: Discover funds that reflect what matters most to you, https://investor.vanguard.com/investing/esg/ (last visited Feb. 15, 2021).

[45] *See, e.g.*, Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PENN. L. REV. 17, 19 (2019) (explaining growth of market for index funds).

[46] Vanguard, *supra* note 44; see FTSE Russell, FTSE4Good Index Series, https://www.ftserussell.com/products/indices/ftse4good (last visited Feb. 15, 2021).

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funds essentially delegates the evaluation of portfolio companies to the index provider.[47]

A second ESG investment strategy is engagement.[48] ESG engagement involves a fund exercising its power as a shareholder in an effort to cause its portfolio companies to perform better on some ESG criteria. Engagement may include the manner in which the fund votes the shares of its portfolio companies but can also include more proactive measures such as letter writing, meeting management, sponsoring shareholder proposals and initiating litigation.[49]

A third strategy is impact investing. Impact investing targets companies seeking to achieve specific goals that are beneficial to society. Impact investing might target a company that produces a clean energy product – such as wind or solar power – or alternatively might finance efforts to convert the manufacturing processes of a traditional company in an effort to reduce its environmental impact.[50]

Notably, the foregoing ESG strategies can be used independently or in combination. For example, an S&P 500 index fund, which invests in accordance with the composition of the S&P 500 index,[51] does not incorporate ESG considerations into its stock selection process, but nothing prevents that fund from engaging on ESG issues. By the same token, a fund that invests according to ESG criteria could also engage on ESG issues but need not do so. Indeed, media reports have highlighted instances in which ESG funds do not vote differently, even with respect to ESG issues, from non-ESG funds.[52]

How funds communicate the role that ESG plays in their investment strategy is a separate issue. One obvious tool for communicating a fund's strategy is its name. We

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[47] *See* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. ON REG. 795 (2019) (explaining that index funds delegate stock selection decisions to those who construct the index, who retain a substantial amount of investment discretion).

[48] Michelle Edkins at BlackRock defines engagement as "direct communication between investors and companies—on environmental, social and governance matters." Michelle Edkins, *The Significance of ESG* Engagement, ENGAGEMENT STRATEGIES, 4 (2014). https://pcg.law.harvard.edu/wp-content/uploads/2015/12/esg-excerpt.pdf.

[49] *See, e.g.*, Boston Trust Walden, https://www.bostontrustwalden.com/investment-services/impact-investing/ (describing its engagement strategy).

[50] *See, e.g.*, Martin, *supra* note 3 (explaining that "Many sustainable fund managers — including our own — reserve a portion of the portfolio for actively intervening in companies that need an extra nudge, using the voting rights that share ownership affords them to try to change the companies from within.").

[51] *See* Adriana Z. Robertson, The (Mis)Uses of the S&P 500 (Working Paper, June 29, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205235 (describing the extensive use of the S&P 500 index by mutual funds).

[52] *See, e.g.*, Gita R. Rao, *A surprise about some ESG funds — they actually vote against environmental and socially conscious resolutions*, MARKETWATCH, Dec. 18, 2020, https://www.marketwatch.com/story/a-surprise-about-some-esg-funds-they-actually-vote-against-environmental-and-socially-conscious-resolutions-11608306020 (reporting that "some index funds with an environmental, social and corporate governance mandate rarely vote in favor of their stated preferences.").

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constructed our initial sample of ESG funds, for example, by searching for terms such as "sustainable," "ESG" and "green" in fund names. Using a fund's name to communicate the role of ESG is tricky, however.

Consider a fund called "XYZ Green Fund." What information is conveyed by the fund's name? One possibility is that the fund invests in sustainable or green industries — solar panel and wind turbine manufacturers or makers of electric vehicles. An alternative is that the fund seeks out companies that have environmentally responsible practices relative to their industry peers – motivated either by a desire to encourage more environmentally responsible practices or out of the expectation that such companies will be better positioned to withstand market and regulatory burdens that are imposed on environmentally harmful companies in the future. The delivery service UPS runs a large fleet of diesel trucks, hardly a "green" business compared to wind farms, but if UPS has converted more of its vehicles to electric than competitors, then the XYZ Green Fund might buy more of UPS and less of FedEx. Many of the companies in this fund's portfolio would not be "green" in the sense used above, but rather retailers, manufacturers, and perhaps even oil companies, that are better situated than their competitors to thrive if carbon emissions are restricted.

There is a third possibility too. Perhaps XYZ Green Fund is an impact fund that seeks to make companies greener (either to generate returns or to make the world a better place). *That* XYZ Green Fund might hold a portfolio of particularly egregious polluters—industrial dinosaurs that have failed to consider their environmental impact at all—and then, through the power of their proxy voting, attempt to induce those companies to improve. The portfolio of such a fund would look anything but green in either of the above senses, but such a strategy might nevertheless be consistent with the "green" name so long as the fund seeks to reform those companies.

Even setting aside the alternative notions of being a green fund, the question of what counts as "green" looms large. There is no settled notion of an environmentally responsible company. Is Tesla a green company because it makes electric vehicles, or is it not, because it harvests vast quantities of lithium for its batteries? A wind farm company might be green because it produces electricity with zero emissions, but what if it repeatedly refuses to take straightforward steps to mitigate the impact of its wind farms on wildlife?[53] What is true of the "E" in ESG is equally true of "S" and "G." A company might be a leader in addressing workplace inequality but fail to oversee child labor practices in its supply chain. Funds that purport to consider E, S and G, must also consider how to weigh practices across all three categories. Does Facebook's low carbon footprint outweigh its failures in safeguarding customer privacy or its dual class

[53] As Commissioner Pierce recently put it "One person's ecofriendly windmill is another person's bird killer." Hester Peirce, *Remarks by Commissioner Peirce on The Role of Asset Management in ESG Investing,* HARV. LAW SCH. FORUM ON CORP. GOV., Sept. 18, 2020, https://corpgov.law.harvard.edu/2020/09/18/remarks-by-commissioner-peirce-on-the-role-of-asset-management-in-esg-investing/.

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voting structure? Of course, this problem is not unique to ESG investing; there are a plethora of different self-described "growth" and "value" funds in the market, and different funds sometimes have very different conceptions of what "value" and "growth" investing strategies mean.[54] Notwithstanding this, no one reasonably argues that funds should not be able to use the words "value" or "growth" in their names.

Obviously a fund name cannot fully explain the fund's investing strategy. Mutual fund companies are required to provide information beyond fund names, however. They must share information that enables investors to determine if the fund's conception of ESG matches the investor's preferences. The SEC's disclosure requirements for mutual funds take a layered approach to disclosure.[55] Mutual funds disclose a minimum amount of information in the summary prospectus, which is typically three to four pages in length.[56] Additional information is provided in the statutory prospectus and the statement of additional information.[57] Funds disclose, in these documents, their investment objectives and how they incorporate ESG criteria. They disclose whether they follow an index strategy and, if so, the applicable index. In many cases, they also disclose their policies regarding voting or engagement. Mutual funds are also required to disclose their portfolio holdings on a quarterly basis.[58] In addition, SEC rules adopted in 2002 require mutual funds to disclose their overall voting policies as well as the votes they actually cast at each of their portfolio companies. This information is publicly available on Edgar.[59]

Commentators have criticized the mutual fund disclosure system on the basis that retail investors rarely read the prospectus or other disclosure documents.[60] In recent

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[54] *See* Robertson, *supra* note 45 at 825-6 (describing the heterogeneity across different "growth" and "value" indices tracked by index mutual funds).

[55] *See, e.g.*, Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L. BUS. & FIN. 1 (2009) (describing SEC's mutual fund disclosure requirements).

[56] *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, Investment Company Act Release No. 28,584, 74 Fed. Reg. 4546, 4549 (Jan. 26, 2009) (to be codified at scattered parts of 17 C.F.R) (stating that the summary prospectus contains "key information that is important to an informed investment decision").

[57] *See generally* Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PENN. L. REV. 1961, 1969-70 (2010) (describing SEC-mandated mutual fund disclosures).

[58] *Id.* at 1970.

[59] *See* U.S. Sec. & Exch. Comm'n, EDGAR, Mutual Funds, https://www.sec.gov/edgar/searchedgar/mutualsearch.html (providing mechanism to search for mutual funds and view their proxy voting records).

[60] A 2006 Investment Company Institute survey reported that only thirty percent of recent mutual fund investors consulted shareholder reports before their most recent purchase, and only thirty-four percent used the fund prospectus. Inv. Co. Inst., Understanding Investor Preferences for Mutual Fund Information 12 (2006), available at http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf. A 2008 telephone survey reported that nearly two-thirds of respondents who said that they received mutual fund prospectuses "rarely" "very rarely" or "never" read them. Abt SRBI, Mandatory Disclosure Documents Telephone Survey, July 30, 2008, at 56, https://www.sec.gov/pdf/disclosuredocs.pdf.

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years, however, internet-based disclosures have become increasingly detailed. In addition to providing links to the mandated disclosure documents, funds generally provide detailed descriptions of their screening and engagement strategies on their websites. Mutual fund companies are starting to post their voting disclosures on their websites as well. For example, Vanguard provides a tool that enables investors to search, by fund, for the proxy votes cast at each of the fund's portfolio companies for the 2019-2020 proxy season.[61]

Concerns over ESG Funds

As the number and size of ESG funds have grown, a number of concerns have been raised about them. Perhaps the most serious concern is that ESG funds falsely portray themselves as adhering to an ESG investing (or voting) strategy to attract investor money, a practice characterized as "greenwashing."[62] Particularly in the absence of consistent data for evaluating the sustainability of individual portfolio companies, it is difficult to measure the ESG-orientation of a mutual fund or compare the "greenness" of one fund's portfolio to that of another. As one commentator observes, the possibility that investors do not understand what they are buying or are being misled by false claims of sustainability raises consumer protection concerns that fall into a gap in existing law.[63]

Greenwashing is not the only issue. Commentators express concern that ESG funds charge higher fees. These fees could reflect the higher costs associated with identifying and monitoring investments from an ESG perspective.[64] It could also be the case that ESG funds are smaller and therefore less able to benefit from economies of scale.[65] More nefariously, they could be capitalizing on the demand for ESG products and charging high fees while providing little incremental value to investors. Another concern is that ESG funds sacrifice performance. Commissioner Roisman,

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[61] Vanguard, *How our funds voted*, https://about.vanguard.com/investment-stewardship/how-our-funds-voted/ (last visited Feb. 15, 2021).

[62] Rachel Evans, *How Socially Responsible Investing Lost Its Soul,* Bloomberg Businessweek, Dec. 18, 2018, https://www.bloomberg.com/news/articles/2018-12-18/exxon-great-marlboros-awesome-how-esg-investing-lost-its-way.

[63] Zachary Barker, *Socially Accountable Investing: Applying Gartenberg v. Merrill Lynch Asset Management's Fiduciary Standard to Socially Responsible Investment Funds*, 53 COLUM. J.L. & SOC. PROBS. 283, 286 (2020).

[64] *See* DOL Final Rule, *supra* note 9 at 8. *See also* Principles for Responsible Investment, *How Can a Passive Investor Be a Responsible Investor?* (Aug. 2019), www.unpri.org/download?ac=6729, at 15 (ESG passive investing strategies likely result in higher fees compared to standard passive funds); Wayne Winegarden, *ESG Investing: An Evaluation of the Evidence*, Pacific Research Institute (May 2019), www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf, at 11-12 (finding average expense ratio of 69 basis points for ESG funds compared to 9 basis points for broad-based S&P 500 index fund).

[65] David Kathman, *Are Sustainable Funds More Expensive?* Morningstar, March 16, 2017, https://www.morningstar.com/articles/798280/are-sustainable-funds-more-expensive ("Most ESG funds are not very large, so they are not able to benefit from the economies of scale found in funds with huge asset bases").

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for example, has worried about "the extent to which retail investors understand that some of these funds may be prioritizing environmental or social goals above the fund's economic returns."[66] Although early studies provided some evidence for this claim, more recent studies suggest that ESG strategies have evolved and that, in recent years, ESG funds perform as well or better than non-ESG funds.[67]

Critically, ESG criteria and their use in ESG funds are attracting investors: investment dollars are flowing into self-described ESG funds. Net flows of assets into ESG funds "in 2020 were more than double the total for 2019 and nearly 10 times more than in 2018."[68] Many retail investors express strong preferences for ESG investing, and the mutual fund market is driven largely by those preferences.[69]

A final concern is the variety of ESG funds and the investment strategies they offer. ESG funds may be actively-managed or tied to an index. They may focus on a small number of companies or offer broad diversification. They may focus on stock selection or engage actively with their portfolio companies. And they may offer a range of substantive ESG priorities – environmental sustainability, diversity, or ethical and religious values – or take a more generalist approach to ESG. This variation may lead to investor confusion.[70] Dana Reiser and Anne Tucker warn that the dizzying array of ESG mutual funds means that investors cannot readily "differentiate between their claims of ESG effort or impact."[71] Some commentators have called for increased disclosure mandates, such as an SEC requirement that mutual funds disclose how they "approach ESG and long-term matters generally, including voting and any engagement."[72] Acting SEC Chair Allison Lee has warned that greater regulation may be necessary, both to standardize disclosure by ESG fund managers and to "require

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[66] Roisman, *supra* note 22.

[67] *See* Elizabeth Schulze, *'Sustainable' investors match the performance of regular investors, new IMF research finds*, CNBC, Oct. 10, 2019, https://www.cnbc.com/2019/10/10/imf-research-finds-esg-sustainable-investment-funds-dont-underperform.html (reporting evidence that ESG funds sacrificed performance "in the early days" but have evolved to address this sacrifice); Siobhan Riding, *Majority of ESG funds outperform wider market over 10 years,* FIN. TIMES, June 13 2020, https://www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824 (reporting finding that "a sample of 745 Europe-based sustainable funds shows that the majority of strategies have done better than non-ESG funds over one, three, five and 10 years").

[68] Jon Hale, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, Morningstar, Jan. 28, 2021, https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights.

[69] MSCI, *Swipe to invest: the story behind millennials and ESG investing*, March 2020, https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b.

[70] *See, e.g.*, Jon Drimmer, Tara K. Giunta & Audrey Karman, *ESG Strategies Could Be Misleading Investors*, Lexology, March 11, 2020, https://www.lexology.com/library/detail.aspx?g=46ec13e9-da35-47c2-8164-abc44bd991d3 (the "growth in ESG investing has led to increased potential for confusion among the investing public as to what ESG means for a particular company, fund, or investor."),

[71] Reiser & Tucker, *supra* note 14 at 1997.

[72] Andy Green, *ESG Disclosure and Corporate Long-Termism*, 69 CASE W. RES. 909, 925 (2019).

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advisers to maintain and implement policies and procedures governing their approach to ESG investment."[73]

II. Regulatory Pressure on ESG Funds

The significant growth in ESG investing has begun to attract the attention of regulators. In the past year, both the SEC, which comprehensively regulates mutual funds, and the DOL, which regulates the trillions of dollars saved in employee retirement accounts,[74] have taken action motivated by concerns about ESG investing. The SEC sought comments from the public on potential future regulation related to the use of ESG terms in fund names.[75] In doing so, the SEC raised a number of important issues about what, exactly, ESG funds are selling.[76] Meanwhile, the DOL adopted a rule creating potential legal risk for retirement plans that include ESG funds.[77] The DOL rule was adopted over vigorous dissent from much of the asset management industry, although as of early 2021, its future is uncertain.

A. The SEC Names Rule

The SEC has signaled interest in potentially tightening regulation of mutual fund names that suggest ESG investing.[78] This interest is motivated by concern about greenwashing— that a fund might incorporate labels such as ESG, green or sustainable to give investors the false impression that the fund offers ESG exposure when it actually invests conventionally.[79] In a speech, SEC Commissioner Pierce said, "Investors are pouring assets into ESG-labelled investment products, and asset managers are churning out new products in response. While the demand for these products is clear, less clear is what exactly these investors are buying."[80] In particular,

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[73] Allison Herren Lee, Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation, Nov. 5, 2020, https://www.sec.gov/news/speech/lee-playing-long-game-110520

[74] U.S. Department of Labor, History of EBSA and ERISA, *available at* https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa.

[75] Request for Comments on Fund Names, *supra* note 9.

[76] In April 2021, the SEC Division of Examinations released a Risk Alert regarding ESG investing. Risk Alert, Division of Examinations, The Division of Examinations' Review of ESG Investing, Apr. 9, 2021, https://www.sec.gov/files/esg-risk-alert.pdf. The Alert warned of a variety of deficiencies in ESG investing including unsubstantiated claims regarding ESG approaches and proxy voting problems. *Id.* at 4-5. Although the Risk Alert is a statement by the Division's staff, not a formal rulemaking, we note that it focuses on ESG investment strategies as presenting distinctive compliance risks for investment advisers and mutual funds.

[77] DOL Final Rule, *supra* note 9.

[78] Request for Comments on Fund Names, *supra* note 9.

[79] *See* Roisman, *supra* note 22 ("Another risk that concerns me is "greenwashing"—asset managers conveying a false impression to retail investors that a given product is environmentally friendly.").

[80] Commissioner Hester M. Pierce, Lucy's Human: Remarks at Virtual Roundtable on The Role of Asset Management in ESG Investing Hosted By Harvard Law School and the Program on

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Commissioner Pierce highlighted the risk of "an asset manager who talks the ESG talk, but doesn't walk the ESG walk."[81] Given the rapidly increasing demand for ESG funds, should we be concerned that funds that hold themselves out as pursuing social or environmental goals through their names are not actually delivering on those marketing promises?

The SEC's Names Rule, Rule 35d-1, was predicated on the fact that mutual fund names are an important source of information to investors.[82] Under Section 35(d) of the Investment Company Act, it is unlawful for a fund to use in its name "any word or words that the Commission finds are materially deceptive or misleading." [83] Originally, the SEC policed naming conventions through staff guidance and occasional one-off enforcement actions for particularly misleading funds. In 1996, Congress amended the Investment Company Act of 1940 Act to give the SEC explicit rule-making authority to enforce 35(d).[84] As a result, the SEC promulgated the Names Rule in 1997 and adopted it in 2001.[85]

The Names Rule outlines requirements for the use of certain terms in mutual fund names. The most important aspect of the rule is for funds whose name suggests a particular type of investment or industry. Under the rule, a fund whose name contains a type of security, an industry, or a geographic area must hold 80% of their portfolio in investments consistent with the designation.[86] Thus, the "XYZ Pharmaceuticals Sector Fund" must hold 80% of its assets in pharmaceutical companies and the "ABC Bond Fund" must hold 80% bonds.

This much is straightforward, but the Names Rule excludes from the 80% requirement terms that describe a fund's "investment objective, strategies, or policies."[87] Thus, while a "stock fund" must hold 80% stock, there is no requirement under the names rule that a "growth fund" hold 80% of its portfolio in assets with any particular characteristic. For example, "growth" is an investment strategy that has many different connotations. To some, a growth stock is a stock of a company with a low ratio of book value to market value of equity.[88] To others, it connotes smaller

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International Financial Systems (Sept. 17, 2020) https://www.sec.gov/news/speech/peirce-lucys-human-091720.

[81] Peirce, *supra* note 53.

[82] *See* Final Rule: Investment Company Names, I.C. Rel. No. 24828, Jan. 17. 2001, https://www.sec.gov/rules/final/ic-24828.htm ("the name of an investment company may communicate a great deal to an investor").

[83] 15 U.S.C. § 80a-34(d).

[84] Pub. L. 104–290, Title II, § 208 (Oct. 11, 1996).

[85] 17 CFR § 270.35d-1 (2001).

[86] 17 CFR § 270.35d-1(a) (2001).

[87] SEC Release No IC-33809 at 6 (March 2, 2020) available at https://www.sec.gov/rules/other/2020/ic-33809.pdf.

[88] This is the standard definition of "growth" in the asset pricing literature. *See, e.g.,* Eugene F. Fama and Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, J. FIN. ECON. 33, 41 (1993).

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companies with higher potential returns (often coupled with higher risk).[89] Given this ambiguity, assessing what counts as a growth stock is far more difficult for a regulator than identifying "stock" in a portfolio. While names like "growth" and "conservative" are subject to the anti-fraud provisions of securities law and cannot be "deceptive or misleading" within the meaning of 35(d), the bright-line requirement of the Names Rule does not apply to such language in fund names.[90]

Despite the limitations imposed by Rule 35d-1, funds have substantial leeway in the names that they choose. Moreover, investors rely heavily on names in selecting mutual funds. Studies have shown that when mutual funds adopt a name that is associated with a hot investment trend or style, investments into the fund increase even if the name change does not reflect any change in the fund's underlying strategy.[91]

The SEC has not updated the Names Rule in twenty years. In 2020, however, the SEC issued a request for comment on the rule.[92] Among the issues upon which the SEC requested comment was the application of the Names Rule to ESG funds. The SEC specifically noted potential confusion about whether ESG is an investment type (to which the Names Rule would apply) or an investment strategy (to which it would not).[93]

Lurking behind the naming issue is the genuinely unsettled reality of ESG investing. ESG is a rapidly evolving space with numerous strategies pursuing different goals in different ways, and investors may not understand the role of ESG in a particular fund's strategy. For that reason, the SEC asked, suggestively, "Instead of tying terms such as 'ESG' in a fund's name to any particular investments or investment strategies, should we instead require funds using these terms to explain to investors

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[89] *See, e.g.,* "Growth Stock," NASDAQ Glossary, https://www.nasdaq.com/glossary/g/growth-stock.

[90] *Id.*

[91] *See, e.g.*, Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825 (2005) (finding substantial inflows into funds that change their names to look like hot styles); Susanne Espenlaub, Imtiaz ul Haq & Arif Khurshed, *It's all in the name: Mutual fund name changes after SEC Rule 35d-1*, J. BANKING & FINANCE 123, 133 (2015); Sadok El Ghoul, Aymen Karoui, *What's in a (Green) Name? The Consequences of Greening Fund Names on Fund Flows, Turnover, and Performance*, FINANCE RESEARCH LETTERS (forthcoming 2020) (Funds that changed their name to a more ESG-related name had increased flows but no change in performance.).

[92] U.S. Securities and Exchange Commission, Request for Comment, 85 C.F.R. 12,221 (March 6, 2020). Requests for comment are often precursors to rulemaking. The request indicates that the SEC may be looking to revise the Names Rule in the near future. The SEC's 2020 request for comment touched on a number of issues that the SEC staff felt might warrant updating, including the use of derivatives in funds to create leverage, the use of hybrid instruments that do not fit neatly into the categories of "stock" and "bond," and the evolution of index funds.

[93] *Id.* at 9 ("The staff has observed that some funds appear to treat terms such as "ESG" as an investment strategy … while others appear to treat "ESG" as a type of investment").

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what they mean by the use of these terms?"[94] Commissioner Roisman signaled a similar concern in a 2020 speech, saying:

> It would make sense to me that asset managers who want to use these terms to name their funds or advertise their products should be required to explain to investors what they mean. How do the terms "ESG," "green," and "sustainable" relate to a fund's objectives, constraints, strategies, and the characteristics of its holdings? Are "E," "S," and "G" weighted the same when selecting portfolio companies? Does the fund intend to subordinate the goal of achieving economic returns to non-pecuniary goals, and if so, to what extent?[95]

Requiring ESG funds to explain their ESG commitments to investors seems unobjectionable; even absent regulatory change, funds holding themselves out as ESG funds ought to be delivering *something* different to investors to justify their use of the ESG nomenclature. The portfolios of ESG funds should be distinguishable from non-ESG funds. Similarly, although the voting policies of ESG funds might differ among themselves, we would expect ESG funds collectively to vote differently from non-ESG funds, especially on salient ESG issues.

B. DOL Fiduciary Duties in Retirement Plans

Participant-directed retirement accounts, such as 401(k) plans, are among the largest holders of mutual funds.[96] In a participant-directed plan, the employer provides plan participants (employees) with a menu of investment options, and plan participants decide how to allocate their money among those options.[97] Under ERISA[98] and DOL regulations, retirement plans are subject to a complex set of rules regarding investment selection, plan design, and the obligations of employers in interacting with plan assets.[99]

ERISA applies trust law to the management of retirement accounts, with plan sponsors held to stringent fiduciary duties.[100] Under ERISA § 404, fiduciaries for employee benefit plans, including retirement plans, must as act prudently to minimize

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[94] *Id.* at 15.

[95] Roisman, *supra* note 22.

[96] Investment Company Institute, ICI Fact Book 2020 https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2020/20_fb_table63.pdf

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

[98] 29 U.S.C. 1001 et seq.

[99] Fisch & Wilkinson-Ryan, supra note 97 at 614-17.

[100] 29 U.S.C. § 1103(a). These fiduciary duties are commonly enforced through private class action litigation. George S. Mellman and Geoffrey T Sanzenbacher, Center for Retirement Research at Boston College, *401(k) Lawsuits: What are the Causes and Consequences?* (May 2018), https://crr.bc.edu/wp-content/uploads/2018/04/IB_18-8.pdf.

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risk to investors, including by diversifying plan assets.[101] Fiduciaries must also act "solely in the interest" of plan participants for the purpose of "providing benefits to participants and their beneficiaries."[102] These obligations track the trust law fiduciary duties of loyalty and care.[103]

Whether ERISA fiduciaries can properly include ESG funds in retirement plans has been the subject of ongoing debate, a debate premised largely on the question of whether taking nonpecuniary criteria into account is consistent with ERISA's mandate.[104] Different presidential administrations have taken different approaches with respect to whether ESG investing is consistent with ERISA fiduciary duties.

Starting in 1994, the DOL addressed the issue of ERISA plans choosing "economically targeted investments,"[105] or ETIs, defined as "an investment that is selected for the economic benefit it creates, in addition to the investment return to the employee benefit plan investor." The DOL explained that, while fiduciaries need to act "solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to their participants and beneficiaries . . . [t]he fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally."[106] That meant, as long as the ETI investment was as good as other options available to the plan, it could be prudently chosen. A plan could not, however, accept lower economic returns to pursue collateral benefits.

The DOL's guidance on what is now called ESG investing turned more negative in 2008.[107] The 2008 interpretive bulletin stated that "ERISA's plain text does not permit fiduciaries to make investment decisions on the basis of any other factor than the economic interest of the plan."[108] As a result, a fiduciary that weighed collateral benefits when choosing an investment risked breaching its fiduciary duties to the plan. The sole exception, in view of the DOL, was if after "examin[ing] the level of diversification, degree of liquidity, and the potential risk/return" of prospective investments, the fiduciary deemed "two or more investment alternatives" to be "of equal economic value to a plan" in which case, the fiduciary was permitted to factor in the non-economic benefits as a tiebreaker.[109] The bulletin's approach reflected the

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[101] 29 U.S.C. § 1104(a).

[102] *Id.*

[103] See e.g., Schanzenbach & Sitkoff, *supra* note 1 at 399-400 (explaining relevant fiduciary principles under trust law).

[104] *See generally* Schanzenbach & Sitkoff, *supra* note 1.

[105] Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32606, 32607 (1994).

[106] *Id.*

[107] Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61734, 61734 (2008).

[108] *Id.* at 61735.

[109] *Id.* The bulletin required, in such a case, that the choice "be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards. *Supra* note 97, at 61734.

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then-prevailing view that considering ESG factors might benefit society generally but would usually come at the expense of returns.[110]

In 2015, the DOL withdrew the stricter 2008 guidance, and reinstated the 1994 articulation of the standard.[111] In so doing, the DOL emphasized that just because an investment is an ETI or ESG investment does not mean that the investment is of limits or "inherently suspect or in need of special scrutiny."[112] A "fiduciary may not use plan assets to promote social, environmental, or other public policy causes at the expense of the financial interests of the plan's participants and beneficiaries,"[113] but may consider ESG investments that meet those criteria without drawing special scrutiny or paperwork obligations.

A Field Assistance Bulletin in 2018 "clarified" the 2015 guidance by offering new—and more negative—guidance in how plans can consider ESG factors.[114] The bulletin warned that an ERISA fiduciary's use of ESG factors must "be appropriate to the relative level of risk and return involved compared to other relevant economic factors."[115] Reflecting the increasingly widely held view that ESG factors can be relevant to risk and return, the 2018 guidance acknowledged "ESG issues [can] present material business risk[s] or opportunities."[116] The guidance noted that if a fiduciary deems ESG factors to "present material business risk[s] or opportunities," then those factors "should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments."[117]

In 2020, the DOL raised the stakes by engaging in formal rulemaking, rather than sub-regulatory guidance.[118] Its proposed rule, issued on June 30, 2020, took a decidedly negative view of ESG funds as an asset class. The DOL wrote in the preamble that "As ESG investing has increased, it has engendered important and substantial questions and inconsistencies, with numerous observers identifying a lack of precision and rigor in the ESG investment marketplace,"[119] and said flatly that "ESG investing raises heighted concerns under ERISA."[120]

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[110] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-18-398, RETIREMENT PLAN INVESTING: CLEARER INFORMATION ON CONSIDERATION OF ENVIRONMENTAL SOCIAL AND GOVERNANCE FACTORS WOULD BE HELPFUL 2, 17-18 (2018).

[111] Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135, 65135 (2015).

[112] *Id.* at 65,136.

[113] *Id.* at 65,135.

[114] DOL, Field Assistance Bulletin No. 2018-01, Apr. 23, 2018.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] Financial Matters in Selecting Plan Investment, 85 Fed. Reg., 39,113 (2020).

[119] *Id.* at 39,115.

[120] *Id.*

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The DOL pointed to the inconsistencies among ESG ratings,[121] which it described as "vague" to argue that "there is no consensus about what constitutes a genuine ESG investment"[122] The DOL also pointed to the cost of ESG funds, stating that "ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective."[123] The DOL cited the SEC's request for comment on the names rule as evidence of the "questions and inconsistencies" plaguing the ESG space.[124]

Most importantly, the DOL highlighted the concern that ESG funds might be affirmatively inferior to non-ESG funds from a pecuniary perspective. "[I]n the case of some ESG investment funds being offered to ERISA defined contribution plans, fund managers are representing that the fund is appropriate for ERISA plan investment platforms, while acknowledging in disclosure materials that the fund may perform differently or forgo certain opportunities, or accept different investment risks, in order to pursue the ESG objectives."[125]

The DOL's proposed response to these concerns was to reiterate that a plan may not subordinate risk and return to achieve collateral benefits outside the plan. The proposed rule explicitly stated:

> Plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote nonpecuniary benefits or any other nonpecuniary goals. *Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.* The weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return. [126]

The rule would have also barred "the environmental, social, corporate governance, or similarly oriented"[127] funds from being used as default options in 401(k) plans, though such funds were still permissible if their inclusion was based *only*

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[121] *See* supra section I.B.

[122] Financial Matters in Selecting Plan Investments, *supra* note 17 at 39,113.

[123] *Id* at 39,113.

[124] *Id.*

[125] *Id.*

[126] *Id.* at 39,127. Emphasis added. The proposed rule also imposed significant new documentation requirements on cases in which fiduciaries used collateral benefits as a tiebreaker. See § 2550.404a-1 (c)(2) (requiring the fiduciary to "document specifically why the investments were determined to be indistinguishable and document why the selected investment was chosen based on the purposes of the plan, diversification of investments, and the interests of plan participants and beneficiaries in receiving benefits from the plan").

[127] *Id.*

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on "objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types" in selecting options for the plan.[128] In short, the DOL's proposed rule would have subjected ESG investments to heightened scrutiny for potential fiduciary breach.

The proposed rule's skepticism toward ESG funds was met with withering criticism from most of the asset management industry[129], garnering more than 8,000 comments.[130] Three months later, on October 30, 2020, DOL adopted a substantially modified final rule.[131] Significantly, the new rule removed all explicit discussion of ESG considerations and dropped the requirement that ESG funds not be used as QDIAs.[132] The revised version still emphasized the need for fiduciaries to base investment decisions on pecuniary factors and, as a result, poses some risk to the ESG investment space.[133] By focusing investment choice on pecuniary factors, it may be difficult for funds to rely on ESG ratings unless those all of the criteria underlying those ratings are pecuniary in nature.[134]

Much remains uncertain about the DOL rule. The revised rule is largely in line with the 1994 guidance, and it is possible that fiduciaries will feel comfortable adding ESG investments to plans in light of the final rule's neutral take on the selection of ESG investments and the arguments of ESG advocates that ESG is aimed at pecuniary goals. On the other hand, plan sponsors might be sufficiently risk averse, particularly in light of the threat of private litigation, to simply avoid funds that foreground ESG goals. To date, ESG funds are rarely included as an investment option in 401(k)

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[128] *Id.* at 39,118.

[129] Gorte, et al., *Public Comments Overwhelmingly Oppose Proposed Rule Limiting the Use of ESG in ERISA Retirement Plans*, (August 20, 2020) available at https://www.ussif.org/Files/Public_Policy/DOL_Comments_Reporting_FINAL.pdf

[130] Financial Factors in Selecting Plan Investments: A Proposed Rule by the Employee Benefits Security Administration, https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments.

[131] DOL Final Rule, *supra* note 9.

[132] Joseph Lifsics, *The Department of Labor's ESG-less Final ESG Rule*, HARV. L. SCH. FORUM ON CORP. GOV., Nov. 24, 2020, https://corpgov.law.harvard.edu/2020/11/24/the-department-of-labors-esg-less-final-esg-rule/.

[133] In addition, the DOL's skepticism of ESG investing survived in the preamble to the final rule. See Karina Karakulova, *DOL Finalizes Rule on ESG Investing: Is "Nonpecuniary" a Synonym for "ESG"?*, Market Integrity Insights, CFA Institute, Dec. 2, 2020, https://blogs.cfainstitute.org/marketintegrity/2020/12/02/dol-finalizes-rule-on-esg-investing-is-nonpecuniary-a-synonym-for-esg/ ("the Department reiterates throughout the preamble to the final rule its numerous concerns about the 'growing emphasis on ESG investing, and other nonpecuniary factors'").

[134] *See id.* (warning that "industry participants remain concerned about [the rule's] chilling effect on ESG investing and factor integration, as well as about the integrity of the rulemaking process.").

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plans.[135] In addition, the status of the rule under the Biden administration is unclear, and the media has reported that the administration may reverse it.[136] What *is* clear is that the original rule evinced deep skepticism toward ESG investing based on claims about cost and performance that are empirically testable. In what follows, we test some of the claims that motivate the DOL rule and SEC request for comment.

III. Empirical Analysis

This section presents our empirical tests of the differences between ESG funds and other mutual funds. We construct several categories of ESG funds. We then examine the holdings, voting practices, costs, and performance of ESG funds, and compare them with the rest of the mutual fund industry or what we term non-ESG funds. To summarize our results briefly, we find that ESG funds generally deliver greater ESG exposure in their portfolio allocations than non-ESG funds, that they are more likely than other funds to oppose management in the proxy voting, particularly when votes are salient to ESG issues, and that they do not cost more or perform worse than similar non-ESG funds. Overall, our findings suggest that, on average, investors in ESG funds do seem to be getting funds that "walk the walk," at least to some extent, without any material sacrifice in performance or cost.

Section A describes our data. Sections B and C relate primarily to the issues that underlie the SEC's concerns about ESG funds, namely, the questions of whether investors are getting what they think they're getting when they invest in ESG funds. Section B examines the portfolio composition of ESG funds and explores to what extent ESG funds invest in companies with higher ESG ratings. Section C turns to fund voting behavior and explores the differences between the voting patterns of ESG and non-ESG funds. As is appropriate in a regime based on anti-fraud provisions, both of these concerns center around investor expectations. Section D then considers the DOL's primary concerns about ESG funds. Unlike the SEC, the DOL's focus is on pecuniary costs and pecuniary performance. We explore fund fees and performance to investigate the extent to which these concerns are warranted.

A. Description of data

[135] *See, e.g.*, Ron Lieber, *How to Get Socially Conscious Funds Into Your 401(k),* N.Y. TIMES, Jan. 10, 2020, https://www.nytimes.com/2020/01/10/your-money/esg-funds-retirement-401k-plan.html (reporting that 2.9% of 401(k) plans offer even a single ESG fund option).

[136] *See, e.g.*, Lewis Braham, *Biden Administration Will Reverse the Department of Labor's Ruling on ESG Funds, Analysts Say*, BARRON'S, Jan. 31, 2021, https://www.barrons.com/articles/biden-administration-will-reverse-the-department-of-labors-ruling-on-esg-funds-analysts-say-51612094408 (reporting that administration may reverse the rule but that the process could take eighteen months).

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1. Data Sources

The market for ESG products has evolved rapidly, both in the number of such products offered and in their characteristics. Analyzes that use data from as recently as five years ago may not accurately reflect current market realities. Our analysis focuses on 2018-2019 because these are the most recent years for which we have data available.

Mutual fund performance and fee data, as well as holdings data, come from the Center for Research in Security Prices (CRSP) Survivorship Bias Free Mutual Fund Database, which we obtain through Wharton Research Data Services (WRDS). Mutual fund voting data for 2018 and 2019 comes from ISS's Voting Analytics Database, also through WRDS.

We use two different methods to identify ESG funds. [137] First, we screen funds on the basis of their names. We identify all mutual funds whose names contained one or more of a series of relevant keywords.[138] We then hand check this list to ensure that all of the funds that it identified have an ESG connotation. From this, we drop funds that focus primarily on asset classes other than equities,[139] as well as funds for which we are missing data. This yields 204 funds, which we refer to as the "ESG name" funds. Second, we rely on a list of mutual funds identified by Morningstar as being ESG funds. For simplicity, we rely on a list obtained on May 5, 2020. This list contains 314 funds, but we are unable to match 11 of them with CRSP portfolio numbers. Again, we drop funds that focused on asset classes other than equities, leaving 241 funds, which we describe as the "Morningstar ESG" funds. Because of overlap between the two groups, this results in a total of 303 different funds over the sample period.[140]

In addition to Morningstar ESG funds, Morningstar identifies a group of what it calls "ESG Consideration" funds. These are funds that, according to Morningstar, do not have ESG as a central part of their investment strategy, but nevertheless mention ESG as a factor considered by the fund managers in assessing investment options.[141]

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[137] Because of data limitations, some of our analyses below involve a subset of these firms. The number of ESG funds included in the analysis is indicated in each table.

[138] Examples of these keywords include "esg," "impact," "fossil," and "responsible."

[139] This includes funds that focus mostly on debt, funds of funds, and funds that focus on commodity linked derivatives. We retain funds that invest in a mix of debt and equity, including so-called "balanced" funds.

[140] We also identified a small number of fund families that we call "ESG families." These are fund families where, using these two approaches at least half of the fund classes in our sample were coded as "ESG." ESG families are families like Calvert and Parnassus that specialize in various forms of ESG investing. While not all of the funds offered by these families are captured using either the ESG name approach or the Morningstar ESG approach, the specialization of the fund family might reasonably cause an investor to think of them as "ESG funds." We therefore repeat our analysis re-estimate our results including all funds offered by ESG families and find consistent results.

[141] Morningstar Sustainable Funds Landscape 2019, p. 3.

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These funds do not have names that connote ESG investing, nor do they market themselves as ESG funds. While we do not classify these as "ESG" funds, we repeat many of our analyses in this section on this set of funds.

As noted above, hundreds of providers collect ESG data and disseminate ESG ratings, and their ratings are only weakly correlated. We are agnostic on whether it is possible to measure an issuer's ESG in a manner that is objectively correct. To address this concern as well as the possibility that a particular provider's approach may be idiosyncratic, we incorporate ratings from four leading ESG ratings providers – ISS, S&P, Sustainalytics, and TruValue Labs. Providers also differ in coverage, so that some portfolio firms will have ratings from some, but not all, of the providers.

While all four of the ESG ratings that we use involve a comprehensive assessment, they employ significantly different data and methodologies. S&P's ESG ratings rely heavily on information obtained directly from the company in question. Rated companies are sent a detailed industry-specific questionnaire and scores are based on both these responses and other publicly available data.[142]

In contrast, rather than beginning with the company, Sustainalytics's methodology during our sample period sought comment from the company in question only near the end of its six-step process.[143] Its process begins with information collected from the company's own public disclosures, which are then supplemented by reporting from NGOs and the media.[144] In steps three and four, the data are analyzed, and the company is compared against its peers.[145] The draft report is prepared and sent to the company for feedback before the report is revised and made public.[146] For its part, TruValue Labs does not incorporate any data that is obtained directly from the company in creating its ratings. Instead, it relies exclusively on third party data about the company, including reports by regulators, media, analysis, and advocacy groups.[147] TruValue Labs then processes this information using a natural language machine learning algorithm to come up with its scores.[148] These two features, in combination, mean that TruValue Labs is employing both different data and a different analytical approach to constructing its ratings, compared to ISS, Sustainalytics, or S&P. We rely on TruValue Labs's "insight" score in our primary analysis.

Rather than producing a score from 1 to 100, ISS assigns firms a rating from A+ to D-, which can be mapped to a score from 1 to 4 (similar to a grade point average).

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142 *See* S&P DJI ESG Scores, https://www.spglobal.com/spdji/en/landing/investment-themes/esg-scores/ (describing the S&P Dow Jones ESG scores).

143 *Sustainalytics' ESG Rating Research Methodology*, Sustainalytics, 4-5 (2017). Sustainalytics has revised its process over time. For the most recent version, see *ESG Risk Ratings - Methodology Abstract, Version 2.1*, Sustainalytics (2021).

144 *Id.*

145 *Id.*

146 *Id.*

147 https://truvaluelabs.com/why-truvalue-labs.

148 https://truvaluelabs.com/trends/artificial-intelligence.

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The scores are assigned by way of a performance assessment which draws from a pool of over 800 indicators. Industry plays an important role: the overwhelming majority of the indicators ISS uses (approximately 90%) are industry-specific, and the rating structure provides different weights to the indicators depending on the industry.[149] We use the "overall" rating in our primary analysis.

We use these ratings to construct the "ESG tilt" of fund portfolios. To do so, we use the ESG rating of the companies that the fund invests in to calculate the weighted average ESG rating of the fund's portfolio, weighted according to the proportional share that each company represents of the fund's total portfolio. Because we do not have ESG ratings by all providers for all the companies that each fund invests in, we scale the weights by the proportion of the portfolio for which ratings are available.[150] We refer to this as the scaled weighted ESG score, or simply the weighted ESG score for brevity. For robustness, we also use these weighted ESG scores to construct ESG percentile scores. These ESG percentile scores capture a portfolio's relative ranking among all the portfolios in our sample in a given quarter. Because they capture slightly different things, we use both these ESG tilt scores in our analysis.

2. Sample construction

Before beginning our quantitative analysis, we downloaded the prospectuses of each of the funds identified using the fund's name or by Morningstar (either as an ESG fund or as an ESG consideration fund). At least two people – one research assistant and at least one author – then read each prospectus. What we uncovered was a rich and diverse array of different funds.[151] Importantly, the way that we *know* about this diversity is precisely because the funds tell investors about it in their prospectuses.

Each reader independently read and coded the prospectuses for a number of features, including the asset class that the fund was targeting (equities, debt, mixed, other) as well as the fund's objective, including whether it was environmentally focused, focused on social issues, focused on governance, or some combination of these. The readers also noted whether the fund was generic, or whether it has a more specific or specialized objective. Throughout, readers made notes about things that stood out about the funds, and these notes provide additional texture to our understanding of this market. For example, in reading the prospectuses, readers noticed a substantial number of religiously motivated funds, which are intended to

[149] *ESG Corporate Rating*, ISS ESG, 2, on file with authors.

[150] This approach implicitly assumes that any securities in a fund's portfolio that are not rated have a rating that is equal to the weighted average rating of the rest of the portfolio. For robustness, we construct alternative versions of both scores where we assign missing securities a score of 0. We find the same pattern of results using these alternative tilt measures.

[151] While not all of the funds made it into our sample – for example, we omit bond funds from our analysis because bond holders do not have voting rights– they are nevertheless relevant for understanding the overall state of the market, and so we include them in this discussion.

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provide investors with the means of investing according to the tenets of a particular set of religious belief. Readers also made notes describing some of the more specialized funds that they came across, including funds that incorporated concerns about gender diversity (like the SPDR SSGA Gender Diversity Index ETF) or animal welfare (like the Karner Blue Animal Impact Fund).

After completing the initial coding, we took a second pass through the prospectuses to collect information on how the fund described its approach to ESG issues when engaging in proxy voting. Here again, we found a substantial amount of diversity: some had fund manager-wide proxy voting policies that considered ESG matters (to varying degrees), while others had fund-specific voting policies. Some of these policies focused on the impact of ESG issues on firm value, while others explicitly sought to support ESG improvement. Interestingly, some prospectuses explicitly noted the manager's belief that investors in ESG funds might be particularly interested in proxy voting with respect to ESG matters. For example, while BlackRock Investment Stewardship (BIS) generally expects companies to effectively manage environmental and social risks, in describing the proxy voting guidelines for the family of iShares ESG funds (including the iShares ESG MSCI USA ETF), the prospectus specifically contemplates "split voting," where BlackRock would vote differently for different funds.[152] According to the prospectus, this is based on "an assessment that clients invested in the ESG funds may expect more urgent action be taken by the company," and BlackRock's view that that "it is reasonable to expect that clients invested in ESG funds may be less patient with regard to evolution in corporate policies on material E&S matters and therefore wish to send a stronger signal to the company by supporting a shareholder proposal."[153] This suggests that at least some fund managers are attentive to the particularized expectations of investors in ESG funds and are seeking to meet these expectations.

We merge our hand collected information with fund-level data from the CRSP Mutual Fund database. This allows us to identify index funds, fund objectives[154] and other important attributes of the funds in our sample.

In Table 1, we provide a breakdown of the ESG funds that were included in our final sample. In Panel A, we summarize the number of ESG included in our final sample, broken down by how the fund entered our sample. In Panel B, we tabulate the number of certain sub-types of ESG funds in the sample. For brevity, we restrict the breakdown in Panel B to just the sub-types of funds that we investigate in the quantitative analyses in the remainder of this section. Because missing data forces us

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[152] iShares ESG MSCI USA ETF Prospectus (Form N-1A), Appendix A4 – Supplemental BlackRock Sustainable Proxy Voting Guidelines (Dec. 30, 2019) (available at https://www.sec.gov/Archives/edgar/data/1100663/000119312519316357/d750097d485bpos.htm).

[153] *Id.*

[154] Examples of the types of objectives captured by the CRSP objective codes are large cap domestic equity funds, or domestic equity growth funds.

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to omit some of these funds from some of the analyses below, we report the number of ESG funds that we are able to include for each analysis.

Table 1: ESG Mutual Funds in our Sample

Panel A: Number of ESG Funds in Final Sample, by Type	
Identified by Fund Name	204
Identified using Morningstar	241
Identified using Either	303
ESG "Consideration" Funds	274
Panel B: Selected Sub-Types of ESG Fund	
"Environmental" Funds	48
Indexed ESG Funds	69
Specialized ESG Funds	88

B. Portfolio composition

The first thing that an investor might reasonably expect from an ESG mutual fund is a portfolio that is tilted towards companies with better ESG characteristics. That is, an ESG fund should hold larger positions in stocks that perform well on ESG metrics relative to non-ESG funds with similar investment objectives. We therefore investigate the extent to which ESG funds invest in portfolio companies with higher ESG ratings. We do this in two ways. First, we simply plot the distribution of ESG tilts among ESG funds and compare it to the non-ESG funds in our sample. This approach has two major benefits. First, because we are plotting the entire distribution, it is easy to see what part(s) of the distribution are driving the difference, if any, between the groups. Second, because it is so simple, there is no complex statistical analysis required to produce or interpret the results.

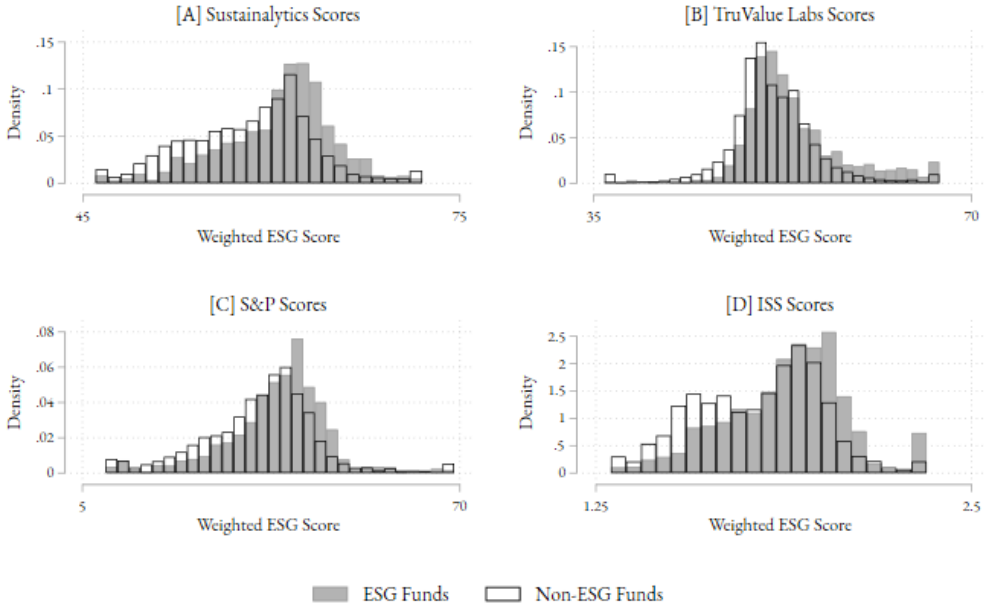
Figure 1 contains histograms using weighted ESG scores from the four different data providers. The shaded histograms represent the distribution of ESG funds, and the transparent histograms represent conventional funds. "ESG funds" refer to fund that either identify themselves as ESG by their name or are identified by Morningstar as ESG funds.[155] Histograms contain data at the fund x quarter level. Panel A includes 259 distinct ESG funds, panel B contains 279 ESG funds, panel C contains 243 ESG funds, and panel D contains 271 ESG funds. In all cases, the non-ESG funds include all funds in the CRSP database (other than those we identify as ESG funds) for which we have enough data to produce a portfolio tilt score. The histograms are constructed

[155] We do not include treat "ESG consideration" funds as "ESG funds" in this analysis. We analyze these funds separately in the regressions reported below.

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using quarterly fund-level data.[156] This means that if a fund appears in the sample for a full year, it will appear 4 times in the histograms.[157]

Figure 1: ESG Tilt of Mutual Fund Portfolios: Weighted ESG Scores



The striking thing about Figure 1 is the consistency across the panels. Using any of the measures of ESG tilt, we find the same general pattern: ESG funds have portfolios with higher ESG scores, on average, than non-ESG funds. As we would expect with an average, the distributions tend to have a central peak, with bars fanning out on both sides. While this general shape applies to both the ESG and the non-ESG funds in the sample, the ESG distribution is shifted slightly to the right of the non-ESG distribution in all four panels. There is, of course, substantial variation across the panels: the pattern is perhaps more visible in panel A, which uses Sustainalytics scores, than it is in panel B, which uses scores from TruValue Labs. Panels C and D, which use scores from ISS and S&P, respectively, appear to be somewhere in between. In panel C, there is a sharp spike of ESG funds slightly above the mean value, but there is simultaneous a significant mass of non-ESG funds at the very top of the distribution. In panel D, the distribution of non-ESG funds is double-humped, while ESG funds are largely missing from the lower hump. Notwithstanding this variation across providers, the overall pattern is the same.

[156] Note that this is fund, not fund class.

[157] To ensure that funds that appear in our sample for longer periods are not driving our results, we construct alternative versions of these histograms using a fund's average weighted ESG score rather than its score each quarter. We find consistent results.

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Certainly, there are some ESG funds with low ESG tilts (represented by the ESG bars towards the left of each of the panels), just as there are some funds that are not classified as ESG funds that have high ESG tilts (represented by the non-ESG bars towards the right of each of the panels). This raises the question whether there is a substantial population of ESG funds that do not exhibit substantial ESG tilt with respect to any of our ESG rating services. Even if the average ESG fund has increased exposure to strong ESG companies, there could be a group of ESG funds that are really conventional funds masquerading as ESG funds. The fact that *most* ESG funds do what they claim to be doing is, after all, cold comfort to an investor who is unlucky enough to invest in one that does not. A significant number of such funds could raise concerns for regulators.

To test whether there are a significant number of "fake" ESG funds, we examine the funds that fall below varying percentile cutoffs under *all four* of the ESG measures. Of course, this alone would not necessarily demonstrate that the fund is not in good faith pursuing an ESG strategy: the fund's portfolio might score well under a different scoring methodology, or the fund might employ its own idiosyncratic ESG analysis. Alternatively, the fund might be pursuing an impact strategy in which it invests in low scoring firms and then pressures management to do better. So while a low score under all four of the methodologies that we use might constitute a red flag, it is not dispositive. As it turns out, however, this red flag goes up for very few funds.

Only two ESG funds are in the bottom 20 percent of tilt for all four data providers, and none stays there for the whole sample period. Of course, even two funds might be cause for concern if the funds are promising investors something quite different from what they are delivering. We therefore return to these funds' prospectuses and websites to investigate how these funds are presenting themselves to investors. Both funds are managed by a fund manager that specializes in "impact and ESG investments": one of them is expressly an impact fund, and the other commits only to considering ESG factors in portfolio selection. Given this impact orientation, it is perhaps unsurprising that the funds sometimes invest in companies with low ESG scores.

Doubling the cutoff to 40 percent implicates only eleven ESG funds, none of which remains there for the whole sample period. Even if we raise the cutoff to the 50^{th} percentile, we find that only 16 funds are consistently below the median, only two of which remain there for the entire sample period. This is a fairly striking result: of the 280 ESG funds for which we have the data to include in this analysis, and even with incomplete insight into ESG exposure, only two ESG funds are not above the median ESG tilt at some point during our sample period. This strongly suggests that the appearance of ESG funds in the left tail of the histograms above is an artifact of the different scoring methodologies used across the four data providers rather than a failure to deliver ESG exposure with respect to some identifiable measure.

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The heterogeneity of ratings approaches also underscores the general consistency of the diagrams in Figure 1. Though each ratings provider measures different firm characteristics in different ways and the correlation among ratings is relatively low, the different ratings consistently show higher ESG exposure for ESG funds when viewed in aggregate.

There are some limitations to simply examining histograms. First, they do not easily accommodate the use of control variables to account for other features of the mutual funds. Second, this analysis does not, without more, allow us to conduct statistical tests to investigate whether observed differences are statistically significant.

We therefore estimate a series of regressions. As with the histograms, we include one observation per fund-quarter in the regressions. In each model, we include CRSP objective code-quarter fixed effects.[158] This allows us to compare the ESG ratings of funds within the same general category, where the "category" is funds classified by CRSP as pursuing the same broad investment objective in a given quarter. This is important because certain types of funds in certain periods might happen to have relatively high or low ESG scores on average. Including this control allows us to make apples-to-apples comparisons. For example, we are not comparing the portfolio of a growth fund in the fourth quarter of 2019 to the portfolio of a small cap fund in the second quarter of 2018.

We present the results of these regressions in Table 2. We separate ESG funds identified by their names from those identified by Morningstar[159] and perform the analysis separately on the two groups. As a result, Table 2 contains results from 16 different regressions, each of which represent a different way to ask the question "on average, do investors in ESG funds tend to get portfolios with more ESG characteristics?" As before, the non-ESG funds in the analysis include all funds in the CRSP database (other than those we identify as the relevant category of ESG fund) for which we have enough data to produce a portfolio tilt score.[160] In Panel A, we measure the ESG tilt of a portfolio using weighted ESG scores (consistent with the histograms in Figure 1). For robustness, we repeat the analysis using ESG percentiles in Panel B.

The results in Table 2 are strikingly consistent. Using all four ESG ratings, and in both panels A and B, we find that ESG funds – whether identified by their names or

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[158] Including these fixed effects allows us to control for the average behavior of different fund styles (i.e., objectives) at each point in time. This is more flexible – and therefore more conservative – than just controlling for fund objective.

[159] See *supra* notes 138 through 141 and accompanying text.

[160] This implies that, for example, a fund identified as an ESG fund by Morningstar but that we did not identify as an ESG fund based on its name will be treated as a non-ESG fund for the purposes of the regression in columns 1, 4 and 7. While this approach makes it slightly harder for us to find statistically significant regression results, it is the fairest way to test whether, for example, funds on the Morningstar list are *actually* different from funds not on that list.

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Morningstar – have portfolios that are substantially more tilted towards companies with high ESG ratings than non-ESG funds. The coefficients on the dummy variables are large and highly statistically significant. For example, the coefficient in column 3 of Panel A (2.2) represents close to the difference between the 75th percentile and median (53.6-51.2= 2.4) of the dependent variable and is larger than the difference between the median and the 25th percentile of that variable (51.2-49.5=1.7). Similarly, the coefficient of 0.1 in column 7 is almost equal to the difference between the 75th percentile and median (1.95-1.82=0.13) of the dependent variable in that regression. The coefficients in columns 1 and 5 represent 69% and 70% of the difference between the 75th percentile and the median of the dependent variables in their respective regressions. These relationships are unlikely to be the result of chance: the p-values associated with all 16 of the coefficients are smaller than 0.001.

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

Panel A: ESG Tilt Measured by Weighted ESG Scores

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

Panel B: ESG Tilt Measured by ESG Percentile

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

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

This pattern does not hold for the funds Morningstar identifies as "ESG consideration" funds. To show this, we repeat the analysis from Table 2 using an indicator for the fact that a fund is an "ESG consideration" fund, as identified by Morningstar. The results, presented in Table 3, are highly variable. In columns 2, 4, 7 and 8, the coefficients are positive (although not statistically significant), while in columns 1, 3, 5 and 6, they are negative (but again not statistically significant). In other words, there is no systematic statistical relationship in either direction. Given this, we are unable to make any firm conclusions about the overall ESG characteristics of these "ESG Consideration" funds. One possibility is that there could the much more variation across funds in this category, making it hard to detect average differences.[161]

Table 3: ESG Portfolio Tilts – ESG Consideration funds

	Sustainalytics Scores		TruValue Labs Scores		S&P Scores		ISS Scores	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG Consideration	-0.117	0.729	-0.798	1.769	-0.793	-1.031	0.008	1.932
	(-0.42)	(0.49)	(-0.76)	(1.34)	(-1.30)	(-0.70)	(0.95)	(1.69)
Type of Score	Weighted Score	Percentile	Weighted Score	Percentile	Weighted Score	Percentile	Weighted Score	Percentile
Objective Code x Quarter FE	YES	YES	YES	YES	YES	YES	YES	YES
N	46432	46432	50658	50658	41778	41778	48304	48304
adj. R-sq	0.070	0.377	-0.002	0.241	-0.002	0.259	0.045	0.397
Number of ESG Funds	253	253	265	265	223	223	260	260

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

To summarize, the results in Tables 2 and 3 make clear that, on average, an investor in an ESG fund is investing in a portfolio that is more tilted towards companies with high ESG scores than an investor in a non-ESG fund. This holds whether we identify ESG funds by their names or using Morningstar's classification. At the same time, we find no consistent evidence that funds that are described as "considering" ESG hold portfolios with more ESG characteristics. By and large then, the evidence suggests, contra the concerns of some at the SEC, that investors in ESG funds are getting something more than "greenwashing."

Of course, the category of "ESG funds" is extremely broad, and "environmental" concerns can be qualitatively different from "governance" concerns. As a result, the

[161] We thank Jason Seligman for this suggestion.

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fact that ESG funds have, on average, portfolios that are substantially more tilted towards companies with high ESG ratings does not necessarily mean that investors in, for example, environmental funds, are getting a fund with a higher *environmental* tilt. To explore this, we drill down further into environmental funds.[162] We manually identify environmental funds by reading the summary prospectus of each ESG fund. We construct the "E-tilt" of each fund in a manner that is analogous to the ESG-tilt measures discussed above, but rather than using the ESG score of the companies in the fund's portfolio, we use each provider's environmental scores.[163] We then estimate a version of the regressions presented in Table 2, where the dependent variable is the environmental tilt of the fund, rather than the ESG tilt, and the independent variable of interest is an indicator variable for the relevant type of environmental funds. While we think that this analysis will be informative, we caution that the number of "Environmental" funds in these regressions is small, which makes it difficult to draw firm conclusions from the regression analysis that follows. As such, we prefer to interpret them as providing suggestive evidence.

[162] We choose environmental funds for this analysis, rather than social or governance focused funds, because the category of environmental funds is the most homogeneous of the three.

[163] TVL does not produce an environmental score. Instead, it produces scores for each SASB general issue category. We aggregate scores from the following categories to produce the firm's environmental score: Air quality; Ecological Impacts; Energy Management; GHG Emissions; Product Design Lifecycle Management; Waste Hazardous Materials; Water Wastewater.

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Table 4: Environmental Portfolio Tilts – Environmental /Non- Environmental Funds

Panel A: E Tilt Measured by Weighted E Scores

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

Panel B: E Tilt Measured by E Percentile

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

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

The results are presented in Table 4. While the results in Table 4 are slightly more mixed than those in Table 2' overall they indicate that environmental funds hold portfolios with higher environmental scores. Beginning with Panel A, the coefficients of interest in columns 1-2 and 5-8 are consistently larger (sometimes much larger) than their analogues in Table 2, and the coefficients in those columns in Panel B, moreover, are about the same size as their Table 2 analogues. This indicates that using either Sustainalytics, S&P, or ISS scores, environmental funds tilt substantially more towards companies with high environmental ratings than comparable non-environmental funds.

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The biggest difference is in columns 3 and 4. Here, we find that using environmental scores constructed using data from TruValue Labs, environmental funds identified using the names (column 3) have a slightly higher environmental tilt in their portfolios, although this difference is not statistically significant. Using funds identified by Morningstar, we find a null relationship – while the point estimates are negative, the t-statistics are quite small, indicating that the relationship is not distinguishable from zero. We note that TruValue does not produce and market separate environmental scores; their emphasis is on SASB categories. As a result, our finding is likely due to our inability to construct an accurate environmental rating by identifying and aggregating the relevant SASB categories.

C. ESG Fund Voting Behavior

We turn next to the question of whether ESG funds vote the shares in their portfolio companies differently from non-ESG funds. Investors in ESG funds may expect that they will vote their shares to support ESG proposals which may be opposed by management and conventional mutual funds. The SEC has explicitly suggested that some ESG funds fail to follow their stated proxy voting guidelines.[164] The failure of so-called ESG funds to vote differently from non-ESG funds has been highlighted as similar to greenwashing, with critics calling out funds for not voting their proxies in accordance with their "values."[165]

We note that there need not be a conceptual connection between an ESG stock selection strategy and an ESG voting strategy. An ESG index fund may select stocks on the basis of an ESG index but the fund's investment advisor may apply uniform voting policies to all the funds it manages, and those voting policies may or may not reflect ESG considerations. Indeed, several of the large asset managers are now incorporating ESG considerations into their voting decisions for both their ESG and non-ESG funds.[166]

The likelihood of a connection between stock selection and voting also depends on the nature of a particular fund's ESG mission. A fund that screens against investing

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[164] Securities Exchange Commission, Division of Examinations, "Division of Examinations' Review of ESG Investing" (April 9, 2021) https://www.sec.gov/files/esg-risk-alert.pdf.

[165] *See, e.g.*, Rao, *supra* note 52 (stating that the voting by State Street's Gender Diversity ETF "appears inconsistent with the stated fund objectives").

[166] *See* BlackRock 2021 Letter to Clients, https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter ("Using our new approach to shareholder proposals, in the second half of 2020, we supported 54% of all environmental and social proposals, having assessed that they were aligned with long-term value"). But see Lucca de Paoli and Alastair Marsh, *BlackRock, Vanguard Show Little Favor for Shareholder ESG Votes*, Bloomberg, Nov. 30, 2020, https://www.bnnbloomberg.ca/blackrock-vanguard-show-little-favor-for-shareholder-esg-votes-1.1529800 (reporting that BlackRock and Vanguard voted in favor of just 11% and 15% of climate resolutions in the twelve months through August 2020).

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in alcohol or tobacco companies for religious or ethical reasons, for example, might not be expected to vote differently on climate change proposals or executive compensation from a non-ESG fund. A fund that screens investments based on their carbon footprint, however, might also support shareholder proposals that seek to address climate change. On the other hand, a fund that has critically evaluated the environmental performance of its portfolio companies and invested in those companies based on the quality of that performance may not view additional shareholder demands in the form of reporting or otherwise to be necessary.

Although these concerns make it difficult to evaluate the significance of a fund's vote on a specific shareholder proposal, it is reasonable to ask whether, on a broad basis, ESG funds vote their proxies differently from non-ESG funds. We examine whether there is a difference in the frequency with which ESG funds vote against management as compared to non-ESG funds. There are at least three reasons why we might expect them to do. First, many ESG funds actively promote their engagement activities. That is, they claim to be seeking to persuade corporations to align their behavior with ESG values.[167] To the extent these engagement activities fail to persuade managers, we would expect such funds to disagree with management about issues with high ESG salience. Second, fund voting behavior might be more salient to the investors in ESG funds than it is to the investors in conventional mutual funds. ESG funds market themselves as advancing certain social goals, and their investors may expect the funds' votes to align with those goals. This may lead ESG funds to vote against management more often. Finally, ESG funds might simply be more independent of management because they are operated by companies that are less likely to seek out 401(k) business from their portfolio companies, which is often argued to induce funds to toe the management line.

Without attempting to distinguish these causal stories, we investigate this question using the Voting Analytics database from ISS for 2018-19. The database contains more than 25,000,000 fund-vote observations during those years on issues including director elections, corporate governance changes, say on pay votes, and shareholder proposals. For each issue, the database records the management recommended vote as well as each fund's actual vote.

Because there is no common identifying variable between Voting Analytics (VA) and other mutual fund databases, we match VA with ESG funds based on names. Not every ESG fund appears in VA (or, in some cases, the name match appears unreliable) so our sample of 303 ESG funds is reduced to 231 for analysis of voting patterns.

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[167] *See* Khurram Gillani, Cheryl I. Smith & Matthew A. Zalosh, *Active engagement: how top ESG managers make a difference*, John Hancock Inv. Mgmt., June 2, 2017, https://www.jhinvestments.com/viewpoints/esg/active-engagement-how-top-esg-portfolio-managers-make-a-difference ("Today's top ESG portfolio managers are proactive, directly engaging with firms and investing in those making the most significant positive impact in a way that potentially enhances long-term financial strength.").

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We investigate whether ESG funds vote differently by regressing a variable indicating that the fund voted against management's recommendation on a variable indicating that the fund is an ESG fund (under either of our definitions). In the first three regressions, models one through three, we use company-year dummy variables to control for the average characteristics of each portfolio company. This allows us to compare ESG funds' votes with the votes of conventional funds *at each particular company*. This control is important because of the propensity of ESG funds—documented above—to hold different portfolios from conventional funds. In all regressions, standard errors are clustered at the fund level to address the correlation among votes coming from the same mutual fund.

In addition to the controls described above, in the first three regressions we include an indicator variable that takes the value 1 if the fund is part of an ESG family (more than 50% ESG funds based on the CRSP data) or 0 otherwise. This is important because mutual fund voting has historically been highly correlated at the family level, with many fund families voting in lockstep. By including separate variables to identify ESG funds and funds in ESG families, it is possible to determine whether ESG voting patterns are entirely driven by ESG-specialist fund families.[168]

In models 4 through 6, we replace the company year dummy variables with dummy variables identify unique combinations of companies and fund families in a particular year. Implicitly, this compares funds from the same family, voting at the same company in a given year. This provides additional robustness against the possibility that ESG fund support for ESG issues is driven solely by ESG-focused families.

[168] While voting within fund families is often correlated, there can be within-family differences, as fund families often have centralized policies for fund voting but may reserve discretion on some issues to individual funds. Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds,* __ *REV. FIN. STUD.* __ (forthcoming), https://ssrn.com/abstract=3124039 offer a comprehensive overview of mutual fund voting behavior. We note that the degree to which fund families centralize their voting decisions has been decreasing. See Fisch, et al., *supra* note 45 (discussing extent to which fund sponsors centralize their voting policies and citing changes to Vanguard's policies).

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Table 5: Likelihood of Voting Against Management Recommendation (LPM)- ESG/Non-ESG Funds

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

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

Table 5 presents the results. Column 1 examines the relationship between classification as an ESG fund and the propensity to support shareholder proposals over management objections. Notably when a shareholder proposal is included in the proxy statement, management virtually always recommends that shareholders vote against it.[169] The results show that ESG funds are substantially more likely to oppose

[169] Typically if management is willing to take the actions required by a shareholder proposal, it reaches a settlement with the shareholder, and the shareholder withdraws the proposal from the proxy statement. *See, e.g.*, Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering of Public Elections*,

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management by supporting shareholder proposals than other funds invested in the same company.

These results do not seem to be driven just ESG fund families. The control variable ESG Family is positive and significantly associated with increased propensity to vote against management, but the ESG fund indicator still has independent predictive value. In unreported regressions, the association between being an ESG fund and voting against management goes through even when all votes from funds in ESG families are dropped from the sample.

Column 2 examines the subset of ESG funds we identify has having an explicit environmental focus ("E" funds). Just as there is a tremendous amount of heterogeneity across ESG funds,[170] "ESG" proposals include a wide variety of issues. One would expect environmental issues to be particularly important to funds focused on environmental issues, and perhaps less interested in social and or governance issues. Once again, these tests focus on shareholder proposals with ESG salience, but this regression includes controls for funds with an explicit environmental focus and shareholder proposals that raise environmental issues. The results show that E funds are statistically no more or less likely than conventional funds to oppose management on shareholder proposals in general. However, when the shareholder proposals address environmental issues "E" funds are far more likely than other funds to oppose management.

Finally, Column 3 steps outside of the context of shareholder proposals and looks at fund votes in uncontested director elections. Funds can express displeasure with management by withholding their votes from directors, even when there are no other candidates. At many companies, if a majority of votes are withheld, the director must resign the board seat. While shareholder proposals can have an impact when they are broadly supported, director elections have immediate, concrete consequences. Notably, fund votes against management recommendations in uncontested director elections are relatively rare.[171] The results in Column 3 show, that ESG funds vote differently from non-ESG funds in these elections, with ESG funds and funds in ESG

126 YALE L.J. 262, 279 (2016) (explaining that "settlement of proposals has become a common practice.").

[170] *See* section I.B, *supra.*

[171] Older work finds mutual funds and other shareholders vote to support management and management proposals more than 90% of the time. *See, e.g.* Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 888 (2010) (reporting that the average percentage of shares voted "for" directors in uncontested elections in 2005-2006 was 95%); Jill Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101, 106 (2018) (finding that average percentages of shares voted in favor of executive compensation plans from 2011 to 2016 was over 90%). This level of support has likely declined in recent years. But see Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy*, 119 COLUM. L. REV. 2029 (2019) (criticizing index fund voting as excessively deferential to management).

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families being sharply more likely to oppose directors. Overall, ESG funds are about twice as likely to withhold votes in an uncontested director election.

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

In summary, we find substantial differences between the voting behavior of ESG and non-ESG funds. Although our results do not speak to the question of whether ESG funds vote against management or in favor of shareholder proposals "enough", there is compelling evidence that they vote differently from their peers, and that a typical ESG fund's mission involves voting policies as well as stock selection.

D. Performance and Fees

Having established that investors in ESG funds seem to receive, on average, a portfolio tilted towards companies with higher ESG scores and distinctive voting behavior, we next ask what this "costs" them. We investigate this "cost" in two ways. First, we ask whether the fees charged by ESG funds are higher than those of comparable non-ESG funds. This represents a direct measure of the cost of choosing to invest in an ESG fund. Next, we consider a broader concept of "cost," which includes both risk and opportunity cost. We therefore ask whether the returns offered by ESG funds differ systematically from those of comparable non-ESG funds. We also adjust these returns for risk, and again look for differences between ESG and non-ESG funds.

As discussed, critics of ESG investing, particularly regulators, are concerned that investors that ESG funds may be sacrificing returns or taking on higher costs. For example, the DOL investments rule, as originally drafted, identified concerns about increasing risk or sacrificing returns to pursue "non-pecuniary" benefits as a major issue. Empirical evidence on fund cost and performance can give context to the need for regulatory intervention.

To assess the fees of ESG funds, we regress expense ratios on our identifiers of ESG funds and present the results in Table 6. Unlike the tilt analyses, in this analysis we use fund class-year level observations, that is, one observation per fund share class per year.[172] We also include a series of additional control variables and fixed effects in the regressions. First, we include objective code-year fixed effects. As in the tilt

[172] We do this because while all classes of a fund relate to the same portfolio (and therefore have the same ESG characteristics) mutual fund fees and expense vary by class. A single mutual fund with one portfolio might offer different share classes at different prices to institutional investors, small retail investors, and retail investors with large balances, for example. Moreover, while mutual funds are required to report their portfolios on a quarterly basis, fee data are available from CRSP on an annual basis.

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regressions presented in Tables 2 through 4, this allows us to ensure that we are comparing "apples-to-apples" by comparing the expenses of funds with similar investment objectives at the same time. Because index funds are known to have lower fees than actively managed funds, we also control for whether a fund is an index fund.

In addition to these fixed effects, we include three different controls for size, since fund fees are known to vary systematically by size.[173] First, we include a control variable for the total net asset value of all funds managed by the fund manager. This allows us to account for the ability of larger asset managers to spread costs over more total dollars invested, for example, because they have more in-house ESG expertise at the manager level. Second, we control for the total net asset value of the fund by adding up the size of all the classes of the fund. This allows us to account for the fact that the managers of larger *funds* might be able to spread certain costs – such as portfolio selection (as well as administrative costs) – across all the classes of the fund. Finally, we control for the total net asset value invested in the particular class itself. For all three of these variables, we use the natural logarithm of the size, as is common in the literature.[174] We cluster standard errors by fund (not class).

[173] Mutual funds enjoy economies of scale at both the fund level and the sponsor level. Vanguard founder Jack Bogle testified before Congress that there are "staggering" economies of scale in the mutual fund industry. Statement of John C. Bogle, Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, 108th Cong. 73 (Mar. 12, 2003), https://archives-financialservices.house.gov/media/pdf/031203jb.pdf at 9, John A. Haslem, *Mutual Fund Economies of Scale: Nature and Sources*, 20 J. WEALTH MGMT. 97 (2017) (explaining sources of economies of scale based on expense types).

[174] We omit the coefficients on the size controls to keep the exposition from becoming cluttered and to keep the focus on the variables of interest. As expected, however, we find that funds offered by larger fund managers have lower fees, on average, as do larger fund classes. Controlling for both the size of the fund class and the size of the fund manager, we find that larger funds tend to have slightly higher fees.

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Table 6: Expense Ratios - ESG/Non-ESG Funds

	(1)	(2)	(3)
ESG Name	-0.00049		
	(-1.47)		
Morningstar		0.00017	
		(0.70)	
Morningstar Consideration			0.00079***
			(4.31)
Class Size Control	Yes	Yes	Yes
Fund Size Control	Yes	Yes	Yes
Manager Size Control	Yes	Yes	Yes
Objective x Year FE	Yes	Yes	Yes
Index Fund FE	Yes	Yes	Yes
Observations	52,592	52,592	52,592
Adjusted R-squared	0.340	0.340	0.341
Number of ESG Funds	178	218	249

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

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The results in columns 1 and 2 show no evidence that ESG funds – identified in either of the two ways – are more expensive, as measured by their expense ratios, than non-ESG funds. This suggests that while investors in these funds are receiving portfolios that have a greater ESG tilt, on average, they are not paying for it through higher expenses. Column 3, in contrast, suggests that the ESG consideration funds identified by Morningstar do charge investors more than their competitors. Interestingly, these are funds that, according to the results in Table 3, do not exhibit higher ESG tilt than mutual funds generally.

Next we turn to returns, both raw and risk adjusted. There is a vigorous ongoing debate over the impact of ESG investing on economic returns.[175] Much of this debate has centered around individual companies. That is, scholars and practitioners have asked whether the stocks of companies with strong ESG scores are likely to outperform the market. The performance we are interested in capturing here is not at the individual company level, but rather at the mutual fund level. This is important because the general performance of high- and low-ESG stocks may not be fully informative about mutual fund performance.[176]

We do not seek to settle the question of whether ESG investing is an advisable strategy here. ESG encompasses a vast number of potential strategies, and advocates point to benefits that they believe will accrue over a very long time-horizon, both of which make empirical evaluation of ESG investing a thorny topic.[177] Our goal is much narrower and more modest: to evaluate whether the empirical claims that underlie the DOL's concerns about the inclusion of ESG funds in 401(k) plans is supported by the evidence. In other words, we look at ESG fund performance over our sample period for evidence suggesting that investors in such funds are bearing short-term costs in terms of reduce performance or increased risk.

To do so, we estimate similar regressions as the expense ratio regressions presented in Table 6, except that here we use returns as the dependent variable in columns 1 through 3. In columns 4 through 6, we adjust these returns for risk by computing Sharpe ratios. An investment's Sharpe ratio, defined as its return divided by its standard deviation, is a common risk adjusted performance measure.[178]

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[175] *See supra* note 31.

[176] *See, e.g.*, Nina Röhrbein, *ESG risk in a portfolio context*, IPE Magazine, April 2010, https://www.ipe.com/esg-risk-in-a-portfolio-context/34522.article (distinguishing between ESG risk at specific issuers and "the link between ESG and the risk/return profile of an entire portfolio").

[177] In addition, some investors may be willing to sacrifice economic returns in favor of social factors. *See, e.g.*, Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare not Market Value*, 2 J. L. FIN. & ACCOUNTING 247 (2017) (arguing that corporations should seek to maximize shareholder welfare, not stock price, and to incorporate shareholders' social preferences into their objective function).

[178] Generally, return in excess of a proxy for a risk-free investment (such as US treasuries) is used in computing a Sharpe Ratio. We abstract from this for simplicity: because our time period is so short and the return on risk-free investments was so low during our sample period, the additional complication is not warranted.

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Intuitively, the Sharpe ratio captures the incremental return that an investor receives per unit of risk. A higher Sharpe ratio therefore implies a higher risk-adjusted return. Because return data are available at the monthly level, we use fund class x month level observations and objective code x month fixed effects. Similar to Table 6, we control for objective codes[179] and whether or not the fund is an index fund using fixed effects, and we include the same three controls for size (manager, fund, and class).[180] We cluster the standard errors by fund and month. The results of these regressions are presented in Table 7.

[179] Because we are using monthly data here, we use objective code x month fixed effects.

[180] As with Table 6, we omitted the coefficients on the size controls from the table to simplify the presentation of the results. In the regressions, we find that large fund classes are associated with better performance in all six columns. In a few of the specifications, larger funds (aggregating across classes) are associated with better raw (but not risk-adjusted) performance. The rest of the size controls are not statistically distinguishable from zero.

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Table 7: Returns and Sharpe Ratios - ESG/Non-ESG Funds

	(1)	(2)	(3)	(4)	(5)	(6)
ESG Name	0.00214*			0.04917*		
	(2.62)			(2.80)		
Morningstar		0.00090			0.01647	
		(1.86)			(1.62)	
Morningstar Consideration			0.00127**			0.02667**
			(3.43)			(3.06)
Class Size Control	Yes	Yes	Yes	Yes	Yes	Yes
Fund Size Control	Yes	Yes	Yes	Yes	Yes	Yes
Manager Size Control	Yes	Yes	Yes	Yes	Yes	Yes
Objective x Month FE	Yes	Yes	Yes	Yes	Yes	Yes
Index Fund FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	721305	721305	721305	721186	721186	721186
Adjusted R-squared	0.651	0.651	0.651	0.780	0.780	0.780
Number of ESG Funds	202	234	260	201	233	259

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

The results in Table 7 suggest that investors in ESG funds do not give up returns – either raw or risk adjusted. If anything, investors in these funds might do a bit better, on average, than investors in non-ESG funds. Both returns and Sharpe Ratios are higher for funds identified as ESG by their names (columns 1 and 4), and the point estimates are also positive for the funds identified by Morningstar, although the results are not statistically significant. Interestingly, the funds that *consider* ESG also do better, on average, than non-ESG funds, although the magnitudes are smaller (roughly half as large) than the funds identified by their names.

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As we did in the portfolio tilt analysis, where we drilled down and looked specifically at environmental funds, we repeat our analyses of costs and performance focusing in on certain specific types of ESG funds. Here, we focus on two categories of funds. First, we investigate the differences, if any, between indexed ESG funds and actively managed funds with respect to fees and performance. Second, we investigate whether there are differences between "generic" ESG funds and specialized funds in terms of costs and performance. For the sake of brevity, rather than including four additional tables, we omit the tables showing these results.

We begin by splitting out indexed ESG funds from their actively managed competitors. We then repeat the analyses in Tables 6 and 7, this time including a variable indicating that a particular ESG fund is indexed. Because we are already including a variable to control for whether a fund is an index fund, adding in this new variable effectively allows us to answer the question: apart from any difference we would expect to see between index funds and actively managed funds, do indexed *ESG* funds behave differently from actively managed ESG funds, in terms of either expenses or performance?

The answer, with respect to fees, is no. Whether identified by their names or by Morningstar, we find no statistically significant difference between the actively managed ESG funds and the index ESG funds. Of course, this does not mean that indexed ESG funds charge the same fees as their actively managed counterparts. Instead, it simply means that their fees do not appear to be different from what we would expect, given all the other controls we include, from other index funds.

Turning to the performance analyses, we find that ESG index funds (whether identified by Morningstar or their names) perform slightly better than actively managed ESG funds. This incremental performance boost is statistically significant at the 5% level with respect to raw returns (the analogue to columns 1 and 2 in Table 7), and is marginally significant (i.e., significant at the 10% level) with respect to Sharpe Ratios, or risk-adjusted performance. Again, this result is on top of any performance differential we see on average between actively managed funds and index funds.

What about highly-specialized ESG funds? These are funds like the Fidelity Women's Leadership Fund, or the LKCM Aquinas Catholic Equity Fund. While these funds have highly varied goals, purposes, and strategies, what they have in common is that the product they are selling to investors is much more specific than a "generic" ESG fund. While there are a relatively small number of these funds in our sample (compared to generic ESG funds), they have received a disproportionate amount of attention. To study the fees and performance of these funds, we repeat the analysis presented in Tables 6 and 7 a third time, this time including a variable indicating that the fund in question is *both* an ESG fund (as identified either by its name or Morningstar, as appropriate) *and* that it is a highly-specialized ESG fund. Including this variable allows us to investigate whether these highly-specialized funds behave

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differently, in terms of fees or performance, than generic ESG funds, given all the other controls we are including.

While the small number of funds in this category suggests caution in interpreting our result, our findings are quite favorable for specialized funds. Beginning with fees, we find that if anything, these specialized funds have lower expenses, once we include all our control variables, than either non-ESG funds or even generic ESG funds, although this difference is only statistically significant when we identify funds using the Morningstar list. Turning to performance, we find no statistically significant difference in any of the four specifications (using raw returns or Sharpe Ratios, where ESG funds are identified by their names or with the Morningstar list). While the relatively small number of specialized funds in the analysis[181] means that these results should be interpreted with caution, there is certainly nothing to suggest that there is cause for concern, let along regulatory intervention.

Overall, the results in this subsection indicate that ESG funds, on average, do not cost investors more than comparable funds in terms of higher fees, reduced returns, or diminished risk-adjusted performance. To be clear, these results do not imply that ESG funds are a superior investment to ordinary funds, and the question of whether ESG investing outperforms conventional investment strategies is beyond the scope of this paper.[182] There is simply nothing in our results that suggests that ESG funds are worse than conventional funds when it comes to costs, returns, or risk. Given that the DOL's primary focus in its ERISA rulemaking is on prudent decision making, it is therefore hard to see why ESG funds should be singled out for particular scrutiny.

ESG consideration funds present a more puzzling set of questions. ESG consideration funds do not hold themselves out as using ESG as a central part of their investment thesis. Instead, they typically commit only to considering it, often among many other factors, and this is typically only disclosed in their prospectuses rather than highlighted in their marketing materials. Their portfolios show no obvious ESG tilt relative to conventional funds, and their fees are higher, though their performance

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[181] For the performance analysis, there are 64 and 43 specialized funds in the regressions using names and the Morningstar list, respectively. Because of missing data on expenses for a few funds, these figures are 60 and 43 for the expense analysis.

[182] We note, as well, that our data allow us to explore this question with respect to a limited time period. Other factors likely contribute to our results, such as the high performance of the technology sector and the poor performance of the oil and gas sector. See, e.g., Esther Whieldon, Robert Clark & Michael Copley, *ESG funds outperform S&P 500 amid COVID-19, helped by tech stock boom*, S&P GLOBAL MARKET INTELLIGENCE, Aug. 13, 2020, https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-outperform-s-p-500-amid-covid-19-helped-by-tech-stock-boom-59850808 (noting that ESG fund performance was "buoyed in part by the funds' heavy weighting in large technology company stocks that have seen their own strong performance"); Siobhan Riding, *Majority of ESG funds outperform wider market over 10 years,* FIN. TIMES, June 13, 2020, https://www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824 (observing that "ESG funds' low exposure to oil and gas gave them an edge at a time when energy stocks suffered steep losses").

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seems to offset these fees at least during our sample period. ESG consideration funds appear to be a distinct category of fund from "true" ESG funds. At the same time, the very fact that the commitment these funds make to their investors in terms of ESG investing – which may be buried somewhere in the fine print of the fund's prospectus – is only to "consider" ESG alongside other factors should lower the level of concern these funds might pose to regulators. On the other hand, it remains unclear *why* these funds make such a commitment at all.[183]

IV. The Implications of These Findings for Regulatory Policy

It is not surprising that the rapid expansion of ESG funds and the introduction of significant number of new products would attract the attention of regulators. However, our findings suggest that a regulatory response specifically targeted to ESG funds is unwarranted. Specifically, our results stand in contrast to the criticisms of high costs, reduced performance, and greenwashing and generally point to a market that is working.

Importantly, we do not argue that ESG investing is an optimal or even advisable strategy. There is a significant literature on ESG investing as an asset management strategy and evaluating the long-term prospects of the numerous iterations of ESG is beyond the scope of this paper. Instead, we simply observe that we find no glaring evidence of problems in the ESG space from the perspective of the regulatory mandate of either the SEC or the DOL. The ESG sector of the fund market does not seem to be functioning worse than other parts of the mutual fund industry.

In this section, we describe the implications or our results for the criticisms of ESG and current regulatory interventions and advance a suggested framework for regulators. We argue that regulators should adopt a presumption against ESG-specific interventions in the absence of clear evidence of ESG-specific problems. If there are issues with transparency around names or problems with fund costs, regulators should begin by questioning whether those issues are unique to ESG funds before making

[183] It is possible that mutual funds purport to consider ESG not to market themselves to investors but to ward off negative reactions to their size and growing influence in the capital markets. *See, e.g.*, Robin Wigglesworth & Richard Henderson, *Vanguard and the US financial system: too big to be healthy?,* FIN. TIMES, Jan. 12, 2020, https://www.ft.com/content/9414052a-3142-11ea-9703-eea0cae3f0de (observing that Vanguard's "deepening control over the stock market could at some point become unhealthy"); John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve* (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 (warning that in the future roughly twelve senior money managers will have power over most US public companies); Lucian Bebchuk & Scott Hirst, *The Spector of the Giant Three*, 99 B.U. L. REV. 721 (2019) (arguing that large asset managers are excessively deferential to management). A working paper by Jeff Schwartz argues that mutual fund complexes engage in stewardship out of fear of public retribution if they fail to do so. *See* Jeff Schwartz, "Public" Mutual Funds, working paper (2021) (on file with authors).

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new rules targeting this particular segment of the market. Our results suggest that, given the current state of the market, the answer to that question is generally "no."

A. Responding to the Critiques of ESG Funds

As noted above,[184] critics have identified numerous concerns about the growth of ESG mutual funds. They have questioned whether ESG funds live up to their names by providing investors with a different (and more sustainable) portfolio of investments than non-ESG funds. They have chastised ESG funds for failing to vote and engage in a manner that is consistent with their ESG mission. They have criticized asset managers for greenwashing – using an ESG name or describing an investment strategy as an excuse to charge investors higher fees. And the Department of Labor, in particular, has worried that fiduciaries will cause their beneficiaries to sacrifice returns by choosing or offering ESG-oriented investments.

A. The Empirical Picture

We interrogate the empirical basis for these concerns and find it lacking. Although our analysis does not speak to the issue of whether ESG funds are a better investment option than non-ESG funds, either from an economic perspective or otherwise, we find that investors in ESG funds largely get what they pay for. ESG funds genuinely offer their investors different portfolio and different voting policies that seem generally aligned with ESG goals as measured by ESG ratings. At least in recent years, these funds do so without higher fees, lower returns or increased risk. There is no evidence, in other words, that ESG funds are not performing on ESG-specific matters, or that they are any worse than the rest of the mutual fund market on matters that are not ESG-specific.

To be fair, our analysis focuses on the past several years, and the market for ESG mutual funds is evolving rapidly. Over the past several years, the number of ESG investing options and the total quantity of assets invested in ESG funds have both exploded. The patterns we document may well be the result of increased competition in the market for ESG funds. It may also be a response to scrutiny by the financial media and regulators and the prospect of regulatory action for high fees or false claims. But if that market has improved, then critics and regulators should note that improvement. Potential problems in the market from years ago should not drive today's regulatory interventions. When focusing on the ESG market as it currently stands, many of the critiques of ESG lack empirical support. This could, of course, change as the market evolves, but taking the market as it is, there seems to be little need for action.

The role of third-party information providers in improving the market is notable. Morningstar and ESG ratings providers have constructed extensive disclosure mechanisms well beyond what regulations require. These evaluations are inputs into

[184] *See* section I.C, *supra.*

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our empirics and our results should provide some comfort that this privately-ordered system of information production is succeeding in providing useful information to investors.[185] While the proliferation of ESG ratings has drawn some criticism, it is clear that the market is responding to investors' desire for more information about ESG factors without regulators stepping in.[186]

Our observations are important in that capital market regulation poses ongoing challenges. Market participants place a premium on innovative new products, and regulators are often slow to identify and respond to market trends. Regulatory responses must be flexible enough to allow new developments while nonetheless protecting against market disruption, misallocation of capital and outright fraud.

Although it is difficult to extrapolate from a single example, the characteristics we document with respect to today's ESG funds offer a promising story for capital market regulation. Existing disclosure requirements, market competition, third party information providers, and the prospect of enforcement action appear to have offered investors sufficient protection against the potential for abuse in connection with the introduction of a new product. The regulatory regime that governed these funds, moreover, was generic: the funds were not subject to specialized, ESG-specific regulation during this time. And importantly, the mutual fund market is a largely retail market and, as such, this protection did not depend on intermediation by more sophisticated investors.

B. The Pecuniary Benefits Debate

Much has been made of the possibility that ESG funds pursue social benefits at the cost of returns to investors. The distinction between collateral-benefit ESG and risk-return ESG drawn by Schanzenbach and Sitkoff [187] was part of the motivation for the DOL rule, and SEC Commissioner Roisman cited the concern that funds might be sacrificing returns without explicit disclosure to investors.[188]

If certain ESG funds are explicitly making decisions that sacrifice returns, that information should be disclosed to investors. And indeed, some funds do disclose on their websites that their investment strategy might lead them to sacrifice returns.[189]

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[185] Portfolio companies, and some investors, have called for standardization of ESG disclosures in order to reduce (from the companies' point of view) the duplicative effort that goes into answering surveys from various ratings providers and (from the investors' point of view) ensure that information is produced in a consistent way. These concerns might provide a reason for the SEC to provide a single disclosure framework, but the motivation would not be that investors in retail mutual funds are not getting the information they need to make informed decisions.

[186] Indeed, the proliferation of ratings providers may well be a response to the breadth of the market. Investors may vary substantially in the nature of the information they seek. In addition, other stakeholders, including consumers, employees and policymakers also consumer ESG information.

[187] Schanzenbach & Sitkoff, *supra* note 1.

[188] *See*, *supra* note 66.

[189] For example, the Calvert Balanced Fund states on its website and in its prospectus that "Investing primarily in responsible investments carries the risk that, under certain market conditions,

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Having done so, these funds provide fiduciaries with clear and explicit notice that their investment strategy might not be appropriate for an employer-sponsored pension plan under ERISA. There is no need for any sort of ESG-specific rule here: plan sponsors can straightforwardly apply standard fiduciary principles in light of this disclosure and might reasonably exclude the fund from a 401(k) menu.

But the vast majority of ESG funds argue that ESG ultimately creates long term value for investors: "doing well by doing good." The claim that ESG can act as a hedge against long-term risks like climate change that may be excluded from conventional financial analysis is hard to test empirically, but the question of the long-term benefits of ESG investing would be far more pressing if there was evidence that investors are bearing short-term costs in pursuit of those benefits.

While our analysis clearly relies upon a relatively short evaluation window, we find nothing to contradict this claim. If anything, ESG funds perform a little better than other funds (net of costs) and cost about the same. Of course, these industry-level measurements are not substitutes for evaluating individual funds as suitable investment options, but if ESG funds as a category do not seem to be making short-term sacrifices, the case for subjecting them to special scrutiny, as the originally proposed DOL rule sought to do, seems weak even if one is skeptical of the long-term prospects of ESG factors.

The DOL should be conscious of a countervailing risk as well. If including ESG funds in retirement plans carries heightened risk for plan sponsors, such funds may simply be excluded from plan menus. ERISA fiduciary duties are backed by a private right of action and plaintiffs' attorneys have enjoyed success in a recent wave of 401k lawsuits alleging excessive fees.[190] This has led 401k plans to simplify and streamline

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the Fund may underperform funds that do not utilize a responsible investment strategy." Eaton Vance, *Calvert Balanced Fund Fact Sheet* (2020) available at https://www.calvert.com/media/23932.pdf. One might dispute whether this is a concession that the fund does not seek to maximize long-run returns, though. After all, the same might be said of any thematic investment strategy. For example, investment strategies based on the traditional "value" factor have substantially underperformed over the past decade. See Amy Whyte, *The Main Reason Quants Have Performed Badly? Value*, INSTITUTIONAL INVESTOR (Jan. 15, 2021) *available at* https://www.institutionalinvestor.com/article/b1q48vjkrgzc1w/The-Main-Reason-Quants-Have-Performed-Badly-Value (noting that "[v]alue investing — allocating to stocks that are seen as cheap relative to the company's underlying financial position — has yielded poor returns for over a decade"). Just as some ESG funds disclose the risks of underperformance that could accompany an ESG investing strategy, some mutual funds that employ a value strategy warn investors that this strategy could lead to underperformance. *See, e.g.*, AQR Large Cap Multi-Style Fund Prospectus (Form N-1A) 4 (Jan. 29, 2021) *available at* https://www.sec.gov/ix?doc=/Archives/edgar/data/1444822/000119312521020794/d80422d485bpos.htm (warning that "there may be periods during which the investment performance of the Fund while using a value strategy may suffer"). Notwithstanding this persistent underperformance, few argue that it is categorically imprudent to employ a value strategy.

[190] *See* Mellman and Sanzenbacher, *supra* note 92.

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their menus,[191] often dropping high-fee options. Few will lament striking high cost-funds from plan menus,[192] but our results show that ESG funds offer something different from conventional funds without increased costs. Deterring plan sponsors from offering such funds risks harming investors financially if some version of the ESG investment thesis turns out to be correct. More broadly, many savers *want* options attuned to ESG issues, and offering these options may be a critical ingredient in encouraging younger investors to save.[193]

C. The Puzzle of ESG Consideration Funds

Finally, we are puzzled by the empirical picture of so-called ESG consideration funds. These funds do not foreground ESG values in their name or marketing but claim to consider ESG as part of their overall investing strategy in their prospectus or other disclosures. These funds *are* more expensive than other funds (though their short-term performance is also better) and exhibit no discernible ESG tilt. These funds are also more numerous than "real" ESG funds.

Because ESG consideration funds do not aggressively market themselves as ESG funds, concerns about greenwashing or investors being misled are more subdued. If ESG consideration funds do not ultimately deliver much ESG tilt, they also never held themselves out as doing more than weighing ESG factors. On the other hand, if mutual fund complexes are touting their consideration of ESG in an effort to avoid challenges to their power to affect corporate decision-making or public retribution for the exercise of that power, the accuracy of their claims may be of concern.[194]

It is fair to ask though, what ESG consideration funds *are* doing. Where ESG funds often provide some clarity on their overall ESG strategy, ESG consideration funds leave investors (at least those who are somehow aware of the nature of these funds) guessing as to precisely how ESG factors come into the equation, if they do at all. Ironically, concerns about insufficient disclosure and high costs commonly directed

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[191] *See 2019 Defined Contribution Trends Survey*, CALLAN INSTITUTE (2019), https://www.callan.com/wp-content/uploads/2019/04/Callan-DC-Trends-Survey-2019.pdf.

[192] For an overview of issues with high-cost options in 401(k) plans, see Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and Dominated Funds in 401(k) Plans*, 124 YALE L.J. 1346 (2015).

[193] *See, e.g., BlackRock, Wells Fargo Reportedly Preparing ESG Funds for 401(k) Plans*, PENSIONS & INV. (June 13, 2018), https://www.investmentnews.com/article/20180613/FREE/180619973/blackrock-wells-fargo-reportedly-preparing-esg-funds-for-401-k-plans. ("The move is aimed at spurring reluctant Millennials to invest more for retirement. There's evidence that a younger generation of investors want such options and have yet to create a nest egg for the future."). For an overview of the interest of younger investors in ESG funds in retirement plans see Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance,* 93 S. CAL. L. REV. 1243, 1300 (2020).

[194] *See* Schwartz, *supra* note 183.

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at ESG funds would appear more suitably directed at ESG consideration funds that do not even foreground their ESG commitment to investors.

D. The Diversity of ESG Ratings

Our results also shed light on the broader ESG ecosystem. Some critics have called out the variety and low correlation of ESG ratings as suggesting that ESG investing lacks discernible content.[195] If the key ratings providers cannot agree about what is important or how to measure it, then how can ESG work as an investment strategy if it takes those ratings as an important input? If an investment strategy cannot be precisely characterized, what prudent person would choose to pursue it?[196]

From an investor point of view, however, it seems less important that ESG ratings agree about individual companies than that they have some consistency at the portfolio level. If we can agree what counts as an ESG fund, then maybe there is less need for precision in determining what counts as an ESG company. This portfolio-level consistency is, in fact, what we find. While ratings are heterogenous, ESG funds tend to have higher ESG-tilt across the ratings we measure.

This is consistent with two possibilities. ESG fund managers might be diversifying across ESG ratings in portfolio selection, so that they exhibit ESG-tilt regardless of the ratings-provider used to evaluate the fund. Alternatively, it may be the ESG fund managers are engaging in their own independent evaluations of companies so that their portfolios exhibit a commitment to ESG in aggregate that the various ratings providers successfully measure, despite micro-level disagreement about individual portfolio companies.

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

Some commentators have criticized fund sponsors for taking advantage of a "low-regulation environment" to offer an opaque and "dizzying array of ESG products."[197] But, as with concerns over the heterogeneity of ESG ratings, why should we worry about numerous, divergent ESG funds when our results suggest that essentially all of these funds provide a degree of ESG tilt with respect to at least one set of ESG ratings? There is no consensus about what ESG investing means or precisely how to do it, but

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[195] *See* section I.C, *supra*.

[196] Alternatively, the variety of ESG ratings and ratings providers may simply reflect that the term ESG is used to convey a mix of strategies and considerations, and investors may have different preferences with respect to those strategies.

[197] Reiser & Tucker, *supra* note 14 at 1999.

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ESG funds are doing *something* measurable and consistent with broad ESG ratings. To demand more precision is to hold the rapidly evolving ESG market to a standard that is simply not applied to other types of funds. There is not great consternation over disagreement about what a "growth" fund is, what counts as a "growth" stock, or that different "growth" funds might take materially different approaches. On what basis should ESG be singled out?

E. An ESG-Neutral Agenda for Regulators

Our results suggest that the market for ESG mutual funds is functioning reasonably well, and regulators should be responsive to that reality. It may be that the ESG fund market of, say, five years ago, consisting of a much smaller number of funds, lacked sufficient competition and transparency to enable effective decision making. But with ESG entering the mainstream, regulators are faced with a more mature, competitive market and ever-improving disclosure practices in which investors seem to be getting the information they need.

In our view, the most productive approach regulators can take when it comes to ESG funds is to adopt a presumptive stance of "ESG neutrality." Many of the critiques of ESG funds might be made with equal force against other types of funds. When faced with a critique of ESG funds, regulators should ask first whether there is an empirical basis for singling out ESG funds, or if the purported ESG issue is one that affects the entire fund market.

Notably, this is more or less the approach that the Department of Labor ultimately took in their rule on financial considerations in asset selection for retirement plans. The initial draft of the rule evinced considerable skepticism toward ESG strategies and emphasized that such funds could only be included in plans if fiduciaries conducted sufficient diligence to establish that such funds would ultimately generate an optimal trade-off of risk and return for investors.[198] The DOL's preface to the proposed rule cited many of the criticisms of ESG outlined above and was read by many in the industry to create a presumption against the use of ESG factors in retirement plans.[199] This singling out of ESG sparked significant criticism of the rule from asset managers who viewed ESG as integral to portfolio management.

In the final version of the rule, the DOL all but abandoned explicit mention of ESG and instead focused on the types of diligence that prudent fiduciaries should conduct before selecting an investment option, regardless of the strategy.[200] While the DOL emphasized the need to produce financial benefits through asset appreciation—rather than benefits to other constituencies—in the context of an ERISA plan, the ultimate rule did not explicitly target fiduciaries' use of ESG factors. Despite this

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[198] U.S. Department of Labor, *Financial Matters in Selecting Plan Investments*, 85 Fed. Reg. 39,113 (June 30, 2020),

[199] *Id.*

[200] DOL Final Rule, *supra* note 9.

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ostensibly neutral approach in the text of the rule, the DOL made its skepticism of ESG investing clear in the preamble, concluding that ESG investing "raises heightened concerns under ERISA."[201] Similarly, the SEC's Risk Alert for ESG Investing, suggesting that ESG products and services pose distinctive risks.[202]

In our view, neutrality rather than special scrutiny is the correct approach. Take the Names Rule as an example. It is certainly the case that ESG terminology in a fund name provides investors with limited information about a fund's approach. But this is true of many other terms that are commonly used in fund names: "growth," "capital preservation," "blue-chip" all connote strategies in broad terms but are hardly concrete. Without taking a position on the need for further regulation of names, it is certainly plausible that investors would be served by increased disclosure around the use of these kinds of terms in fund names. It could well be that revising the 20-year-old names rule makes sense, but the vagueness of ESG-names seems no worse to us than other types of names suggesting investment strategies.

We find no evidence that "sustainable" funds present a more pressing informational problem than more conventional terms like "growth," or that investors are more likely to be misled by one name than the other. In the absence of such evidence, a narrow fixation on ESG names seems misguided. If investors receive too little information to understand what a particular "sustainable" fund seeks to do, the SEC should ask whether disclosures around investment strategies and objectives not subject to the Names Rule's 80% requirement are insufficient for all funds, ESG or not.

V. Conclusion

ESG investing is more important than ever, and ESG mutual funds are the primary mechanism by which ordinary people can engage in ESG investing. Regulators, academics and the financial media have raised concerns, however, about the growth of ESG mutual funds and the substantial asset flows into such funds. Among the concerns are that labeling a fund with the term ESG is potentially misleading, that asset managers may be exploiting investor demand to charge excessive fees, that an orientation toward ESG sacrifices economic value and that ESG funds do not vote their proxies in accordance with their values. These concerns have already resulted in new DOL regulation as well as the prospect of further regulatory intervention by the SEC. The prospect of regulation targeted specifically at ESG mutual funds will likely make it more difficult for mutual fund sponsors to provide

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[201] Karakulova, *supra* note 133.

[202] Risk Alert, *supra* note 76; but see SEC Commissioner Hester Peirce, Statement on the Staff ESG Risk Alert, Apr. 12, 2021, https://www.sec.gov/news/public-statement/peirce-statement-staff-esg-risk-alert (stating that firms do not need "a special set of policies and procedures for ESG").

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these investment options and for employers to include ESG mutual funds in their 401(k) plans.

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

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