William & Mary Business Law Review

Volume 13 (2021-2022)
Issue 2

Article 4

2-1-2022

Why Comparability is a Greater Problem than Greenwashing in ESG ETFS

Ryan Clements

WHY COMPARABILITY IS A GREATER PROBLEM THAN GREENWASHING IN ESG ETFS

DR. RYAN CLEMENTS*

ABSTRACT

This Article argues that comparability in environmental, social, and governance (ESG) exchange traded funds (ETFs) is a much greater problem than greenwashing. Rising demand for sustainable investment products in recent years has been met with an explosion in ESG ETF varieties, and numerous ESG-themed funds have captured massive capital inflows. There is little evidence, however, that deceptive "greenwashing" is widespread in ETFs. ETF issuers face significant reputational costs from such behavior, and there are effectively no consumer switching costs for hyper-liquid, easily accessible ETFs. While nondeceptive practices of asset managers are observable in the zero-sum, highly competitive, asset management game of capturing new ESG-directed capital flows, the subjectivity that ETF issuers use to integrate ESG considerations into the composition of underlying ETF holdings is so disparate that investors face tremendous information acquisition and synthesis costs, and difficulty comparing products. This dilemma grows as product choice expands. ESG ETFs also create unique issuer and commercial index provider conflicts. An investor focused regulatory framework for ESG ETFs would aid comparability, standardization, and consistent product marketing presentation. To this end, this Article builds on the author's prior work on comparative complexity in ETFs by advancing three immediate measures to improve comparability and facilitate more efficient capital allocation in ESG ETF varieties: first, require justification of a fund's usage of ESG terminology in its name through specific ETF disclosures; second, standardize ESG measurement metrics; and third, mandate uniform information presentation layouts on ETF issuer websites.

---

* Assistant Professor, Chair Business Law and Regulation, University of Calgary Faculty of Law. Special thanks to Ryan Amaral for excellent research assistance. The author also wishes to thank Bryce Tingle, Arthur E. Wilmarth Jr., Lawrence Baxter, and Lee Reiners for helpful insights. The views expressed, and any remaining inaccuracies, are solely those of the author.

TABLE OF CONTENTS

INTRODUCTION

Rising demand for investment products that are "sustainable" or "responsible" has been met with an explosion in environmental, social, and governance (collectively, ESG) exchange traded fund (ETF) varieties.[1] Numerous ESG-designated funds have captured massive capital inflows[2] in what is likely the most popular investment product since the 2008 global financial crisis—the ETF.[3] The media over the last several years has frequently cited concerns of "greenwashing"[4] in relation to growth in ESG investing, including in ETFs.[5] There is little evidence, however,

---

[1] *See* Peter Krull, *Opinion: Buyer Beware: What's Really in Your 'Earth-Friendly' ESG Fund*?, MARKETWATCH (Mar. 11, 2021, 1:01 PM), https://www.marketwatch.com/story/buyer-beware-whats-really-in-your-earth-friendly-esg-fund-11615485716 [https://perma.cc/9XFN-PYYH]; *infra* Section I.B.

[2] *See* Paul Blow, *What Is Greenwashing? Here Is What Investors Need to Know*, WALL ST. J. (Nov. 8, 2020, 8:00 PM), https://www.wsj.com/articles/what-is-greenwashing-here-is-what-investors-need-to-know-11604881371 [https://perma.cc/B2TC-EAAT]; *infra* Section I.C.

[3] *See* Ryan Clements, *Are ETFs Making Some Asset Managers Too Interconnected To Fail?*, 22 U. PA. J. BUS. L. 772, 788–94 (2020) [hereinafter Clements, *Too Interconnected*].

[4] Greenwashing is a term that has been frequently used in the media over the last several years to describe when a corporation or investment asset manager purports to integrate meaningful environmental, social, and governance (ESG) considerations into their decision-making processes, but in reality, they are merely creating a "false impression" and generally misleading the public. *See* Celia A. Soehner & G. Jeffrey Boujoukos, *ESG Disclosures and Traps for the Unwary—What's Workable?*, REUTERS (June 30, 2021, 11:57 AM), https://www.reuters.com/legal/legalindustry/esg-disclosures-traps-unwary-whats-workable-2021-06-30/ [https://perma.cc/SJ9J-YTJF]. Greenwashing could be a particularly lucrative temptation in the asset management industry because of tremendous recent investor demand for "sustainable" investment products that are characterized around ESG considerations. *See* Huw Jones, *Regulators to Tighten Scrutiny of Asset Managers to Stop 'Greenwashing'*, REUTERS (June 30, 2021, 10:25 AM), https://www.reuters.com/business/sustainable-business/regulators-tighten-scrutiny-asset-managers-stop-greenwashing-2021-06-30/ [https://perma.cc/FY79-6899].

[5] *See* Krull, *supra* note 1; Blow, *supra* note 2; Tim Quinson, *Al Gore Warns Greenwashing May Stop the Climate Fight in Its Tracks*, YAHOO FIN. (July 13, 2021, 7:01 PM), https://www.bloomberg.com/news/articles/2021-07-13/al-gore-warns-greenwashing-may-stop-climate-fight-in-its-tracks-green-insight [https://perma.cc/C3Y3-LW5B]; Shaheen Contractor, *Cleaning up ETF ESG Greenwashing*, ETF STRATEGY (May 20, 2021), https://www.etfstrategy.com/cleaning-up-etf-esg-greenwashing-98547/ [https://perma.cc/HE7P-FTER]; Tom Eckett, *Are Climate Change ETFs Greenwashing*?, ETF STREAM (Feb. 1, 2021), https://

that this is the case.[6] The most pressing concern in ESG ETFs is not greenwashing—it is side-by-side comparability.[7] Due to a lack of requirements tying the ESG name and terminology usage to specific ETF disclosures, non-standardized ESG scoring metrics, and discretionary information presentation methods on websites by ETF issuers, ESG investors face a formidable task attempting to compare ESG objective ETFs.[8] If not remedied, this could cause significant investor harm and capital misallocation.[9]

ETF issuers face significant reputational costs from engaging in greenwashing, and the consumer-switching costs of hyper-liquid, ultra-fee sensitive, easily accessible ETFs are effectively zero.[10] Yet the terms and practices associated with integrating ESG considerations into investment products, like ETFs, vary considerably.[11] While nondeceptive efforts to integrate sustainable and responsible investment factors are likely being deployed by asset managers in the zero-sum, highly competitive game of capturing new ESG-directed capital flows, the subjectivity that ETF managers use to integrate such considerations into the composition of underlying ETF holdings is so disparate that investors face tremendous information acquisition, synthesis costs, and difficulty comparing products.[12]

---

www.etfstream.com/features/are-climate-change-etfs-greenwashing/ [https://perma.cc/7L8M-M2XE]; Brittany Damico, *Greenwashing*, ETF TRENDS (Sept. 26, 2020), https://www.etftrends.com/esg-channel/greenwashing/ [https://perma.cc/FW7E-2L7L]; Dale Jackson, *'Greenwashing' in ETFs: Why Some Socially Responsible Funds May Be Misleading Investors*, GLOB. AND MAIL (Nov. 5, 2019), https://www.theglobeandmail.com/investing/markets/etfs/article-etfs-can-help-build-an-environmentally-friendly-portfolio-but-beware/ [https://perma.cc/57LT-7KZ5].

[6] *See* Soehner & Boujoukos, *supra* note 4; *infra* Section II.A.

[7] *See* Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds,* 41 CARDOZO L. REV. 1921, 1943, 1997 (2020).

[8] *See id.* at 1940–42, 1947, 1997–2001.

[9] *See id.* at 1943, 1997; Ryan Clements, *Exchange-Traded Confusion: How Industry Practices Undermine Product Comparisons in Exchange Traded Funds*, 15 VA. L. & BUS. REV. 125, 166 (2021) [hereinafter Clements, *Exchange-Traded Confusion*]; *infra* Part III.

[10] *See* Clements, *Too Interconnected*, *supra* note 3, at 792–93; *infra* Part II.

[11] *See* R. BOFFO & R. PATALANO, OECD PARIS, ESG INVESTING: PRACTICES, PROGRESS AND CHALLENGES 32–34 (2020).

[12] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 128–31; *infra* Section II.B.

The ETF market provides a perfect test case to study the problems resulting from ESG product choice "overload."[13] This Article builds on the author's prior work showing how ETFs, as a generalized investment product class, are nearly impossible to perform a true "apples to apples" product comparative analysis, due to a wide array of discretionary operational, management, and financial practices of ETF issuers that obscure and undermine simple ETF product and performance comparisons.[14] It also compliments other legal scholars' recently conducted work showing how the ESG investment space is creating significant consumer protection concerns given its quick expansion, wide variety of product offerings, and largely opaque investment decision-making methodologies.[15]

This Article shows how some of these comparative pathologies are particularly acute in the ETF ESG subproduct segment.[16] As such, the United States Securities and Exchange Commission's (SEC), and other global regulators', primary focus in this increasingly popular investment product segment should be ease of comparability, standardization, and consistent product marketing presentation.[17] Without requiring justification when a fund uses an ESG term in its name,[18] standardizing ESG measurement and scoring metrics,[19] and mandating simplified and uniform issuer website layout standards for ESG information presentation by

---

[13] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 166 ("ETFs present a prime case study of the dual cognitive frictions of 'information overload' and the 'paradox of choice.' Maximum information dissemination is not efficient if the costs of impaired decision-making outweigh the marginal benefits. The deleterious impact of 'information overload' on investors has been well documented, as has the 'limited attention' of consumers in general. Research has also shown that lengthy disclosures can be ineffective. A prospective ETF investor has an exhaustive (and largely unrealistic) plight in attempting to navigate, for multiple comparative fund choices, cumulatively dense and voluminous ETF fact sheets, summary and full prospectus, SAI, and ongoing disclosures like semi-annual and annual reports to get a clear and comprehensive side-by-side picture.").

[14] *See id.* at 128–29.

[15] *See* Reiser & Tucker, *supra* note 7, at 1925–29.

[16] *See infra* Part III.

[17] *See infra* Part IV.

[18] *See* Reiser & Tucker, *supra* note 7, at 1940–42; *infra* Section IV.A.

[19] *See* Reiser & Tucker, *supra* note 7, at 1940, 1998–2001; *infra* Section IV.B.

ETF issuers,[20] ESG ETFs will continually expose investors to harm and potential capital misallocation.[21]

There are now more than three hundred combined ETFs and mutual funds that have sustainable investing as a core strategy, two-thirds of which are equity funds.[22] An investor focused regulatory framework for ESG ETFs would aid comparability, standardization, and consistent product marketing presentation.[23] To this end, the Article builds on this author's prior work on comparative complexity in ETFs by advancing three immediate measures to improve comparability and facilitate more efficient capital allocation in ESG ETF varieties: first, require ETF firms to justify in their disclosures why they used a sustainable term in their name; second, standardize ESG measurement and scoring metrics; and third, mandate uniform information presentation layouts on ETF issuer websites.[24]

Greenwashing grabs the headlines by evoking emotions—envisioning nefarious investment issuers unscrupulously manipulating vulnerable investors—but it oversimplifies, obscures, and distracts from the greater issue.[25] ESG ETFs are commonly incorporating sustainability measures with tremendous subjectivity, using an unregulated, non-standardized universe of available names, metrics, and methodologies.[26] This is creating a product comparison nightmare.[27] Without specific regulatory intervention, ESG ETFs expose investors to continual harm and potential capital and risk misallocation.[28] Enhanced ESG ETF product choices generate information acquisition and synthesis costs, increase

---

[20] *See* Reiser & Tucker, *supra* note 7, at 1940, 1947, 1997; Clements, *Exchange-Traded Confusion*, *supra* note 9, at 184; *infra* Section IV.C.

[21] *See* Reiser & Tucker, *supra* note 7, at 1943, 1997.

[22] *See* Jon Hale, *Are Sustainable Equity Funds Doing What They Claim to Be Doing?*, MORNINGSTAR (Mar. 26, 2020) [hereinafter Hale, *Sustainable Equity*], https://www.morningstar.com/articles/973152/are-sustainable-equity-funds-doing-what-they-claim-to-be-doing [https://perma.cc/BR4K-S52X].

[23] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 187–94.

[24] *See infra* Part IV.

[25] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 128–30; *infra* Section I.A.

[26] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 129–31; *infra* Parts II, III.

[27] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 129.

[28] *See* Reiser & Tucker, *supra* note 7, at 1943, 1997; *infra* Part III.

complexity for investors, while incentivizing unique ETF issuer and commercial index provider conflicts.[29]

The Article will proceed in Part I by first identifying the factors influencing investor demand for ESG investment products, in particular the ETF form where product variety has proliferated.[30] This Part will also look at the variable definition of ESG, including the many emerging subcomponents and evaluation determinants, and will canvas the debate around whether ESG investments are creating real world sustainable impacts or otherwise generating investment return alpha.[31]

Part II will show why comparability is a much greater problem than greenwashing and how ETF issuers have significant incentives to avoid such behavior.[32] It will review numerous studies showing ESG integration into ETFs and show how ETF issuers use ESG evaluation discretion, non-standardized (or justified) fund name usage, variable ESG scoring processes and metrics, and discretionary index construction methodologies to create incredible information acquisition and synthesis costs for investors.[33] Part III shows how these information costs harm investors and impede efficient capital and risk allocation.[34] Finally, Part IV shows how these costs can be mitigated and comparability improved by requiring ETFs to justify in their disclosures their usage of ESG terminology in their fund name, having the regulator develop standardized measurement metrics, and requiring uniform ESG information presentation layouts in ETF issuer websites.[35]

I. SUSTAINABLE INVESTING AND THE RISE OF ESG ETFS

A. Defining ESG in the Exchange Traded Universe

Passive indexing, which includes ETFs, now accounts for nearly half of the entire U.S. stock market.[36] The ESG ETF variety

---

[29] *See infra* Part III.
[30] *See infra* Section I.C.
[31] *See infra* Sections I.A, I.B.
[32] *See infra* Section II.A.
[33] *See infra* Sections II.B, II.C.
[34] *See infra* Part III.
[35] *See infra* Part IV.
[36] *See* Jeff Cox, *Passive Investing Automatically Tracking Indexes Now Controls Nearly Half the US Stock Market*, CNBC (Mar. 19, 2019, 5:56 PM),

is an increasingly popular product subclass. ESG ETF investors are fueled by a desire for meaningful social change, a belief that ESG considerations are "an integral part of sound investing" and will generate higher potential returns, and a conviction that investment managers can have a significant influence on the actions of corporations.[37] ESG investing evokes "emotional drivers" which many financial advisors are actively tapping.[38]

Millennial investors, many of whom are powered by fintech trading applications like Robinhood,[39] have also shown a significant interest in ESG ETFs.[40] There has also been a surge in demand for ESG products by pensions, sovereign wealth funds, insurance companies and institutional investors,[41] as well as by foundations and charities.[42] However, the United States does not currently have clearly defined standards for what constitutes ESG in ETF products[43] and there are no regulated,

---

https://www.cnbc.com/2019/03/19/passive-investing-now-controls-nearly-half-the-us-stock-market.html [https://perma.cc/MBJ4-GJBZ].

[37] *See Factors behind the Growing Popularity of ESG Investing*, NASDAQ (Apr. 24, 2021, 7:00 PM), https://www.nasdaq.com/articles/factors-behind-the-growing-popularity-of-esg-investing-2021-04-24 [https://perma.cc/4EUP-RY84].

[38] *See* Sally Hickey, *Advisers Need to Tap Into ESG Emotional Drivers, Says Aviva*, FT ADVISER (May 24, 2021), https://www.ftadviser.com/investments/2021/05/24/advisers-need-to-tap-into-esg-emotional-drivers-says-aviva/ [https://perma.cc/6TEF-6GX9].

[39] *See* Stephen McBride, *Millennials Will Propel Stocks Higher for Years*, FORBES (Feb. 8, 2021, 9:33 AM), https://www.forbes.com/sites/Stephenmcbride1/2021/02/08/millennials-will-propel-stocks-higher-for-years/?sh=5a9a11326e5d [https://perma.cc/E6H4-YHDD]; Rob Walker, *How Robinhood Convinced Millennials to Trade Their Way through a Pandemic*, MARKER (June 1, 2020), https://marker.medium.com/how-robinhood-convinced-millennials-to-trade-their-way-through-a-pandemic-1a1db97c7e08 [https://perma.cc/AWY9-B5W7].

[40] *See* BOFFO & PATALANO, *supra* note 11, at 17; Meagan Andrews & Shrinal Sheth, *Why ESG Exchange-Traded Funds Might Not Be as Green as You Think*, WORLD ECON. F. (July 8, 2021), https://www.weforum.org/agenda/2021/07/esg-exchange-traded-funds-not-as-green-as-you-think/ [https://perma.cc/JVB5-THXC].

[41] *See* Reiser & Tucker, *supra* note 7, at 1978–80.

[42] *Id.* at 1986–87.

[43] Claire Ballentine, *Big Oil Is Boosting ETF Returns and ESG Funds Are No Exception*, BNN BLOOMBERG (Apr. 30, 2021), https://www.bnnbloomberg.ca/big-oil-is-boosting-etf-returns-and-esg-funds-are-no-exception-1.1597472 [https://perma.cc/QLZ2-3DJY] ("The inclusion of oil companies in a green fund points

or even generally accepted, standards for what good ESG is or is not.[44]

In its simplest form in the context of asset management, ESG refers to investment products that select for companies (or in the case of an ETF, an index that includes such companies) that integrate "environmental," "social," or "governance" mandates into their firm operations.[45] Common environmental goals include decreasing carbon emissions, "green energy production," and firms engaged in positive biodiversity and reforestation initiatives.[46] Social factors include "consideration of people and relationships" such as an underlying company's gender and diversity practices, labor standards, and data protection.[47] Additionally, governance evaluates the oversight "standards" a firm integrates including measures such as board and audit committee structure, executive compensation, whistleblower schemes, lobbying, bribery, and corruption.[48]

The cumulative breadth of possible ESG considerations is spectacular, and the level of resulting subjectivity this entails for an asset manager or commercial index provider in choosing constituent portfolio companies for an ETF index is tremendous.[49] Adding to the complexity, as the SEC recently noted in a risk alert examination review of ESG investing, ESG funds use different mechanisms to integrate ESG altogether.[50] Some funds integrate

---

to the lack of a clear definition—at least in the United States—for what constitutes ESG investing. Some funds like the Vanguard ESG US Stock ETF (ESGV) take a more strict approach, excluding companies involved in adult entertainment, alcohol, tobacco, weapons, fossil fuels, gambling[,] and nuclear power. Others such as Invesco Solar ETF (TAN) and First Trust Global Wind Energy Fund (FAN) are focused on just one aspect of the broader ESG universe.").

[44] Alpay Soytürk, *Danger of Being Corrupted? ESG Ratings Increase Risk of Greenwashing*, INV. WEEK, May 19, 2021, at 18.

[45] *See TrackInsight: ESG ETFs—The Ultimate Guide*, TRACKINSIGHT (Apr. 29, 2021) [hereinafter *TrackInsight: ESG ETFs*], https://www.trackinsight.com/news/esg-etfs-the-ultimate-guide-2/ [https://perma.cc/H7BN-R39Y].

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *See* SEC'S DIV. OF EXAMINATIONS, THE DIVISION OF EXAMINATIONS' REVIEW OF ESG INVESTING 1 (Apr. 9, 2021).

ESG alongside "macroeconomic trends," while others assess public commitments of portfolio companies or apply "negative, positive, or norms-based screens" in their investment process.[51] Some use ESG scores provided by independent ESG ratings providers.[52] Funds may also use an "impact focus" strategy, which seeks a "non-financial outcome," and is inherently ambiguous given the open-ended nature of some social or societal qualitative impact goals like improvements in governance or climate risk practices.[53]

Other ETFs will employ "best in class," or "exclusionary" (like avoiding tobacco or oil and gas) rules in index inclusion, in which case an asset manager directly incorporates ESG considerations in discretionary index construction decisions.[54] Others will attempt to influence corporate policies through the proxy voting process, or construct an ETF underlying index on the basis of a particular ESG "theme."[55] There are also a host of "investment" strategies, including "ESG Momentum" (which focuses on firms who are showing promise in improving their ESG scores).[56] The net result is that ETF investors are left with a cornucopia of product choice with very little (if any) standardized means of making adequate comparative or evaluative judgments other than performance.[57]

B. The Rise and Impact of ESG and Sustainable Investing

Investor holdings in socially responsible investment products have ballooned to more than thirty trillion in globally managed assets.[58] In 2019, eleven U.S. mutual funds "rebranded" themselves as

---

[51] *Id.*

[52] *See* BOFFO & PATALANO, *supra* note 11, at 32.

[53] *Id.* at 32–33.

[54] *See TrackInsight: ESG ETFs*, *supra* note 45 (A "best in class approach" entails a selection of "the most sustainable companies from each sector" which would include the "best" company from generally unsustainable industries like oil and gas or tobacco. An "exclusionary approach" looks to "exclude companies or industries that do not meet minimum standards of sustainability based on international norms—often weapons manufacturers, tobacco companies[,] or fossil fuel producers.").

[55] *See* RESPONSIBLE INV. ASS'N, 2020 CANADIAN RESPONSIBLE INVESTMENT TRENDS REP. 7 (2020).

[56] *See* BOFFO & PATALANO, *supra* note 11, at 33.

[57] *Id.* at 12.

[58] *See* Kenneth P. Pucker, *Overselling Sustainability Reporting*, 99 HARV. BUS. REV. 134, 137 (2021).

ESG, part of a larger trend that has seen forty-two U.S. mutual funds and 123 European mutual funds, since 2015, take similar steps.[59] Supporters of sustainable investing see it as a way for powerful asset managers like BlackRock to positively enact social and environmental change, and improve governance and disclosure, by influencing management through proxy voting while raising the capital costs of divested companies.[60] ESG investing also may allow firms to improve their reputation, improve customer and employee retention, and maintain the trust of shareholders during periods of market uncertainty.[61] Other studies indicate the possibility of enhanced returns or alpha generation through sustainable investing.[62] Also, it allows the "gears of capitalism" to catalyze sustainable outcomes and foster socially popular businesses.[63]

Some believe, however, that asset managers serve as an "impediment" to addressing real issues like climate change, while sustainable investing acts as a "societal placebo" that delays regulatory reform.[64] Others note the collateral rise in carbon emissions,

---

[59] Dieter Holger, *As Funds Jump on the 'Sustainable' Bandwagon, Regulators Raise Concerns*, WALL ST. J. (Apr. 5, 2020, 10:08 PM), https://www.wsj.com/articles/as-funds-jump-on-the-sustainable-bandwagon-regulators-raise-concerns-11586103274 [https://perma.cc/F983-43ZH].

[60] *See The Impact of Green Investors*, ECONOMIST (Mar. 27, 2021), https://www.economist.com/finance-and-economics/2021/03/27/the-impact-of-green-investors [https://perma.cc/87GE-M4UF] (noting the backlash against BlackRock for investment in oil companies); *see also* BOFFO & PATALANO, *supra* note 11, at 11 (discussing benefits of sustainable investment).

[61] *See* BOFFO & PATALANO, *supra* note 11, at 11.

[62] *See* Tim Verheyden et al., *ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification*, 28 J. APPLIED CORP. FIN. 47, 50–51 (2016); Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1716 (2016); Michael L. Barnett & Robert M. Salomon, *Beyond Dichotomy: The Curvilinear Relationship Between Social Responsibility and Financial Performance*, 27 STRATEGY MGMT. J. 1101, 1102 (2006); Gunnar Friede et al., *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 210, 226 (2015).

[63] Down to Business, *ESG 'Fantasy' Distracts from Real Climate Change Fight, Says Former Blackrock Insider*, FIN. POST, at 02:40 (May 5, 2021), https://financialpost.com/commodities/energy/renewables/esg-fantasy-distracts-from-real-climate-change-fight-says-former-blackrock-insider [https://perma.cc/HV5A-N6PG] (concluding that this approach does not successfully combat climate change).

[64] *See* Bernard S. Sharfman, *How BlackRock Strikes Out on the Issue of Climate Change*, OXFORD BUS. L. BLOG (May 21, 2021), https://www.law.ox.ac.uk

environmental damage, executive pay disparities, and income inequality alongside the explosion in ESG investing.[65] Additionally, some of the highest scoring ESG firms include technology giants like Microsoft, Apple, and Intel, who continue to grow in global market power evoking ongoing anti-trust concerns. These technology firms benefit from a lower cost of capital due to ESG fund inflows, despite implementing complex tax avoidance and arbitrage strategies.[66] There is also evidence that high scoring ESG companies employ fewer people than does the average Russell 3000 company.[67]

Contrarian voices call ESG funds a "deadly distraction" from the real problem of climate change. Tariq Fancy, BlackRock's former Chief Investment Officer of Sustainable Investing, suggests that the mega-asset manager's "socially conscious" investment practices are misleading, nothing more than "marketing hype" or "PR spin" and that the "financial services industry is duping the American public."[68] Also, recent research by ESG index provider *Scientific Beta* suggests that ESG investing does not "generate alpha" (outperform the market), and that claims to the contrary are flawed, and do not apply "standard risk adjustments."[69] Relatedly, a recent study noted that "specialized" ETFs (a term that surely characterizes ESG varieties) which are "appealing to investors," deliver negative risk-adjusted returns, at higher fees,

/business-law-blog/blog/2021/05/how-blackrock-strikes-out-issue-climate-change [https://perma.cc/D7CV-Z8RN].

65 *See* Pucker, *supra* note 58, at 137.

66 *See* Jamie Gordon, *Cyclical Regime Change Represents First Real Test for ESG ETFs*, ETF STREAM (June 28, 2021), https://www.etfstream.com/features/cyclical-regime-change-represents-first-real-test-for-esg-etfs/ [https://perma.cc/57Q9-PX3Y].

67 *Id.*

68 *See* Tariq Fancy, *Financial World Greenwashing the Public with Deadly Distraction in Sustainable Investing Practices*, USA TODAY (Mar. 16, 2021, 4:00 AM), https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashing-column/6948923002/ [https://perma.cc/WSY6-S7NB]; Jason Bisnoff, *Free Markets and ESG Investing Won't Fix the Climate Crisis, Says Former BlackRock Sustainability Chief*, FORBES (Mar. 30, 2021, 11:09 AM), https://www.forbes.com/sites/jasonbisnoff/2021/03/30/free-markets-and-esg-investing-wont-fix-the-climate-crisis-says-former-blackrock-sustainability-chief/?sh=7c3ffe8d4c1f [https://perma.cc/T6UR-B3GJ].

69 Tom Eckett, *ESG Does Not Generate Outperformance, Scientific Beta Warns*, ETF STREAM (May 5, 2021), https://www.etfstream.com/features/esg-does-not-generate-outperformance-scientific-beta-warns/ [https://perma.cc/DV6D-9BND].

when the post fund launch interest dissipates.[70] Other empirical studies counter such evidence, however, and show that sustainable funds outperformed non-sustainable varieties during 2020.[71] Although, the heavy tech stock overweighting of many ESG funds may skew their recent performance.[72]

Some analysts believe that passive investment funds—a classification that captures a large portion of the ETF product universe—are less effective in achieving ESG objectives than are "active" fund structures (including both actively managed mutual funds, hedge funds, and actively managed ETFs[73]) because the latter can engage in more impactful stewardship measures and have greater flexibility in divesting underlying portfolio holdings on the basis of ESG factors.[74] Passive index products, on the other hand, have limited leverage other than proxy voting, engagement with portfolio companies, and waiting until an ETF issuer's index review committee assesses the fund's "index constituents," which usually only happens semi-annually.[75] Mega-ETF issuers, like BlackRock, Vanguard, and State Street have also been accused of employing a "low cost, low value" governance model by excessively deferring to management and proxy advisors and employing very few investment stewardship professionals.[76]

---

[70] *See* Itzhak Ben-David et al., *Competition for Attention in the ETF Space*, SSRN (CEPR Discussion Paper No. DP15762, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3783988 [https://perma.cc/PNN6-VY2G].

[71] *See* Hortense Bioy, *Do Sustainable Funds Beat Their Rivals?*, MORNINGSTAR (June 16, 2020, 10:06 AM), https://www.morningstar.co.uk/uk/news/203214/do-sustainable-funds-beat-their-rivals.aspx [https://perma.cc/RPC8-5QC2]; Jon Hale, *Sustainable Equity Funds Outperform Traditional Peers in 2020*, MORNINGSTAR (Jan. 7, 2021), https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020 [https://perma.cc/R99W-ABMS].

[72] *See* Claire Ballentine, *Wall Street Math Shows ESG Funds Can Ride the Value Stock Boom*, BLOOMBERG (Apr. 8, 2021, 11:11 AM), https://www.bloomberg.com/news/articles/2021-04-08/big-tech-fueled-esg-returns-value-stocks-can-takeover-next [https://perma.cc/C6JP-JUQG].

[73] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 160.

[74] Anna Devine, *Rise of ESG Renews Debate over Whether Passive Funds Can Deliver*, FIN. TIMES (June 25, 2021), https://www.ft.com/content/6f79355b-afe7-486a-b103-cb92cba91aed [https://perma.cc/2T7G-CE7D].

[75] *Id.*

[76] Gordon, *supra* note 66.

C. Capital Flows and Product Proliferation in ESG ETFs

Investor capital flows in ESG ETFs have exploded from $10 billion assets under management (AUM) in 2015, to $264 billion by the spring of 2021, while the number of ESG ETFs has grown from 90 to 578 during the same time period.[77] ETFs that seek out particular ESG goals, like those "aligned with specific goals like the United Nations' Sustainable Development Goals or women-owned businesses" grew over 223% during 2020.[78] Mega-ETF issuer BlackRock saw twenty-two percent of global investment flows for all *iShares* products in 2021 flow into ESG and other sustainable ETF varieties.[79] Relatedly, investors have allocated forty percent of all 2021 investor capital flows in European ETFs by mid-year to ESG strategy funds, with the *SPDR Bloomberg SAD US Corporate ESG UCITS ETF* alone seeing $5.5 billion in inflows during the same period.[80]

Drivers for the explosion of ESG investing include a desire to hedge climate or litigation risk, or normative alignments such as a desire to positively impact society.[81] A 2021 global ETF marketplace data survey of ETF investors, financial advisors, and fund managers by consultancy Brown Brothers Harriman reveals a significant trend in investor interest for ESG ETFs.[82] Of

---

[77] Attracta Mooney, *ESG Benchmark Divergence No Barrier to Investor Demand*, FIN. TIMES (May 9, 2021), https://www.ft.com/content/df328c34-6d9b-4fe6-9074-74091ce23ac7 [https://perma.cc/9V3M-5LX3]; *ETFGI Reports Assets Invested in ESG ETFs and ETPs Listed Globally Reached a Record of US$246 Billion at the End of Q1 2021*, ETFIGI.COM (Apr. 28, 2021), https://etfgi.com/news/press-releases/2021/04/etfgi-reports-assets-invested-esg-etfs-and-etps-listed-globally-reached [https://perma.cc/4NRL-WQ53].

[78] *See* Andrews & Sheth, *supra* note 40; *see also ESG ETF Assets Surge Three-Fold in Record-Setting 2020 for ETFs*, TRACKINSIGHT (Jan. 7, 2021), https://www.trackinsight.com/news/esg-etf-assets-surge-three-fold-record-setting-2020-etfs/ [https://perma.cc/X3TH-C4MW].

[79] *See* Mia Kwok, *Spot the Difference. Does ESG Matter in ETFs?*, LIVEWIRE MKTS. (June 15, 2021), https://www.livewiremarkets.com/wires/spot-the-difference-does-esg-matter-in-etfs [https://perma.cc/J2BT-SBUD].

[80] Gordon, *supra* note 66.

[81] Eckett, *supra* note 69.

[82] *See 2021 Global ETF Investor Survey*, BROWN BROS. HARRIMAN (Mar. 8, 2021), https://www.bbh.com/us/en/insights/investor-services-insights/2021-global-etf-survey.html [https://perma.cc/FG5R-CBPX] ("[The survey] captured responses from 382 ETF financial advisors (44%), institutional investors (30%),

surveyed respondents, eighty-two percent indicated a desire to increase their portfolio allocation in ESG ETFs this coming year.[83] It was revealed, however, that a "lack of consistent methodology and framework" as well as ESG ETFs being "too expensive" were factors that could prevent higher allocations from materializing.[84]

Financial advisor recommendations for ESG investment products also heavily influence the direction of capital flows.[85] ESG investment products were recommended by sixty-one percent of U.S. financial advisors according to a recent *Broadridge Financial Solutions Study*, with seventy-one percent of female investment advisors, and sixty-seven percent of advisors under the age of forty recommending sustainable investment products.[86] The survey points to future growth in this sector, with eighty-one percent of advisors looking to raise their client's ESG exposures over the next two years.[87] According to data compiled by TrackInsight, ESG ETFs grew by over 223% in 2020 and now have a record $189 billion AUM.[88]

U.S. financial market data aggregator *Morningstar* documented a post-2015 explosion in new ESG ETF launches in the United States.[89] Between 2005 and 2015, only twenty-seven ESG ETFs were launched in the United States;[90] however, between 2016 and the first half of 2020, there were seventy-five new ESG ETF products distributed in U.S. markets.[91] ESG demand has been so strong that by the end of 2020 more than 250 existing European

and fund managers (26%) from the U.S., Europe, and Greater China to identify key trends, highlight changing sentiment, and explore areas of innovation.").

[83] *Id.*

[84] *Id.*

[85] Max Chen, *Financial Advisors Respond to Increased ESG Demand Among Clients*, ETF TRENDS (Apr. 18, 2021), https://www.etftrends.com/esg-channel/financial-advisors-respond-to-increased-esg-demand-among-clients/ [https://perma.cc/YY2G-XWVT].

[86] *Id.*

[87] *Id.*

[88] *See ESG ETF Assets Surge Three-Fold in Record Setting 2020 for ETFs*, TRACKINSIGHT (Jan. 8, 2021), https://www.trackinsight.com/en/article/esg-etf-assets-surge-three-fold-record-setting-2020 [https://perma.cc/3NCQ-VAWG].

[89] *See* Jon Hale, *ESG Funds Setting a Record Pace for Launches in 2020*, MORNINGSTAR (June 23, 2020), https://www.morningstar.com/articles/989209/esg-funds-setting-a-record-pace-for-launches-in-2020 [https://perma.cc/D8T7-GY4P].

[90] *Id.*

[91] *Id.*

funds, including a large number of ETFs, had been "repurposed" as sustainable investment products with fund managers introducing "ESG criteria to existing funds."[92]

Available ESG ETFs include not only a wide array of equity index products, but also bond and fixed income ETFs, driven by an increased global demand for "green bonds."[93] Interest in ESG ETFs extends beyond the United States, as this product segment has also become the "top choice" for Chinese, Hong Kongese, and Taiwanese institutional investors, fund managers and financial advisors, even though there are "enduring doubts" about whether they provide superior returns.[94]

II. ESG Information Acquisition and Comparison Costs

A. Comparability Is a Greater Problem Than Greenwashing in ETFs

The term "greenwashing" has become a popular way of characterizing a phenomenon where firms and investment managers promote an ESG ethos (often focusing on climate change or pro-environmental measures), yet their corporate actions and portfolio holdings reveal unsustainable practices,[95] or seemingly non-ESG holdings like oil and gas companies.[96] Given the rise in

---

[92] *See* Elena Losavio, *ESG Demand Prompts More than 250 European Funds to Change Tack*, Fin. Times (Feb. 16, 2021), https://www.ft.com/content/e0237f69-a8c8-4bfc-9ccc-c466fb11f401 [https://perma.cc/RD3J-93Z4].

[93] Green bonds or loans often have "green 'use of proceeds'" such that the money raised in the bond issuance is "earmarked solely for environmentally-focused projects." *See* Andrew Willis, *Green Bonds Go Mainstream*, Morningstar (June 8, 2021, 2:15 AM), https://www.morningstar.ca/ca/news/212846/green-bonds-go-mainstream.aspx [https://perma.cc/YZ79-DS8K] (quoting Steve Hawkins, CEO of Horizons ETFs).

[94] *See* Echo Huang, *Chinese Institutions Put ESG ETFs on Most-Wanted List*, Fin. Times (June 11, 2021), https://www.ft.com/content/7b4a3167-e74e-4565-a3ca-32cdcc2f147e [https://perma.cc/YLY6-VEKQ].

[95] *See* Hao Liang et al., *Greenwashing*, Harv. L. Sch. F. on Cor. Governance (Nov. 17, 2020), https://corpgov.law.harvard.edu/2020/11/17/greenwashing/ [https://perma.cc/J68P-JAQV].

[96] Akane Otani, *ESG Funds Enjoy Record Inflows, Still Back Big Oil and Gas*, Wall St. J. (Nov. 11, 2019, 4:29 PM), https://www.wsj.com/articles/top-esg-funds-are-all-still-invested-in-oil-and-gas-companies-11573468200 [https://perma.cc/QP89-H2U9]; Claire Ballentine, *Big Oil Is Boosting ETF Returns and ESG Funds Are No Exception*, BNN Bloomberg (Apr. 30, 2021), https://www.bnnbloomberg.ca/big-oil-is-boosting-etf-returns-and-esg-funds-are-no-exception-1.1597472 [https://perma.cc/F6P9-VMAM].

investor demand for ESG and sustainable investment products, a potential conflict of interest exists where asset managers could publicly signal pro-sustainability principles (like those articulated in the United Nations' Principles for Responsible Investment[97]) to drive capital flows, yet fail to follow through on their actions, or—even worse—engage in unsustainable practices or undesirable holdings.[98]

A scan of recent headlines suggests greenwashing is a major issue.[99] The underlying concern with greenwashing is deception—firms or asset managers endorse sustainability principles to attract capital, but once procured, abandon ESG principles in favor of performance.[100] Yet, as this Article will show, the details are important. First, ESG ETFs are not a binary "ESG or not ESG,"[101] and the term "greenwashing" adds little for investors in navigating fund structures that incorporate some ESG elements yet in widely disparate ways.[102]

There is little evidence that greenwashing is pervasive in asset management or ETFs.[103] Rather, research by Morningstar on

---

[97] *See What Are the Principles for Responsible Investment?*, U.N. PRINCIPLES FOR RESPONSIBLE INV., https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment [https://perma.cc/E9PP-Z2GZ].

[98] *See* Liang et al., *supra* note 95.

[99] *See Sustainable Finance Is Rife with Greenwash. Time for More Disclosure*, ECONOMIST (May 22, 2021), https://www.economist.com/leaders/2021/05/22/sustainable-finance-is-rife-with-greenwash-time-for-more-disclosure [https://perma.cc/UR44-8N2C]; Felicity Spors, *How to Spot Greenwashing—and How to Stop It*, WORLD ECON. F. (May 20, 2021), https://www.weforum.org/agenda/2021/05/how-spot-greenwashing/ [https://perma.cc/82GW-U84U]; Pedro Gonçalves, *Greenwashing Tops Investors' Concerns around ESG*, INV. WEEK (May 24, 2021), https://www.investmentweek.co.uk/news/4031729/greenwashing-tops-investors-concerns-esg [https://perma.cc/RZ93-Q3LP]; James Langton, *Regulators Target "Greenwashed" Products*, INV. EXEC. (May 17, 2021, 12:15 AM), https://www.investmentexecutive.com/newspaper_/news-newspaper/regulators-target-greenwashed-products/? [https://perma.cc/L87K-LEUA].

[100] *See* Liang et al., *supra* note 95.

[101] *See* Todd Cipperman, *ESG or Not ESG? For the SEC, That Is the Question*, FIN. ADVISOR (Apr. 13, 2021), https://www.fa-mag.com/news/esg-or-not-esg--for-the-sec--that-is-the-question-61461.html [https://perma.cc/6CNB-PG6E].

[102] *See* BOFFO & PATALANO, *supra* note 11, at 21, 33 (listing several ESG elements and later describing various investor strategies).

[103] Shruti Medha & Natalie Koh, *Do Fears of Greenwashing Outweigh the Evidence?*, ASIANINVESTOR (Sept. 2, 2021), https://www.asianinvestor.net/article/do-fears-of-greenwashing-outweigh-the-evidence/472294 [https://perma.cc/5T5N-Y87L].

how well ESG funds (including both open-ended funds and ETFs) are adhering to a sustainability mandate shows that "most sustainable equity funds do appear to be walking the walk" in terms of at least some element of ESG integration and using proxy voting power to support ESG shareholder resolutions more frequently than non-ESG oriented funds.[104] The challenge is distinguishing funds without having to rely on private market information aggregators and assessment metrics.[105] Related scholarly work confirms this analysis that for the most part "investors get the ESG that they pay for."[106]

Second, while greenwashing may be a legitimate concern for actively managed mutual funds,[107] it is less of a worry for ETFs.[108] ETF issuers are less likely to use greenwashing to chase investor capital flows due to a variety of factors, including the passive nature of most ETF indexes,[109] their composition, design, and tracking methodologies,[110] and the lower-fee format of ETFs over open-ended mutual funds.[111] ETFs are increasingly being

---

[104] Hale, *Sustainable Equity*, *supra* note 22 (The research report indicated, however, that it was "less likely to find that the portfolio avoids fossil fuels, although it's reasonable to expect a somewhat lower carbon footprint than you would get with a conventional fund.").

[105] *Id.* (the study cites the Morningstar Sustainability Rating and the Morningstar Portfolio Carbon Metrics as examples).

[106] *See* Reiser & Tucker, *supra* note 7, at 2004; *see also id.* at 1926 (discussing how "high-fee, niche funds have more ESG differentiated holdings and voting patterns").

> Our review of the 2018 and 2019 voting records disclosed by funds in each of our three sample groups on ESG-related shareholder proposals generated results broadly aligned with our sense that investors get the ESG they are willing to pay for. Funds offered by large, generalist fund complexes were the only ones to consistently clash with ESG expectations.

Id. at 1958.

[107] *See* Huw Jones, *UK Watchdog Says Some Asset Managers Fail to Back up Green Label on Investment Products*, REUTERS (May 19, 2021, 12:53 PM), https://www.reuters.com/world/uk/uk-watchdog-says-some-asset-managers-fail-back-up-green-label-investment-2021-05-19/ [https://perma.cc/XX3N-5FZK].

[108] *See* Jackson, *supra* note 5.

[109] *See* Clements, *Too Interconnected*, *supra* note 3, at 772, 788–89.

[110] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 131–34, 139–41.

[111] *See Why Are ETFs So Cheap?*, ETF.COM (Nov. 11, 2014), https://www.etf.com/etf-education-center/etf-basics/why-are-etfs-so-cheap [https://perma.cc

viewed as a lower-cost, more-liquid managed asset alternative to mutual funds,[112] both of which are major factors in the recent trend of mutual funds converting to the ETF structure.[113]

ETFs are easily accessible,[114] and there are many comparable products across the universe of ETF varieties.[115] An ETF issuer who actually deceives through greenwashing could be met with swift product switching by investors, and create an investor herd that spreads to other internal product segments of an ETF issuer, and is exacerbated if the media also detects deceptive behavior.[116] It may also attract the scorn of institutional clients and the "wrath of the regulators."[117] Thus, the possibility of reputational harm to ETF issuers from greenwashing serves as an ever-present Sword of Damocles in the hyper-competitive world of ETF fee pricing.[118]

/URG8-CGW5]; Stoyan Bojinov, *Why Are ETFs So Much Cheaper than Mutual Funds?*, ETF DATABASE (June 24, 2015), https://etfdb.com/etf-education/etfs-vs-mutual-funds-why-etfs-are-cheaper/ [https://perma.cc/4JRQ-5K9F].

[112] *See* Adam Levy, *ETF v. Mutual Fund: Similarities and Differences*, MOTLEY FOOL (Sept. 3, 2021, 1:13 PM), https://www.fool.com/investing/how-to-invest/etfs/etf-vs-mutual-fund/ [https://perma.cc/QN69-MA8C].

[113] *See* Claire Ballentine, *If Your Mutual Fund Becomes an ETF, Here's Why*, BLOOMBERG WEALTH (Apr. 1, 2021, 12:00 AM), https://www.bloomberg.com/news/articles/2021-04-01/if-your-mutual-fund-becomes-an-etf-here-s-why-quicktake [https://perma.cc/GM6C-Y6LF].

[114] *See* Lizzy Gurdus, *The SEC Says It's Making ETFs More Accessible—Here's What That Could Mean for Investors*, CNBC (Oct. 2, 2019, 11:56 AM), https://www.cnbc.com/2019/10/02/the-sec-says-its-making-etfs-more-accessible what-that-could-mean.html [https://perma.cc/5KLK-T6FC].

[115] It was reported that by the end of 2020 the total number of global ETFs had grown to 7,602. *See* Statista Rsch. Dep't, *Number of ETFs Globally 2003–2020*, STATISTA (Feb. 18, 2021), https://www.statista.com/statistics/278249/global-number-of-etfs/ [https://perma.cc/4CQ9-U67P].

[116] *See* Cipperman, *supra* note 101 ("Ultimately, investors themselves will enforce compliant behavior in this regard, by avoiding those funds and managers that fail to live up to their stated ESG objectives. This market discipline, along with the SEC's expected focus on ESG enforcement, and the challenges of defining sustainable investing, make it essential for fund managers and their compliance teams to take immediate action to avoid future ESG-related missteps.")

[117] *See id.*

[118] *See* Max Chen, *In a Fund Industry Fee War, ETF Investors Win*, ETF TRENDS (June 9, 2020), https://www.etftrends.com/in-fund-industry-fee-war-etf-investors-win/ [https://perma.cc/5LJ4-9556]; Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2054–55 (2019).

As noted in prior scholarship, the vast proliferation of available ETFs, combined with broad discretion in operational, management, marketing, and financial practices of ETF issuers has made this popular product nearly impossible to effectively compare side-by-side.[119] The increasingly trendy ESG ETF variety is illustrative of the concern of product comparability,[120] and these products have unique information acquisition and synthesis costs and comparative complexities worthy of heightened regulatory scrutiny which has been identified in other recent studies.[121] The current state of global regulation over ESG ETFs does not help to decrease the comparative complexities that investors face.[122]

B. Information Acquisition Costs and Comparative Complexity

The sheer number of products that have taken on a "socially responsible" description is staggering,[123] and it is unrealistic to think that investors, or even advisors for that matter, can easily compare or distinguish these products.[124] In 2019, the Institute for International Finance noted that the "sheer proliferation" of ESG-related terminology is leading to investor confusion.[125] As the universe of available ESG ETF products, and the diversity of terms relating to sustainable investing, continues to grow, investors face a formidable task in accurately comparing products side-by-side.[126] The SEC has acknowledged this problem,[127] and later in this Article direct steps will be presented to aid investor comparability.[128]

---

[119] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 128.

[120] *See* Reiser & Tucker, *supra* note 7, at 1975–76.

[121] *See id.*, at 1940–45.

[122] *See* Andrews & Sheth, *supra* note 40.

[123] *See* Statista Rsch. Dep't, *supra* note 115.

[124] Popular ETF data aggregator website ETF.com lists 141 "socially responsible" ETFs. *See Socially Responsible ETF Overview*, ETF.COM, https://www.etf.com/channels/socially-responsible [https://perma.cc/2UGS-9FT6].

[125] *See* INST. OF INT'L FIN., IIF SUSTAINABLE FINANCE WORKING GROUP REPORT, THE CASE FOR SIMPLIFYING SUSTAINABLE INVESTMENT TERMINOLOGY 1 (Oct. 2019) [hereinafter IIF SUSTAINABLE FINANCE].

[126] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 127–29.

[127] *See* SEC INV. ADVISORY COMM., RECOMMENDATION FROM THE INVESTOR-AS-OWNER SUBCOMMITTEE OF THE SEC INVESTOR ADVISORY COMMITTEE RELATING TO ESG DISCLOSURE 1 (May 14, 2020) [hereinafter SEC RECOMMENDATION].

[128] *See infra* Part III.

Recently published scholarship highlights how industry practices of ETF issuers, including discretionary operational, management, marketing, and financial practices, "undermined" the ability of investors to make accurate side-by-side product comparisons, and this problem is compounded by ineffective disclosures and investor behavioral tenancies.[129] The challenges encountered when attempting to accurately compare ESG ETFs strongly advance contentions in prior scholarship, resulting in tremendous ex ante information acquisition, synthesis, and "processing" costs for ETF investors.[130]

An ETF investor, who desires exposure to ESG oriented products, faces a formidable task in interpreting and synthesizing ESG metrics and attempting to accurately compare such products side-by-side.[131] Popular ETF information aggregator sites do little to ease this comparative burden since they add diverse ESG sub-rating categories, some of which are also behind paywalls.[132]

---

[129] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 128–29; *see also id.* at 161–62 ("Despite influential works asserting 'rational expectations' of investors and 'efficient markets,' a variety of studies counter that investors are prone to error, limited in their rational functioning, and subject to a wide range of decision-making biases and cognitive limitations when processing information. Studies of this nature look to test 'judgmental processes' when investors assess information and make decisions. Mandated securities disclosure serves many worthy public policy goals. Yet the usefulness to investors of such disclosure is (in part) contingent on their ability to accurately organize, synthesize, and utilize information to make better decisions.").

[130] *Id.* at 171 ("Information disclosure can increase competition, improve product quality, alter consumer behavior, and aid in better decision making if it is used correctly. Information will only be used correctly if it is effectively processed .... Not all information that is available will be readily processible, and information will be more effectively processed if it is delivered with adequate context.").

[131] *See* Andrews & Sheth, *supra* note 40**.**

[132] *See ETG Screener*, ETFSTREAM.COM, https://www.etfstream.com/etf-screener/ [https://perma.cc/K5AU-8BLF] (ETF Stream uses an ESG scoring metric called "Basket-Weighted ESG Score" in its assessment mechanism.). While in the screener ETF Stream states the following concerning their scoring metric system, Arabesque defines this score, in a single security, "as a sector specific analysis of each company's performance on financially material environmental, social, and governance (ESG) issues." *Arabesque S-Ray Sustainability Scores*, FACTSET (Oct. 31, 2019), https://www.factset.com/marketplace/catalog/product/arabesque-s-rayr-score-layer [https://perma.cc/R27Q-FH6X]. This can be used to "identify companies ... that are more likely to outperform

For example, in addition to providing an MSCI ESG rating of greater than zero for 1,889 separate funds, at the time of writing, ETF Database also published bespoke subcategory ratings including "ESG Score Peer Percentile," "ESG Score Global Percentile," "Carbon Intensity," "SRI Exclusion Criteria," and "Sustainable Impact Solutions."[133]

Peer aggregator site ETF.com recently listed 1,941 ETFs with an MSCI ESG rating above zero, with distinct ESG subcategory ratings including "ESG Rating," "Score Peer Rank," "Score Global Rank," "Carbon Intensity," "Sustainable Impact Exposure," and "SRI Screening Criteria Exposure."[134] Having such an ex ante informational burden to navigate, without a standardized regulatory solution, is not in the best interests of investor protection.[135] Not only do ETF managers use diverse and discretionary methods,[136] research has revealed that commercial ESG rating agencies also disagree on the definition of ESG, and the characteristics, attributes, and standards associated with each of the "E[nvironmental]," "S[ocial]," and "G[overnance]" subcomponents.[137] In an ETF global data survey by Brown Brothers Harriman, respondents were canvassed "how" they evaluated ESG ETFs, and the responses were diverse and inconsistent; and not a single suggested individual factor was chosen by a majority of survey participants.[138] There have been recent industry attempts to synthesize, and bring greater transparency, to the underlying selection process driving asset manager ESG investments. Such

---

over the long run." *Id.* (Consult the Arabesque S-Rat methodology for more details.) The aggregator site's screener also includes individual "E," "S," and "G" scores for respective ETFs, as well as stats for "problematic" industries such as gaming, defense, tobacco, oil, coal, adult industries, and stem cells. *Id.*

[133] *See Screener*, ETFDB.COM, https://etfdb.com/screener/ [https://perma.cc/45KU-DSJ2].

[134] *See ETF Finder*, ETF.COM, https://www.etf.com/etfanalytics/etf-finder [https://perma.cc/5KU8-JNSX].

[135] *See* SEC RECOMMENDATION, *supra* note 127, at 1.

[136] *See id* at 4.

[137] *See* Monica Billio et al., *Inside the ESG Ratings: (Dis)Agreement and Performance*, 28 CORP. SOC. RESP. & ENV'T MGMT. 1426, 1427 (2021).

[138] *See 2021 Global ETF Investor Survey*, *supra* note 82 (The sampled participants were provided with the evaluation factors, "third-party ratings," "[i]n-house/proprietary ESG ratings criteria," "[r]eview company statements/reports for underlying holdings," and "[b]rand recognition of ETF manager.").

attempts include those of the working group organized by the Investment Company Institute,[139] and advocacy efforts by the Institute of International Finance to simplify ESG investment terminology.[140] Yet investors are largely left to their own devices to navigate and distinguish these increasingly complex, diverse, and discretionary industry taxonomies and practices.[141]

As noted in prior scholarship, mega-ETF issuers like BlackRock stand to materially benefit from an environment of informational complexity, and ex ante information acquisition costs faced by ETF investors, because of a behavioral principle known as "overreliance on salience" (also known as the "quality heuristic") where larger firms are interpreted as providing better and higher-quality products given their size and public profile.[142] A

---

[139] *See* INV. CO. INST., FUNDS' USE OF ESG INTEGRATION AND SUSTAINABLE INVESTING STRATEGIES: AN INTRODUCTION 1, 10 (July 2020) (working group members include Ariel Investments, LLC; BlackRock, Inc.; Capital Research and Management Company; Columbia Threadneedle Investments; Dimensional Fund Advisors; Eaton Vance Corp.; Fidelity Investments; J.P. Morgan Asset Management; Karla Rabusch, Lord Abbett Funds; Neuberger Berman; New York Life Investment Management LLC; Nuveen; T. Rowe Price; Vanguard; Voya Investment Management).

[140] *See IIF Proposes Alignment Around Fewer, Simpler Sustainable Investment Terms to Enhance Transparency and Bolster Confidence in the Integrity of the Market*, INST. INT'L FIN. (Nov. 6, 2019), https://www.iif.com/Press/View/ID/3637/IIF-Proposes-Alignment-Around-Fewer-Simpler-Sustainable-Investment-Terms-to-Enhance-Transparency-and-Bolster-Confidence-in-the-Integrity-of-the-Market [https://perma.cc/AXT3-L5E4].

[141] *See* INV. CO. INST., *supra* note 139, at 2, 8 (the aforementioned working group identifies a "Broad Spectrum of ESG-Related Investing Strategies" and both qualitative and quantitative practices utilized by asset managers including self-selected integration of ESG factors into investment decisions, both exclusionary and inclusionary practices, and "impact" factor analysis).

[142] Clements, *Exchange-Traded Confusion*, *supra* note 9, at 170 ("[W]hen ETF investors attempt to compare products, the potential exists for a disproportionate windfall in investment assets to flow to the largest ETF firms because of a concept called 'overreliance on salience.' This could create a bias for 'brand names' as 'perceptions of quality based on the brand's profile,' rather than investors looking into the specific details and factors associated with a particular fund. Salience could also be generated by the steady media coverage of the largest ETF firms, particularly BlackRock, in light of its growing influence within the U.S. government in facilitating the coronavirus stimulus."); *see* ONT. SEC. COMM'N, BEHAVIORAL INSIGHTS KEY CONCEPTS, APPLICATIONS AND REGULATORY CONSIDERATIONS 33 (Mar. 29, 2017).

similar phenomenon has been observed with initial public offering performance and the "reputation" of the investment bank underwriting the offering.[143] In BlackRock's case, perception bias is aided by the government's previous high-profile reliance on the asset manager's expertise to navigate both the 2008 global financial and 2020 coronavirus financial crises.[144]

BlackRock is positioning itself to be the world's perceived leader in ESG investing given CEO Larry Fink's consistent message of a need for sustainability,[145] the firm's increasing ESG-integration media footprint,[146] and expanding menu of ESG ETFs.[147] As such, an investor overwhelmed by choice in the ESG ETF universe could easily defer to a BlackRock product because they perceive them to be the best, given the firm's size and public influence,[148] without really digging into the ways that BlackRock's products differ from other ESG choices.

C. Commercial ESG Index Providers and ETF Issuer Bespoke ESG Indices

Navigating the ESG ETF universe is also complexified by the nature of indexing itself.[149] The rise of ESG investment demand, increased capital flows and the proliferation of available ETFs has collaterally given rise to an explosion in ETF indices, including from conventional commercial index provider powerhouses MSCI,

---

[143] Richard B. Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1056–62 (1990).

[144] *See* Gillian Tett, *Why the US Federal Reserve Turned Again to BlackRock for Help*, FIN. TIMES (Mar. 26, 2020), https://www.ft.com/content/f3ea07b0-6f5e-11ea-89df-41bea055720b [https://perma.cc/2V98-YEVH]; Pedro Nicolaci da Costa, *A Glaring New Conflict of Interest Undermines Public Trust in Federal Reserve*, FORBES (Apr. 20, 2020, 12:36 AM), https://www.forbes.com/sites/pedrodacosta/2020/04/20/a-glaring-new-conflict-of-interest-undermines-public-trust-in-federal-reserve/?sh=16c0b96e135d [https://perma.cc/BZY5-ESPA].

[145] *See* Larry Fink, *Larry Fink's 2021 Letter to CEOs*, BLACKROCK (2021), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/SN4L-YR7W].

[146] *See ESG Integration*, BLACKROCK, https://www.blackrock.com/ch/individual/en/themes/sustainable-investing/esg-integration [https://perma.cc/KQ3Q-KAW3].

[147] *See Sustainable Investing*, ISHARES BY BLACKROCK, https://www.ishares.com/us/strategies/sustainable-investing [https://perma.cc/M8BX-EMSB].

[148] *See* Tett, *supra* note 144.

[149] *See* Mooney, *supra* note 77.

FTSE, and S&P.[150] Other major ESG index providers include Bloomberg, Thomson Reuters, and Vigeo Eiris.[151] Each of these commercial index providers uses a different "secret sauce" in constituting ESG tracking measures.[152] Interestingly, however, some commercial sustainability indices have been shown to score poorly in ESG metrics from external ETF sustainability data provider TrackInsight.[153]

Recent research has shown that many ETFs track a "bespoke" index (often designed by an affiliate of the asset manager)—implying a component of active management in a seemingly passive vehicle.[154] A scan of the ever expanding menu of available passive ESG ETF offerings listed through commercial aggregator sites reveal many funds which do not use a commercial index provider like MSCI or FTSE but rather design a unique underlying index around a particular ESG theme.[155] The widening array of bespoke ESG indices constructed by ETF issuers complexify the already difficult to navigate comparable landscape of product selection.[156]

III. How ESG ETF Comparative Opacity Harms Investors

A. It's ESG, But Not Exactly What I Thought I Purchased

Sustainability is big business for Wall Street since ESG varieties are on average forty-three percent more expensive than

---

[150] *Id.* (highlighting popular sustainability indices including the MSCI *USA Extended ESG Focus* Index, the MSCI *Emerging Markets Extended ESG Focus* Index, the FTSE *US All Cap Choice* Index, the S&P 500 *ESG Total Return Net* Index, the *S&P Global Clean Energy* Index, and the *MAC Global Solar Energy* Index).

[151] *See* Boffo & Patalano, *supra* note 11, at 19.

[152] *See* Mooney, *supra* note 77 (MSCI uses ten themes and thirty-seven factors, FTSI uses fourteen themes, and S&P uses twenty-three criteria).

[153] *See id.*

[154] *See* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 Yale J. on Reg. 795, 830–31 (2019).

[155] *See Socially Responsible ETF Overview*, *supra* note 124 (which includes, among many other examples, such bespoke ETF ESG underlying indices as the *BlackRock iShares Global Clean Energy ETF*, the *Vanguard ESG U.S. Stock ETF*, the *Invesco Solar ETF*, and the *Nuveen ESG Large-Cap Value ETF*); *ETF Quickrank*, Morningstar, https://www.morningstar.com/etfs/screener-rank [https://perma.cc/7FDG-2JV3] (which includes, among many other examples, such bespoke ETF ESG underlying indices as the *Clearbridge All Cap Growth ESG ETF*, the *Ecofin Global Water ESG Fund*, and the *WisdomTree U.S. ESG Fund*).

[156] *See* Robertson, *supra* note 154, at 830–31.

regular ETFs.[157] But, when you investigate ESG ETFs, you do not find blatant greenwashing; rather, you find subtle distinctions in legitimate ESG mandates that both impair easy investor comparison and create a scenario where investors may not realize what they are getting.[158] For example, some ETF issuers may enact "exclusionary" policies for certain sectors (like tobacco) but still invest in oil and gas companies because they are "best in class."[159] A recent report revealed that of the top twenty-nine ETF managers (with combined assets under management of over $41 trillion), only a quarter of their products had coal-exclusion policies.[160]

A core contention of this Article is that ESG integration is a matter of degree and discretion, not necessarily one of deception (i.e., greenwashed).[161] For example, some ETFs might look to avoid fossil fuels altogether, while others look to reduce carbon exposure risk.[162] A recent Morningstar research report noted that from a wide cross-analysis of sustainable funds, less than one-third avoided investing in fossil fuels.[163] On the question of fossil fuel exposure, some ETFs could easily confuse investors, such as the three State Street "Fossil Fuel Reserves Free" variety of ETF which still has fossil fuel exposure despite the name.[164]

---

[157] *See* Michael Wursthorn, *Tidal Wave of ESG Funds Brings Profits to Wall Street*, WALL ST. J. (Mar. 16, 2021, 5:30 AM), https://www.wsj.com/articles/tidal-wave-of-esg-funds-brings-profit-to-wall-street-11615887004 [https://perma.cc/7ZGF-CC6G] ("The environmental, social, and governance funds' average fee was 0.2% at the end of last year, while standard ETFs that invest in U.S. large-cap stocks had a 0.14% fee on average, according to data from FactSet.").

[158] *See* Robertson, *supra* note 154, at 830–31.

[159] *See* Christoph Biehl & Jill Atkins, *Responsible Investment in the United Kingdom*, *in* THE ROUTLEDGE HANDBOOK OF RESPONSIBLE INV. 355, 357 (Tessa Hebb et al. eds., 2016).

[160] Chris Flood, *ETFs Present 'Recipe for Climate Chaos' Study Claims*, FIN. TIMES (Apr. 21, 2021), https://www.ft.com/content/8ee2ac80-9025-4dbb-bd1c-b33a86e87549 [https://perma.cc/44BV-VEHU].

[161] *See supra* Part II.

[162] *See* Margaret Giles, *Not All Sustainable Funds are Equally Sustainable*, MORNINGSTAR (Apr. 13, 2021), https://www.morningstar.com/articles/1033389/not-all-sustainable-funds-are-equally-sustainable [https://perma.cc/4MQH-BLLW].

[163] *See* Hale, *Sustainable Equity*, *supra* note 22.

[164] *Id.* ("Investors should be aware of differences in how funds define being fossil-fuel-free. For example, three State Street ETFs use the term 'Fossil Fuel Reserves Free' in their names. They exclude companies that own 'proved

The current regulatory framework favors ETF issuers over ETF investors because it is not easy to compare funds side by side.[165] The range of approaches for fulfilling an ESG mandate are so wide that investors are forced to rely on private market solutions like "sustainability ratings" offered by information intermediators like Morningstar.[166] There are a wide number of ESG ratings providers, including MSCI, Bloomberg, RobecoSAM and Sustainalytics, as well as traditional ratings agencies like Moody's, S&P and Fitch that also provide ESG rating services.[167] These ratings services calculate ESG scoring assessments based on regulatory disclosures utilizing wide-ranging, and proprietary, quantitative assessment practices.[168] Asset managers like ETF issuers routinely rely on these ratings providers to assess the sustainable qualities of portfolio companies.[169]

The problem is that ESG ratings themselves vary considerably depending on the rating provider that is consulted.[170] An investigation conducted by researchers at the Organization for Economic Co-operation and Development (OECD) found that ESG scores vary much more widely than the credit scores of individual corporate issuers.[171] As such, it's highly questionable whether a market solution will remedy the current trend toward discretion and resulting complexity for investors.[172] Without a clear, consistent, and standardized ESG scoring and assessment regulatory framework, investors will continue to have difficulty performing accurate product comparisons.[173]

---

and probable coal, oil, and/or natural gas reserves used for energy purposes' but still have overall fossil-fuel exposure ranging from 4.3% to 7.4%.").

[165] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 169–70.

[166] Giles, *supra* note 162.

[167] *See* BOFFO & PATALANO, *supra* note 11, at 19.

[168] *Id.* at 21–22.

[169] *Id.* at 20.

[170] *Id.* at 3 ("The key findings of our analysis illustrate that ESG ratings vary strongly depending on the provider chosen, which can occur for a number of reasons, such as different frameworks, measures, key indicators and metrics, data use, qualitative judgement, and weighting of subcategories.").

[171] *Id.* at 29.

[172] *Id.* at 22–23.

[173] *Id.*

B. Evaluating Financial Performance and Broad Market Correlation

Given the variability of ESG scoring metrics, ratings and scoring systems, the subjectivity in the investment decision-making process for investment managers (and the diversity of explanations of these processes, and how ESG objectives are met in required disclosure documents), it is very difficult for an investor to efficiently allocate capital in this sector.[174] It is also very difficult for investors to pursue "ESG outcomes that might require a trade-off in financial performance."[175] Additionally, the common inclusion of tech stocks in ESG ETFs increase the likelihood of correlation between thematic ESG funds and broad market indices like the S&P 500.[176]

A recent Bloomberg opinion piece reported that the Vanguard ESG Fund has a nearly identical correlation with BlackRock's iShares Core S&P 500 ETF (a higher correlation than most indices even have to their underlying benchmarks), despite the former having a significantly higher expense ratio.[177] The Vanguard ESG Fund isn't idiosyncratic in its broad index mirroring, and this is largely due to the inclusion of many tech companies (which often score highly in the "E" and "G" elements of sustainable investing) in ESG ETFs. This is particularly the case with several ETFs in Europe which offer exposure to the MSCI USA ESG Universal Screened Index but include tech megafirms like Amazon, Google, Facebook, Apple, and Microsoft in their top holdings.[178]

---

[174] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 162.

[175] *See* BOFFO & PATALANO, *supra* note 11, at 3; *see also id.* at 7–8.

[176] *See* Aaron Brown, *Many ESG Funds Are Just Expensive S&P 500 Indexers,* BLOOMBERG OP. (May 7, 2021, 7:00 AM), https://www.bloomberg.com/opinion/articles/2021-05-07/many-esg-funds-are-just-expensive-s-p-500-indexers [https://perma.cc/VL63-H3G5].

[177] *Id.* ("The other ESG funds charge similar outrageous fees for tiny adjustments to the S&P 500. FlexShares charges 0.32%, which works out to 16% on the active portion of its portfolio. Conscious Companies charges 0.43%, but has a lower S&P 500 correlation, so is a relative bargain at only 11% for its active portion. SPDR charges 0.20%, or 18% on the active portion. ESG Aware is the second cheapest on raw fees at 0.15%, but its sky-high correlation of performance with the S&P 500 means you're paying more than 20% on the active share.").

[178] *See* Tom Eckett, *Are Broad-Based ESG ETFs Closet Trackers?*, ETF STREAM (May 11, 2021), https://www.etfstream.com/features/are-broad-based-esg-etfs-closet-trackers/ [https://perma.cc/W2L2-HHAN].

One portfolio manager recently called many ESG ETFs "just expensive S&P 500 indexers," and recommended investing in the actual index and donating the amount saved on excess expenses to charity.[179] Independent of an investor's motivation for holding an ESG ETF in the first place,[180] a "more expensive" S&P index ETF may just be a wealth transfer from investors to asset managers, rather than a truly impactful sustainable investment.[181] The recommendations in Part IV will help ESG investors clearly distinguish ESG-named funds from more generic passive index fund varieties with lower comparison and information acquisition costs.[182]

C. Is it E, S, or G? Just Trust Us ... We're ESG!

Another legitimate critique of the ESG investing space is that the nomenclature tries to take on too much at the same time.[183] Each of the three segments of ESG are inherently different—and very subjective.[184] ETFs that attempt all at once to integrate environmental and social measures, while aligning sustainable governance practices, will inevitably face internal conflicts.[185] For example, Tenecent is a popular "E" holding, given its low carbon footprint, but scores poorly in "S" and "G" as a result of its history of data privacy violations and data sharing with the Chinese Communist Party and connection to censoring and tracking of Uyghur Muslims.[186]

---

[179] *See* Brown, *supra* note 176.

[180] *See id.* Some of the common justifications for ESG investing including a subjective belief that sustainable enterprises will generate better long run returns, a desire to reduce the cost of capital for "good" companies and increase finance costs for "bad," and a "signal" mechanism as a virtuous investor. *See id.*

[181] *See id.*

[182] *See infra* Part IV; *see also* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 130.

[183] *See* Jason Capul, *ESG ETFs Can Be More Subjective than Investors Realize*, SEEKING ALPHA (May 4, 2021, 8:07 AM), https://seekingalpha.com/news/3690243-esg-etfs-can-be-more-subjective-than-investors-may-realize [https://perma.cc/762W-NLJP].

[184] *Id.*

[185] *See* BOFFO & PATALANO, *supra* note 11, at 36.

[186] Jamie Gordon, *Is It Possible to Reconcile China and ESG?*, ETF STREAM (Apr. 28, 2021), https://www.etfstream.com/features/is-it-possible-to-reconcile

Of the three subcomponents of ESG, the "S" (or social) element is particularly problematic to both apply[187] and comparatively interpret.[188] As part of its "Principles for Responsible Investment" (PRI) framework, the United Nations suggests that the "social" component of ESG focuses on factors such as labor and community relations, consumer rights, supply chain management, product safety, and health and safety.[189] ETFs will often use technology stocks as performance enhancers,[190] which may have good "E" metrics but due to data privacy and worker standards are deficient on the "S."[191] China is an emerging concern in the ESG ETF universe given the country's terrible ESG record.[192]

Interestingly, BlackRock has been shown to overweight itself in ESG ETF financial portfolio allocations, aligned with a belief in its own perceived "virtuous" investment ethos.[193] These

---

-china-and-esg/ [https://perma.cc/L8CC-3XFP] ("According to Dutch hacker Victor Gevers, data on the conversations, payments and travel habits of millions of Uyghur Muslims were passed onto Chinese police and used to censor and track Uyghurs both within the country and overseas.").

[187] *See* U.N. PRINCIPLES FOR RESPONSIBLE INV., SUSTAINABLE AND INCLUSIVE COVID-19 RECOVERY AND REFORM 15 (July 6, 2020); David Wood, *What do we mean by the S in ESG: Society as a stakeholder in responsible investment*, *in* ROUTLEDGE HANDBOOK OF RESPONSIBLE INV. 553, 555 (Tessa Hebb et al. eds., 2016).

[188] *See* Wood, *supra* note 187, at 555.

[189] *See* U.N. PRINCIPLES FOR RESPONSIBLE INV., INTEGRATED ANALYSIS: HOW INVESTORS ARE ADDRESSING ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS IN FUNDAMENTAL EQUITY VALUATION 44 (Feb. 2013).

[190] *See* Patti Domm, *Alphabet Was the Most Widely Held Stock for the Largest ESG Funds. Here's What Else They Own*, CNBC (May 18, 2021, 8:27 PM), https://www.cnbc.com/2021/05/18/alphabet-was-the-most-widely-held-stock-for-the-largest-esg-funds.html [https://perma.cc/FC4M-BGHL].

[191] Wursthorn, *supra* note 157.

[192] Steve Johnson, *China's ESG Ratings Tarnish Its Allure for Sustainable Investors*, FIN. TIMES (Nov. 29, 2020), https://www.ft.com/content/fd835576-59fd-4bb6-93e7-cc30f254a358 [https://perma.cc/8DFD-MNUD]; Gordon, *supra* note 186.

[193] Brown, *supra* note 176 ("BlackRock Inc. thinks it's more virtuous than the average S&P 500 company, so in its own ESG fund the company accounts for a 0.53 percent weighting, compared with a weighting of 0.33 percent as a member of the S&P 500. The money manager is one of the largest percentage overweights in the fund. But it's not the financial industry in general that's virtuous; Blackrock underweights competitors Charles Schwab Corp., Berkshire Hathaway Inc., Goldman Sachs Group Inc., Bank of America Corp. and JPMorgan Chase & Co. Wells Fargo & Co. has a zero weighting. Are BlackRock's analysts and managers the people you want to trust to reflect your ESG opinions?").

asset managers are not reliable "information intermediaries"[194] from the perspective of their synthesizing ESG data to make it ascertainable and useable in investment making decisions by investors.[195] Rather each asset manager, as an intermediary, is competing for the same pool of money in a zero sum game of investment capital flow capture, using subject mechanisms and processes to construct ETF indices or make discretionary decisions in active management style ETF structures.[196]

The five largest ETF issuers in the United States (by way of assets under management (AUM)) present ESG information on their own websites in a way that confirms this Article's analysis—that ESG is being incorporated into funds, but in an entirely opaque way that favors ETF issuers over investors.[197] BlackRock, the world's largest ETF issuer,[198] incorporates an easy to navigate product screener function,[199] and categorized data, including descriptive commentary, under both a "sustainable characteristics," and "business involvement" heading for each fund.[200] BlackRock also provides a "sustainable investing" educational resource under "investment themes" which outlines their approach to sustainable investing.[201]

Similarly, the second largest ETF issuer by AUM, Vanguard[202] has general educational content on ESG investing,[203]

---

[194] *See* Onnig H. Dombalagian, *Regulating Informational Intermediation*, 1 AM. U. BUS. L. REV. 58, 58 (2011).

[195] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 157.

[196] *See id.* at 159–60.

[197] *See id.* at 183.

[198] Mark Kolakowski, *Who Are the ETF Giants?,* INVESTOPEDIA (Mar. 22, 2021), https://www.investopedia.com/who-are-the-etf-giants4691723 [https://perma.cc/9WH7-MUTE].

[199] *See Products*, BLACKROCK, https://www.blackrock.com/americas-offshore/en/products/product-list#!type=ishares&style=All&view=perfNav [https://perma.cc/N5VH-SHL4].

[200] *See iShares Core S&P 500 ETF*, BLACKROCK, https://www.blackrock.com/americas-offshore/en/products/239726/ishares-core-sp-500-etf [https://perma.cc/4SAQ-KY6U] (The "business involvement" heading outlines the percentage of the fund that in invested in potentially controversial or non-ESG industries.).

[201] *See Sustainable Investing*, BLACKROCK, https://www.blackrock.com/hk/en/investment-ideas/sustainable-investing [https://perma.cc/HD6G-XXZK].

[202] *See* Kolakowski, *supra* note 198.

[203] *See ESG Investing*, VANGUARD, https://investor.vanguard.com/investing/esg/ [https://perma.cc/NRJ8-T6WQ].

but provides limited fund specific ESG data for their available ESG-themed funds.[204] Neither ETF issuer has uniformity in their information presentation style, passing on the synthesis burden to individual investors.[205] Rounding out the top five, State Street,[206] and Charles Schwab[207] respectively, provide general information on their approach and goals relating to ESG and "socially responsible investing" in general, but with less fund specific ESG informational content than BlackRock.[208] Invesco, while having an easy-to-navigate website, provides little ESG data at all.[209] Most importantly for the purposes of this Article, the "way" that information is presented is distinct, non-uniform, and non-standardized.[210] This compounds the informational synthesis challenges created when attempting to compare funds side by side, forcing investors to resort to private market aggregators who also present information in a non-standardized way.[211]

---

[204] *See Vanguard ESG U.S. Stock ETF*, VANGUARD, https://investor.vanguard.com/etf/profile/ESGV [https://perma.cc/Y2CT-93J9].

[205] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 183–85; *see also id.* at 184 ("ETF firms do not have market incentives to study the most effective means of website presentation for investors, since they can be easily copied by other firms. One scholar has called this a 'collective action problem' for investment managers to devise an 'optimal layout' on their own. The SEC can remedy this problem, while enhancing comparability and democratizing access, by standardizing website disclosure formats and filing ETF key data in a structured and consistent format, then making it publicly available through a central database or repository in an optimal structure determined by the regulator that allows for ETF side-by-side comparison.").

[206] *See ESG Overview*, STATE ST. GLOB. ADVISORS, https://www.ssga.com/us/en/individual/mf/capabilities/esg/investment-solutions [https://perma.cc/LEG5-DFXG.

[207] *See Socially Responsible Investing*, CHARLES SCHWAB, https://www.schwab.com/socially-responsible-investing [https://perma.cc/4P3U-7AMT].

[208] *See iShares ESG Aware MSCI USA ETF*, BLACKROCK, https://www.blackrock.com/us/individual/products/286007/ishares-esg-msci-usa-etf [https://perma.cc/MPH7-RD6Q] (BlackRock displays a variety of ESG data under a "sustainable characteristics" heading for their menu of funds including "MSCI ESG % Coverage," "MSCI Weighted Carbon Intensity," and "Funds in Peer Group.").

[209] *See* Kristina Hooper, *Markets look for a foothold to climb the 'wall of worry'*, INVESCO (Sept. 13, 2021), https://www.invesco.com/us/en/Individual-investor.html [https://perma.cc/WC5S-MC2J].

[210] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 128, 173, 197–98.

[211] *Id.* at 128–29.

The subjectivity in ESG determinations is even more pronounced in the increasingly expanding "active" ETF space—a "semi-transparent" operating structure,[212] that combines conventional mutual fund proprietary portfolio inclusion decision-making strategies with the low fee, intra-day liquidity that has made ETFs such a popular investment product.[213] For example, Fidelity recently launched two nontransparent actively managed ESG ETFs focusing on U.S. sustainability and women's leadership, respectively.[214] Such active ETF structures allow ETF managers to divest certain companies and deviate from underlying indices they are tracking if the manager considers it as ESG impactful.[215] However, this style of fund management makes the "trust us" sentiment even more pronounced as investors have very little transparency (and no control) ex ante over the decision-making process leading to ad hoc discretionary portfolio adjustments on the basis of ESG determinations.[216]

---

[212] Actively managed ETFs do not provide investors with holdings disclosure on a daily basis, but rather provide delayed disclosure of their full portfolio and a representative portfolio in order for ETF ecosystem participants to perform operational arbitrage and maintain price stability between an ETF's underlying net asset value and the secondary trading price. *See* Ian Young, *Activity-Managed ESG ETFs Offer Diversification for Investors*, ETF TRENDS (June 11, 2021), https://www.etftrends.com/active-etf-channel/actively-managed-esg-etfs-offer-diversification-for-investors/ [https://perma.cc/SCF7-9Q3B]; John Coumarianos, *Stage Set For Broader Array of ETFs, Especially Active Ones*, BARRON'S (Dec. 20, 2019, 4:25 PM), https://www.barrons.com/articles/stage-is-set-for-a-broader-array-of-etfs-especially-active-ones-51576877127 [https://perma.cc/WE26-XENW]; Lizzy Gurdus, '*This could be the year' for Active Management, Says NYSE Head of Exchange Traded Products*, CNBC (May 30, 2020, 9:00 AM), https://www.cnbc.com/2020/05/30/nyse-etf-chief-talks-state-of-industry-as-assets-under-management-rise.html [https://perma.cc/9DG2-HCH5].

[213] *See* Young, *supra* note 212; Aaron Neuwirth, *Fidelity Launches New Active ESG ETFs, FSST & FDWM*, ETF DATABASE (June 16, 2021), https://etfdb.com/news/2021/06/16/fidelity-launches-new-active-esg-etfs-fsst-fdwm/ [https://perma.cc/69QK-QE92].

[214] *See* Simon Smith, *Fidelity Unveils Two Actively Managed ESG ETFs*, ETF STRATEGY (June 17, 2021), https://www.etfstrategy.com/fidelity-unveils-two-actively-managed-esg-etfs-fsst-fdwm-nyse-arca-38493/ [https://perma.cc/V76M-XNBL].

[215] *See* Young, *supra* note 212.

[216] *Id.*

IV. How to Improve Comparability in ESG ETFs

A. Step One: Justify ESG Name Usage in Specific ETF Disclosures

The name of an investment product can have a significant impact on the decision to purchase, and investors are "misled" when a fund invests in a way that isn't consistent with how it's named.[217] Naming mischief in investment products extends beyond ESG products to fixed income and bond funds,[218] factor and thematic funds,[219] and inverse and derivative based products.[220] At the most surface level, without regulated naming conventions for ESG varieties, ETF issuers can rebrand a fund without changing its underlying index composition.[221] But as this Article has shown, it's the subtle details that are most important, since they obscure investor comparisons.[222]

ESG investment products utilize a litany of terms such as "socially responsible investing," "sustainable," "green," "ethical," "impact," and "governance" none of which are formally regulated or standardized in the United States.[223] Other terms, like "best in class" imply a global or industry leader which may not be obvious (or empirically verifiable).[224] A lack of standardized terminology

---

[217] CONSUMER FED'N OF AM., RE:FILE NO. S7-04-20 REQUEST FOR COMMENTS ON FUND NAMES 1 (May 12, 2020) [hereinafter RE:FILE NO. S7-04-20].

[218] *See* Huaizhi Chen et al., *Don't Take Their Word For It: The Misclassification of Bond Mutual Funds*, 76 J. FIN. 1699–1700, 1716, 1727 (2021) (This study shows a widespread problem of bond fund "misclassification" and suggests that over thirty-one percent of all bond mutual funds are misclassified with "safer profiles" compared to their actual publicly disclosed holdings. This results in both better Morningstar ratings and increased fund flows.).

[219] Sloane Ortel et al., *How to See the Hidden Risks of ETFs*, CFA INST. (Jan. 1, 2018), https://blogs.cfainstitute.org/investor/2018/01/18/how-to-see-the-hidden-risks-of-etfs/ [https://perma.cc/K79X-CJYD]; *see* George Athanassakos, *Why Investors Aren't Getting True Value Stocks with Value ETFs*, GLOBE AND MAIL (Oct. 2, 2019), https://www.theglobeandmail.com/investing/markets/etfs/article-why-investors-arent-getting-true-value-stocks-with-value-etfs/ [https://perma.cc/XK49-PE9N].

[220] Clements, *Exchange-Traded Confusion*, *supra* note 9, at 154–57, 189–90.

[221] *See* Holger, *supra* note 59.

[222] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 151–52.

[223] *See* SEC RECOMMENDATION, *supra* note 127, at 1 n.1.

[224] Mark Burgess, *CFA and Other Organizations Move to Fill Gap in ESG Standards*, ADVISORS EDGE (June 28, 2021, 12:31 PM), https://www.advisor

creates the risk for investor confusion and investment advisor conflicts.[225] It is not sufficient to assume that investor advisors will self-correct this problem.[226] Recent reports show that despite "ESG acceptance" among investors, many advisors themselves are poorly informed on product discrepancies and responsible investing in general.[227]

On April 9, 2021, the SEC's Division of Examinations issued a Risk Alert called "Review of ESG Investing" that highlights many of the challenges in this nascent trend,[228] including an absence of ESG internal decision-making policies and procedures;[229] portfolio management actions that are "inconsistent" with ESG-related public disclosures;[230] inaccurate or false claims relating to ESG products;[231] and reliance on third parties to prepare ESG "composite scores" rather than a fund conducting its own internal assessment of ESG suitability.[232]

While "risk alerts" are helpful, they are a short-term solution, and a consistent taxonomy for sustainable investing would greatly enhance investor protection.[233] One possible idea to consider is an "ecolabel" certification for ETF products, with sub-labels for specific terminology, building on the EU ecolabel for financial products currently being developed by the European Commission.[234] Industry led ESG fund certifications, voluntary disclosure

---

.ca/news/industry-news/cfa-and-other-organizations-move-to-fill-gap-in-esg-standards/ [https://perma.cc/UHR3-JEJC].

[225] *Id.*

[226] *Id.*

[227] *See* Leo Almazora, *Despite Rising ESG Acceptance, Advisors' Understanding Remains Limited*, WEALTH PRO. (June 18, 2021), https://www.wealthprofessional.ca/investments/socially-responsible-investing/despite-rising-esg-acceptance-advisors-understanding-remains-limited/357620 [https://perma.cc/6HYZ-PBCZ].

[228] *See* SEC RECOMMENDATION, *supra* note 127, at 1.

[229] *Id.*

[230] *Id.*

[231] *Id.*

[232] Peter D. Hutcheon, *What's in a Name? The SEC Warns Against Confusion in ESG Investments*, NAT'L L. REV. (Apr. 22, 2021), https://www.natlawreview.com/article/what-s-name-sec-warns-against-confusion-esg-investments [https://perma.cc/2H36-URCA].

[233] *See* Emma O'Hara & Michael Grace, *Sustainable Finance—A Frameworks Overview*, LEXOLOGY (Mar. 2, 2021), https://www.lexology.com/library/detail.aspx?g=3c934398-c604-43c1-af50-43bea3ce664e [https://perma.cc/V43C-TTDS].

[234] *Id.*

standards, and ESG screening tools are also being developed by the CFA Institute.[235]

In March 2020, the SEC sought public comment on the current effectiveness of Rule 35d-1 under the Investment Company Act of 1940,[236] the so-called "names rule," which creates a prohibition for funds (including ETFs) from using "materially deceptive or misleading" names.[237] The popularity of "thematic" ETFs (one type of ESG variety) is undoubtedly a factor in the potential regulatory reform.[238] The comments received by the SEC were varied, although there was wide industry support for retaining investment manager discretion in the names they choose for their offered investment products, even for ESG funds, given the wide variance in how this term is interpreted.[239] This is to be expected,

---

[235] *See* Burgess, *supra* note 224.

[236] 15 U.S.C. § 80a-34(d).

[237] *See* Press Release, SEC Requests Comment on Fund Names Rule; Seeks to Eliminate Misleading Fund Names (Mar. 2, 2020), https://www.sec.gov/news/press-release/2020-50 [https://perma.cc/TB4V-G5YX] ("The rule requires a registered investment company or business development company with a name suggesting that the fund focuses on a particular type of investment (e.g., 'stocks' or 'bonds') to invest at least 80% of its assets accordingly. Market and other developments since adoption of the rule, such as increasing use of derivatives, impact the rule's application."); RE:FILE NO. S7-04-20, *supra* note 217, at 3 (requesting comments regarding Section 35(d) of the Investment Company Act of 1940).

[238] *See* Daren Fonda, *SEC Cracks Down on Fund Names*, BARRON'S (Mar. 6, 2020, 1:51 PM), https://www.barrons.com/articles/sec-cracks-down-on-fund-names-51583520632 [https://perma.cc/HYL9-JLRW]; *see also* Matt Orsagh, *Will Revisiting SEC's Names Rule Clear Up ESG Fund Name Confusion?*, CFA INST., MKT. INTEGRITY INSIGHTS (June 17, 2020), https://blogs.cfainstitute.org/marketintegrity/2020/06/17/will-revisiting-secs-names-rule-clear-up-esg-fund-name-confusion/ [https://perma.cc/JT3G-FZCN].

[239] *See* RE:FILE NO. S7-04-20, *supra* note 217, at 5; T. ROWE PRICE, ASSOC., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 1 (May 21, 2020); STATE ST. GLOB. ADVISORS, RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 2–3 (May 5, 2020); INV. CO. INST., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 3 (May 5, 2020); TCHR. INS. AND ANNUITY ASS'N OF AM., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 1–2 (May 5, 2020); COUNCIL OF INST. INV., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 2–3 (May 5, 2020); INVESCO, LTD., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 4–5 (May 5, 2020); BLACKROCK, RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 1–2 (May 5, 2020); FIDELITY INV., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 5 (May 5, 2020);

since as noted, the investment industry does not have an incentive to increase the ease of comparability since it will lower fund switching costs for investors.[240] However, there was also support for applying the names rule to ESG investing at large.[241] There were also reasonable arguments submitted that the eighty percent holding requirement in Rule 35d-1(d)(2) should be applied to ESG specific "themed" funds since these "reflect an investment focus on a particular industry or group of industries."[242]

The SEC's Spring 2021 regulatory agenda included a short-term review of requirements for funds and advisors in relation to ESG claims and disclosures, and public comment on index providers, and a long-term priority to amend Rule 35d-1.[243] It is critical that any amendments cover ESG "strategies" and "objectives" to avoid a fund manager work around, and also commercial ESG indices.[244] A workable taxonomy within the subvarieties of ESG funds, including clarity on the definition of sustainability terms, will undoubtedly improve comparability of ESG ETFs.[245] An effort to standardize and define sustainable terminology in a "classification

MORNINGSTAR, RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 1–3 (May 5, 2020).

[240] *See supra* Sections II.A, II.B.

[241] GLOBAL AFF. ASSOC., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 2 (May 5, 2020) ("Yes, we believe that the SEC should update the Names Rule to apply to terms such as 'ESG' or 'sustainable,' regardless of whether funds consider themselves investment policies or strategies .... Any investment making claims of ESG or sustainability should be required to invest at least 80 percent of its assets per the ESG investment strategy, policy or objective suggested by its name, and be required to make additional disclosures as to the particular qualitative and/or quantitative characteristics of its investments.").

[242] CAP. RSCH. AND MGMT. CORP., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 5 (May 5, 2020); *see* PRINCIPLES FOR RESPONSIBLE INV., RE: REQUEST FOR COMMENTS ON FUND NAMES—FILE NO. S7-04-20, 3 (May 5, 2020) ("[S]ome funds indeed invest to advance a certain goal, such as goals relating to climate neutrality or gender diversity (in addition to integrating financially material ESG factors). In these instances, the PRI believes it may be more appropriate that the fund's name reflect that strategy.").

[243] *See* John S. Marten et al., *Regulatory Agenda Highlights Potential SEC Rulemaking Topics*, NAT'L L. REV. (July 7, 2021), https://www.natlawreview.com/article/regulatory-agenda-highlights-potential-sec-rulemaking-topics [https://perma.cc/ZV2L-CRX2].

[244] *See* Fonda, *supra* note 238.

[245] Orsagh, *supra* note 238.

framework" that funds can self-select into is a worthy undertaking.[246] To this end, numerous potential naming taxonomies are evolving, which the regulator could consider.[247]

In the interim, before developing a taxonomical solution, the SEC, and global regulators, can greatly aid in investors comparability in ESG ETFs by requiring a fund to justify its use of ESG-related terminology in its name in its specific ETF disclosures, and this suggestion received significant support in SEC comment letters on Rule 35d-1.[248] In other words, if a fund uses a specific sustainable term in its name, it must also specifically disclose how it justifies this name usage.[249] MSCI, Inc., in its May 5, 2020, comment letter on Rule 35d-1 provided a useful framework for an ETF justifying its choice of fund name in its disclosures:

> Such a disclosure should include (1) the fund's criteria for the ESG terms it uses in its name; (2) the methodology the fund

[246] *See* MICHAEL COSACK & HENRY SHILLING, SEC RULE REQUEST FOR COMMENT ON FUND NAMES RESPONSE 1 (May 5, 2020).

[247] *See* GLOB. AFF. ASSOC., *supra* note 241, at 4–5, 8–11; HARV. L. SCH., SEC—FILE NO. S7-04-20 2–3 (May 5, 2020); RE:FILE NO. S7-04-20, *supra* note 217, at 5.

[248] *See* MSCI, INC., RE: RESPONSE FOR REQUEST FOR COMMENTS ON FUND NAMES FILE NO. S7-04-20, 3 (May 5, 2020) ("A fund that references ESG (or similar terms) in its name should be required to demonstrate support in its public disclosures"); VANGUARD GRP., INC., ATTENTION: REQUEST FOR COMMENTS ON FUND NAMES FILE NO. S7-04-20, 3 (May 5, 2020) ("[W]e recommend the Commission require funds using ESG and related terms to explain those terms to investors."); SIFMA, RE: RESPONSE FOR REQUEST FOR COMMENTS ON FUND NAMES FILE NO. S7-04-20, 4 (May 5, 2020) ("[A]ny fund that uses ESG in its name should still be required to include clear disclosure in its prospectus with respect to its ESG strategy. This disclosure would better inform investors and enable them to make their investment decisions in alignment with their investment objectives, including investing in a socially responsible way."); GLOB. AFF. ASSOC., *supra* note 241, 3–4 ("At the very least, any investment making such a claim in their name should clearly state in the prospectus, which aspect(s) of 'ESG' they are focused on their specific definition of the term used, ideally referencing a standard definition, the specific criteria screened for.... Funds should demonstrate which aspect of ESG they are focused on, articulate where they fall on the Responsible Investment Continuum, and how they justify their claim."); CREDIT SUISSE, RE: RESPONSE FOR REQUEST FOR COMMENTS ON FUND NAMES FILE NO. S7-04-20 2–4 (May 5, 2020); PRINCIPLES FOR RESPONSIBLE INV., *supra* note 242, at 3.

[249] *See* PRINCIPLES FOR RESPONSIBLE INV., *supra* note 242, at 3.

> employs to support its defined criteria, (3) the metrics the fund uses to validate that it satisfies its criteria and methodology, and (4) historical evidence or metrics to back test that tend to substantiate the effectiveness of the methodology, or a warning to investors that historical evidence to support the effectiveness of the fund's methodology is unavailable.[250]

Ideally, justifying disclosures would be included in both the ETF's prospectus and in a uniform layout style and presentation format (determined by the regulator) on the ETF issuers website, so that such information is easily comparable between funds.[251]

B. Step Two: Standardize ESG ETF Measurement Metrics

As noted by Dana Reiser and Anne Tucker, ESG investing is highly non-standardized,[252] and the "substance" of ESG investing is "essentially unregulated," which introduces significant investor and consumer protection concerns.[253] Industry driven ESG scoring systems vary on the basis of "different frameworks, measures, key indicators and metrics, data use, qualitative judgement, and weighting of subcategories,"[254] as well as "wide differences in factor subcategories below the E, S, and G, the number of metrics, their weighting and subjective judgment" which impact the ability of investors to compare ETFs side by side.[255] Given the exceptional investor interest in this product segment, significant regulatory efforts in the United States should be made to standardize ESG measurement metrics.[256]

By way of comparison, a temperature analogous or caloric-style reference mechanism would help consumers of ESG ETFs compare products.[257] One of the challenges in "negative screen" ETFs, which exclude certain categories like tobacco or firearms, is that there is no way for them to track their actual ESG impact.[258] Scoring metrics are being produced by industry, but diverse

[250] MSCI, INC., *supra* note 248, at 3.
[251] *See infra* Section IV.C.
[252] Reiser & Tucker, *supra* note 7, at 1926.
[253] *Id.* at 1925–26.
[254] BOFFO & PATALANO, *supra* note 11, at 7.
[255] *Id.* at 10.
[256] *Id.*
[257] *See* Pucker, *supra* note 58, at 139.
[258] *Id.* at 140.

measurement metrics seems to be growing at a similar rate as the products themselves.[259] ETF data aggregator TrackInsight recently noted that globally there are now "more than 125 ESG data providers" who have distinct scoring methodologies.[260]

Industry competition on a preferred ESG scoring metric benchmark compounds the information acquisition and synthesis costs, and comparative complexity highlighted by this Article.[261] Not only does an ESG ETF investor face a nearly insurmountable task in comparing products,[262] but they also have a second order (equally daunting) challenge of comparing and evaluating distinct ESG scoring systems altogether![263] Given the nascent popularity of this investment asset subclass, regulatory invention—informed by industry consultation—to standardize ESG scoring metrics is urgently needed.[264]

Standardized measurement metrics could include uniform disclosures on whether an ESG ETF uses its proxy voting power in accordance with their underlying ESG initiative or stated objective.[265] Such disclosure should be easily identifiable through consistent reporting and uniform information presentation (pursuant to step three below).[266] It's important for an investor to understand the correlation between an ETF's stated intent and its actual actions through proxy voting, and an investor focused regulatory structure should lower information barriers to ascertaining this data.[267] For example, research from Morningstar has revealed "varying degrees of intentionality" in the proxy voting actions of gender diversity ETFs, and in many cases gender or diversity themed ETFs public statements don't align with their voting records.[268]

---

[259] *Id.* at 137, 141.

[260] *See TrackInsight: ESG ETFs*, *supra* note 45.

[261] *See* Reiser & Tucker, *supra* note 7, at 1940–45.

[262] *See* IIF SUSTAINABLE FINANCE, *supra* note 125.

[263] *See TrackInsight: ESG ETFs*, *supra* note 45 (in addition to diverse scoring metrics, ESG data providers source their data in distinct ways including public disclosures, interviews, artificial intelligence captures).

[264] *See* Reiser & Tucker, *supra* note 7, at 1926.

[265] *See id.* at 1933–34.

[266] *See* Burgess, *supra* note 224.

[267] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 174–75.

[268] *See* Madison Sargis, *Gender and Diversity Funds: Intentional or Not?*, MORNINGSTAR (Apr. 14, 2019), https://www.morningstar.com/articles/922757

A uniform, standardized reporting mechanism around objective aligned voting measures would greatly aid informed comparability in ESG ETFs.[269] Undoubtedly a top-down regulatory framework will need extensive industry consultation and serious attempts at international consistency; however, such measures are desperately needed in what is perhaps the hottest investment sector at the moment.[270] Also, as advocated by the OECD, metrics in reporting frameworks should also be "consistent," "transparent," and "comparable"—ideally across internationally issued ESG ETF products.[271] Standardized metrics should contemplate sector specific subcategories within each "pillar" of E, S and G respectively.[272] Further, standardized metric systems should contemplate both financial and nonfinancial "materiality" determinations so that investors can assess the effects of ESG factors on financial performance.[273]

C. Step Three: Uniform Information Presentation Style on Websites

Standardized marketing and website layout (uniform information presentation) measures that can reduce information

/gender-and-diversity-funds-intentional-or-not [https://perma.cc/V94Z-NKSX] (the study included proxy voting record of three ETFs having a primary focus on gender diversity including the State Street *SPDR SSGA Gender Diversity ETF* (SHE); *Serenity Shares' Impact ETF*; and *Impact Shares YWCA Women's Empowerment ETF* (WOMN) and found that they failed to support numerous gender-related resolutions during 2016–2018, particularly State Street's ETF, as noted in the study, "Of the three gender diversity funds reviewed, the voting record for State Street's SPDR SSGA Gender Diversity ETF is the least supportive of shareholder resolutions addressing gender and diversity, which seems at odds with the investment objective stated in the fund's prospectus.").

[269] *See* BOFFO & PATALANO, *supra* note 11, at 59 (identifying issues that regulatory reform should be targeting, including objective-aligned voting).

[270] *See id.* at 9 (providing a broad discussion of the issues with the status quo).

[271] *Id.* at 9–10.

[272] *Id.* at 63 ("[T]he way in which environmental risks are captured in energy and financial sectors would be quite different, so sector-specific tailoring would be essential for relevance. Frameworks might benefit from indicating trade-offs associated with completeness vs. availability, suggesting how sector-specific metrics might further develop over time as more consistent data becomes available.").

[273] *Id.* at 63–64.

gathering and synthesis costs in ESG ETFs are critically needed.[274] There are effective measures that could be easily instituted by the SEC that would greatly aid comparability in ESG ETFs.[275] An immediate step would be to mandate uniform website disclosure presentation format on ETF issuer sites, including standardized layout (where the information shows up on each site in the same place and in the same format) and includes consistent content, ideally even enhanced with constituent color coding for easy interpretation.[276]

Investment decision-making is made more efficient when disclosures are presented in a comparative format.[277] Given the hyper-competitive, fee sensitive nature of the industry, ETF issuers do not have incentives to standardize information presentation format on their own.[278] Neither do ETF issuers have incentives to make ETFs easier to compare because this lowers the switching costs that investors face through information acquisition and synthesis.[279] As a result, investment issue website "optimal layouts" have been described as a "collective action problem" in prior scholarship, and thus requires a regulatory solution.[280]

---

[274] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 175 ("A centralized and standardized reporting mechanism, when combined with a uniform website layout format, would also help remedy the related challenge that an ETF investor, when choosing between products, will subjectively weight fund attributes, a phenomenon that has been described as an 'error in self-insight.'"); *id.* at 192 ("Presentation format has also been found to have a material impact on how consumers process information. A 2015 Wharton Business School working paper provides evidence that a 'streamlined' and 'easier to understand' menu format for employees choosing between defined contribution retirement investment options leads to better investor risk profiles, lower turnover rates, reduced expense ratios, and more aggregate savings for plan participants. Simplified disclosures have also increased the effectiveness of tax credit and employer 401(k) programs. Simplifying and ordering ETF disclosures around the most important factors will eliminate the need for investors to take additional steps to use disclosures provided to them.").

[275] *See* BOFFO & PATALANO, *supra* note 11, at 60–61.

[276] Burgess, *supra* note 224.

[277] Clements, *Exchange-Traded Confusion*, *supra* note 9, at 182.

[278] *Id.* at 184–85.

[279] *See* Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 541–42 (2009).

[280] *Id.* at 541.

Previous literature has illustrated the disparity and discretion currently in ETF issuer website layouts, and how this harms ETF investor comparisons.[281] Having a uniform layout allows for an easier investor comparison between ESG ETFs.[282] The ideal uniform content for ESG ETFs would include a description of the "type" of ESG amongst a defined menu of available types (for example exclusionary, best-in-class, full integration, or thematic),[283] combined with a "qualitative" description of how the fund integrates ESG considerations.[284]

You can see the problem of layout disparity by simply looking at similar types of ESG ETFs issued by different fund managers, as illustrated by the following example. Consider five proprietarily constituted U.S. Equity "Total Market" ETFs that select their constituent index on the basis of ESG considerations, issued respectively, by New York Life Investments,[285] FlexShares,[286] Nationwide,[287]

---

[281] *See* Clements, *Exchange-Traded Confusion*, *supra* note 9, at 183 ("A structured layout was not required under the new rule, despite having significant industry support for a standardized approach. Given layout discretion, the SEC openly acknowledged that 'an investor's ability to efficiently extract information from website disclosures for purposes of aggregation, comparison, and analysis across multiple ETFs and time periods may be limited.' Further, third-party aggregation services are costly for investors, who must otherwise engage in a cumbersome process of reviewing each ETF website. The SEC conceded that having to visit each website could 'decrease the information benefits of the new disclosures.'").

[282] *Id.*

[283] *See TrackInsight: ESG ETFs*, *supra* note 45.

[284] Qualitative reporting in ETFs, at large, have previously been advocated by Professors Henry Hu and John Morley using a "Management Discussion and Analysis" (MD&A) style disclosure with respect to potential instability in the ETF arbitrage function. *See* Henry T.C. Hu & John Morley, *A Regulatory Framework For Exchange Traded Funds*, 91 S. CAL. L. REV. 839, 849 (2018); Henry T.C. Hu & John Morley, *The SEC and Regulation of Exchange-Traded Funds: A Commendable Start and a Welcome Invitation*, 92 S. CAL. L. REV. 1155, 1159–61 (2019).

[285] *See IQSU IQ Candriam ESG US Equity ETF*, N.Y. LIFE INVS. [hereinafter *IQSU IQ Candriam*], https://www.newyorklifeinvestments.com/etf/iq-candriam-esg-us-equity-etf-iqsu?ticker=IQSU [https://perma.cc/5EQE-SB8J].

[286] *See STOXX® US ESG Select Index Fund (ESG)*, FLEXSHARES (Sept. 19, 2021) [hereinafter *STOXX®*], https://www.flexshares.com/funds/ESG [https://perma.cc/Y655-RZMY].

[287] *See Nationwide Maximum Diversification U.S. Core Equity ETF*, NATIONWIDE [hereinafter *Nationwide Maximum*], https://etf.nationwide.com/#!/etfprofile/MXDU [https://perma.cc/2QW2-8NCF].

WisdomTree,[288] PIMCO,[289] and BlackRock.[290] The issuer websites for these ESG ETF products are markedly different, and although they contain the required disclosures pursuant to securities law,[291] they present information, including where it's placed on the website, in very distinct ways.[292] There is no investor protection justification for this lack of standardization, and with the extreme growth of ETFs (and ESG varieties in particular) a uniform layout rule would be very beneficial for investors.[293]

---

[288] *See WisdomTree U.S. ESG Fund*, WISDOMTREE [hereinafter *WisdomTree*], https://www.wisdomtree.com/de-at/etfs/esg/resp [https://perma.cc/3BQ8-E275].

[289] *See RAFE RAFI ESG U.S. ETF*, PIMCO [hereinafter PIMCO], https://www.pimco.com/en-us/investments/etf/rafi-esg-us-etf/ [https://perma.cc/XV3S-U6NH].

[290] *See iShares ESG Aware MSCI USA ETF*, BLACKROCK (Sept. 17, 2021) [hereinafter *iShares*], https://www.ishares.com/us/products/286007/ishares-esg-aware-msci-usa-etf [https://perma.cc/T863-U7HK].

[291] *See* 17 C.F.R. §§ 210, 232, 239, 270, 274 (2019).

[292] For example, when you access each of these five issuer websites what one immediately sees, without having to scroll, is markedly distinct. Nationwide immediately presents fund performance data followed by a generalized overview, without specific ESG considerations or the nature of the screening or decision-making heuristics that are used by the fund managers for ESG inclusion. *See Nationwide Maximum*, *supra* note 287. New York Life Investments, after displaying the ticker symbol, current price and limited performance data provides some description on the ESG considerations (without significant details of the sustainable decision-making mechanism), followed by key facts. *See IQSU IQ Candriam*, *supra* note 285. FlexShares provides immediate "Quick Stats" and requires the investor to download PDF files for more detailed information and there is no easily ascertainable data, descriptions, or decision-making descriptors for ESG considerations. *See STOXX®, supra* note 286. WisdomTree provides a general overview with some ESG details, but using mostly generalized language, followed by tabled overview data. *See WisdomTree*, *supra* note 288. PIMCO immediately advocates for "why invest in this fund" with visual aids. *See* PIMCO, *supra* note 289. BlackRock, similar to PIMCO provides advocating language up front ("Why ESGU") with information on the sustainable screens that this fund uses, providing the most detail on ESG considerations compared to the other funds profiled here. *See iShares*, *supra* note 290.

[293] *See* Clements, *Exchange-Traded Confusion, supra* note 9, at 183–84 ("The SEC conceded that having to visit each website could 'decrease the information benefits of the new disclosures.' Standardized website layouts could incorporate learnings from behavioral studies, which show that internet consumers often do not make careful assessments in their online viewing, instead substituting 'depth for speed.' Thus, the JDM principles of prominence and disclosure ordering, including varied screen designs for mobile and desktop viewing platforms, are important to consider in designing a standardized layout and should be further studied.").

Conclusion

This Article has argued comparability in ESG ETFs is a critical problem—even bigger than purported greenwashing.[294] One analyst recently compared the conundrum investors face when attempting to assess ESG ETFs to "archaeologists excavating fund fact documents for buried truths."[295] Another advisor compared himself to "Indiana Jones" in the process of finding the right ETFs for his client.[296] Independent of the merits of ESG investing, which is currently a matter of scholarly debate,[297] and is in need of additional empirical studies, high demand for sustainable ETFs and the concurrent proliferation of available products demands a regulatory solution to prevent against investor harm and capital and risk misallocation.[298] The current system favors the issuers of ETF products, not the investors.[299]

It is not obvious that ESG ETFs are being deceptively "greenwashed."[300] In fact, when reviewing the myriad of ESG ETF products increasingly available on the market, and the research undertaken to date on this subject, it appears that ESG considerations are being integrated in some way.[301] Further, ETF issuers face the damaging prospect of reputational risk from greenwashing in a hyper-competitive, low-margin market, which effectively costs an investor nothing to switch funds in the highly liquid, easily accessible investment segment that is ETFs.[302] While nondeceptive practices of asset managers are observable in the zero sum, highly competitive, asset management game of capturing new ESG-directed capital flows, the subjectivity that ETF managers use to integrate ESG considerations into the composition of underlying ETF holdings is so disparate that investors face tremendous information acquisition and synthesis costs and difficulty comparing products.[303]

---

[294] *See supra* Introduction.
[295] Burgess, *supra* note 224.
[296] *Id.*
[297] *See supra* Section I.B.
[298] *See supra* Sections III.A, III.B.
[299] *See supra* Section III.C.
[300] *See supra* Section II.A.
[301] *See supra* Section II.A.
[302] *See supra* Section II.A.
[303] *See supra* Section II.B.

The concept of ESG can be interpreted in so many different non-standardized ways that it is tremendously difficult to compare products side by side.[304] This dilemma grows as product choice expands, and with the current level of investor interest in sustainable investment products, increased product choice seems like an inevitability.[305] Without an effective regulatory solution, investors and advisors will continue to encounter steepening information acquisition costs and comparative complexity when attempting to make informed choices.[306] These ex ante barriers to investment decision-making greatly enhance the likelihood of capital and risk misallocation.[307] As such, this Article has advocated for three immediate steps to improve investor protection: first, funds should justify their use of ESG-related terminology in their name through specific, uniform ETF disclosures, including on their website;[308] second, regulators must develop standardized and consistent ESG measurement metrics and terminology;[309] and third, ETF issuers should disclose ESG information on their websites in a consistent layout and presentation style to aid investor comparability.[310] These three steps will lower the costs of information synthesis for ESG ETF investors, and allow them to more easily compare funds side-by-side resulting in more efficient capital and risk allocation.

---

[304] *See supra* Section II.B.
[305] *See supra* Section I.B.
[306] *See supra* Section I.B.
[307] *See supra* Section III.B.
[308] *See supra* Section IV.A.
[309] *See supra* Section IV.B.
[310] *See supra* Section IV.C.