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Submitted to: https://ww2.arb.ca.gov/public-comments/public-comments-california-climate-disclosure-information-solicitation

California Air Resources Board
1001 I Street
Sacramento, CA 95814

RE: *Information Solicitation to Inform Implementation of California Climate-Disclosure Legislation: Senate Bills 253 and 261, as amended by SB 219 ("Information Solicitation")*

To Whom It May Concern:

The Investment Company Institute ("ICI")[1] recommends, in response to the Information Solicitation,[2] that California Air Resources Board ("CARB") regulations explicitly exclude registered investment companies (*e.g.*, mutual funds and ETFs) ("funds") from any reporting requirements and allow fund managers to choose whether to report emissions from assets managed on behalf of clients.

CARB should implement SB 253 and SB 261, as amended by SB 219 (together, the "Legislation"), in a manner fully consistent with the legislative intent and exclude funds because, as discussed in further detail below, funds do not produce greenhouse gas emissions and are already subject to a robust disclosure regime under the federal securities laws. Given this, and the specific definitional language used in the Legislation, ICI does not believe that the California Legislature intended to include funds within the scope of the Legislation.

ICI represents the asset management industry, which includes funds and asset managers. Our members have a significant interest in the sustainability related information reported by companies in which they invest. Asset managers use this information to pursue a range of investment strategies on behalf of retail fund investors in California and around the United States saving for retirement, education, and other financial objectives.

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[1] The Investment Company Institute (ICI) is the leading association representing the asset management industry in service of individual investors. ICI's members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in other jurisdictions. Its members manage $39.1 trillion invested in funds registered under the US Investment Company Act of 1940, serving more than 120 million investors. Members manage an additional $9.6 trillion in regulated fund assets managed outside the United States. ICI also represents its members in their capacity as investment advisers to collective investment trusts (CITs) and retail separately managed accounts (SMAs). ICI has offices in Washington DC, Brussels, and London.

[2] Available at: https://ww2.arb.ca.gov/public-comments/public-comments-california-climate-disclosure-information-solicitation.

Section 1: Funds Must be Explicitly Excluded from the Definition of "Reporting Entities" in California Senate Bill 253

SB 253 mandates that CARB develop regulations requiring certain large businesses to disclose their greenhouse gas emissions.[3] While we recognize the importance of operating companies providing transparency about their greenhouse gas emissions, funds, in stark contrast, do not generate emissions. As a result, it does not make sense to impose on them this reporting obligation.

The legislative language of SB 253 notes ways that "[c]ompanies can increase the state's climate risk through emissions activities that include, but are not limited to, company operations, supply chain activities, employee and consumer transportation, goods production and movement, construction, land use, and natural resource extraction." By contrast, a fund pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, or other assets. The combined assets the fund owns are its portfolio, which is managed by an investment adviser that is registered with the U.S. Securities and Exchange Commission ("SEC"). Critically, the assets are owned by the fund, and not by the investment adviser. Each fund share represents an investor's proportionate ownership of the fund's portfolio.

A fund typically is organized under state law either as a corporation or a business trust. Funds, such as mutual funds and ETFs, differ significantly from typical operating companies.[4] Unlike other companies, a fund is typically externally managed (by the fund's investment adviser). It has no employees of its own, does not engage in physical operations or the production of goods, materials, or services and, therefore, does not generate emissions such as those associated with an operating company (*e.g.*, a manufacturing company).

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[3] Health and Safety Code, Section 38532(b)(2) defines "reporting entity" as "a partnership, corporation, limited liability company, or other business entity formed under the laws of this state, the laws of any other state of the United States or the District of Columbia, or under an act of the Congress of the United States with total annual revenues in excess of one billion dollars ($1,000,000,000) and that does business in California."

[4] *See, e.g., Jones v. Harris Assocs. L.P.,* 130 S. Ct. 1418, 1422 (2010). The Court in *Jones* explained that a "mutual fund is a pool of assets, consisting primarily of [a] portfolio [of] securities, and belonging to the individual investors holding shares in the fund." *Ibid*. (quoting *Burks v. Lasker,* 441 U.S. 471, 480 (1979)). It noted that "[a] separate entity called an investment adviser [typically] creates the mutual fund, which may have no employees of its own." *Ibid*. (citations omitted). *See also* "The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation" The Yale Law Journal, vol. 123, no. 5, 2014, pp. 1228–87. JSTOR, http://www.jstor.org/stable/23744442, observing that "[t]hese enterprises place their portfolio securities, currency, and other investment assets and liabilities into one entity (a 'fund') with one set of owners, and their managers, workers, office space, and other operational assets and liabilities into a different entity (a 'management company' or 'adviser') with a different set of owners." The paper provides an example:

> If an S&P 500 index fund did not separate its investment assets from its management assets, the fund would have to employ its managers, secretaries, and other workers directly. It would also have to own its operational assets, such as computers and equipment, and sign operational contracts, such as leases for office space and employee health insurance. As a consequence, the fund's value would reflect not just the fluctuations in the value of the S&P 500, but also fluctuations in the markets for office space, secretarial labor, health insurance, and so on.

The business activities of funds do not implicate the stated legislative intent of SB 253. Therefore, we request that CARB explicitly exclude funds from the definition of "reporting entities" in its regulations implementing SB 253.

1.1 Implementing Regulations Must be Consistent with Greenhouse Gas Protocol Standards and Guidance

With respect to the asset managers and other business entities that may be required to report under SB 253, the legislation requires CARB to issue implementing regulations. In particular, CARB must adopt regulations that require a reporting entity to "measure and report its emissions of greenhouse gases in conformance with Greenhouse Gas Protocol standards and guidance…."[5]

Under the Greenhouse Gas Protocol's guidance for calculating Scope 3 emissions, "[a]sset managers investing clients' capital may *optionally* report on emissions from equity investments managed on behalf of clients (e.g., mutual funds)."[6] As required by SB 253, implementing regulations therefore should allow asset managers to choose whether to report emissions from equity investments managed on behalf of clients, consistent with the legislation and the Greenhouse Gas Protocol standards and guidance.[7] We request that CARB ensure consistency with SB 253 in drafting regulations.[8]

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[5] *See* Health and Safety Code, Section 38532(c)(1)(A)(ii): "A reporting entity shall, beginning in 2026, measure and report its emissions of greenhouse gases in conformance with the Greenhouse Gas Protocol standards and guidance, including the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard and the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard developed by the World Resources Institute and the World Business Council for Sustainable Development, including guidance for scope 3 emissions calculations that detail acceptable use of both primary and secondary data sources, including the use of industry average data, proxy data, and other generic data in its scope 3 emissions calculations."

[6] Emphasis supplied. *See* Greenhouse Gas Protocol, Technical Guidance for Calculating Scope 3 Emissions (version 1.0); Supplement to the Corporate Value Chain (Scope 3) Accounting & Reporting Standard, at 141, Box 15.1, available at: https://ghgprotocol.org/sites/default/files/2023-03/Scope3_Calculation_Guidance_0%5B1%5D.pdf.

[7] Item 7 of the Information Solicitation states:

> Entities must measure and report their emissions of greenhouse gases in conformance with the GHG Protocol, which allows for flexibility in some areas (i.e. boundary setting, apportioning emissions in multiple ownerships, GHGs subject to reporting, reporting by sector vs business unit, or others). Are there specific aspects of scopes 1, 2, or 3 reporting that CARB should consider standardizing?

Our recommendation would appropriately reflect the parameters of an asset manager's exposures and limits of its control. A fund, for example, is a separate legal entity, the assets of which are separate and distinct from those of its asset manager. An asset manager itself does not take on the risks inherent in the securities or other assets it manages for funds or other clients, and the clients are the ultimate owners of these assets, not the asset manager. Moreover, an asset manager does not control the GHG emissions of portfolio companies held by funds or other clients.

[8] We note here ICI's position that regulations should not require companies to disclose Scope 3 emissions at this time because of significant data gaps and the absence of agreed-upon measurement methodologies. ICI's position supports disclosure of the amount and intensity only of Scope 3 emissions by entities that have publicly announced a target or goal to reduce their Scope 3

Section 2: Funds Must be Explicitly Excluded from the Definition of "Covered Entities" in California Senate Bill 261

SB 261 mandates "covered entities" to prepare climate-related financial risk reports.[9] We are concerned that CARB may read this part of the legislation to extend to funds. CARB should not do so, as funds are already required by federal securities laws to provide extensive disclosures, including risk disclosures, designed to help investors evaluate the risks of an investment and decide whether to invest in a fund.

The legislation defines "climate-related financial risk" to mean a "material risk of harm to immediate and long-term financial outcomes due to physical and transition risks…." Fund disclosure requirements, set forth by federal securities laws and regulations, mandate that a fund "[d]isclose the principal risks of investing in the Fund, including the risks to which the Fund's particular portfolio as a whole is expected to be subject and the circumstances reasonably likely to affect adversely the Fund's net asset value, yield, or total return."[10]

The legislative language of SB 261 notes that "[c]urrent disclosure standards are voluntary, and thus inadequate, for meeting rapidly accelerating climate risks. In order to begin to address the climate crisis, consistent, higher level, and mandatory disclosures are needed from all major economic actors…." Far from being voluntary, fund disclosures are mandatory under federal securities laws and regulations.[11]

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emissions. *See* ICI Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (File No. S7-10-22); *see also* ICI Comment Letter on Scope 3 Emissions in the UK Reporting Landscape: Call for Evidence, 19 October 2023. Additionally, we note that the SEC declined to mandate disclosure of Scope 3 emissions in its 2024 rule package, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, available at https://www.govinfo.gov/content/pkg/FR-2024-03-28/pdf/2024-05137.pdf. In declining to adopt mandatory Scope 3 emissions disclosure at this time, the Commission stated that it was "mindful of the potential burdens such a requirement could impose on registrants and other parties as well as questions about the current reliability and robustness of the data associated with Scope 3 emissions…."

[9] Health and Safety Code, Section 38533(a)(4) defines "covered entity" as "a corporation, partnership, limited liability company, or other business entity formed under the laws of the state, the laws of any other state of the United States or the District of Columbia, or under an act of the Congress of the United States with total annual revenues in excess of five hundred million United States dollars ($500,000,000) and that does business in California. Applicability shall be determined based on the business entity's revenue for the prior fiscal year. 'Covered entity' does not include a business entity that is subject to regulation by the Department of Insurance in this state, or that is in the business of insurance in any other state."

[10] *See* Item 9(c) of Form N-1A. Form N-1A is the form used by funds to register under the Investment Company Act of 1940 and to offer their shares under the Securities Act of 1933.

[11] Under the federal securities laws and SEC rules, funds are subject to extensive disclosure requirements. Funds are required to maintain a current prospectus, which provides investors with information about the fund, including its investment objectives, investment strategies, risks, fees and expenses, and performance, as well as how to purchase, redeem, and exchange shares. Importantly, the key parts of this disclosure, with respect to performance information and fees and expenses, are standardized to facilitate comparisons by investors. Funds are also required to make statements of additional information ("SAIs") available to investors upon request and without charge. The prospectus, SAI, and certain other required information are contained in the fund's registration statement, which is filed electronically with the SEC and is publicly available via the SEC's Electronic Data Gathering, Analysis, and Retrieval system. Most fund registration statements are amended at least once a year to ensure that

These combined and periodically updated required disclosures provide the investing public, regulators, and other interested parties with far more information on funds than is available for other types of investments. This information is easily and readily available from funds and the SEC. These disclosure requirements result in a high degree of transparency that provides investors and other market participants with a clear understanding of a fund's investment strategy, holdings, risks, and financial condition.

As fund disclosures are mandatory and designed to help investors evaluate the risks of a potential investment in a fund, we request that CARB explicitly exclude funds from the definition of "covered entities."

Section 3: Funds Do Not Meet the Legislation's Scoping Definitions

The Legislation appears to focus on operating companies. For example, as referenced above, the legislative discussion in SB 253 specifically references "employee and consumer transportation, goods production and movement, construction, land use, and natural resource extraction."[12] As discussed previously, these are the activities of operating companies and not funds. The focus on operating (rather than investment) companies continues through the defined terms used to establish the universe of companies to which the Legislation applies.

Each of SB 253 and SB 261 applies to certain entities based on "total annual revenues."[13] The use of the term "revenue" in each of these definitions effectively serves to exclude funds from their scope. Funds do not report "revenue" in their financial statements and accordingly do not satisfy the quantitative revenue thresholds triggering application of the laws. Revenue (sometimes called "sales") is the amount of consideration a business entity receives in exchange for the transfer of goods or services to customers.[14] SEC Regulation S-X specifies the form and content of public company financial reporting and requires commercial and industrial businesses to report revenue on their income statement.[15]

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financial statements and other information do not become stale. Funds also amend registration statements throughout the year as necessary to reflect material changes to their disclosures. Funds also must provide shareholders with several other disclosure documents, including annual and semiannual shareholder reports containing performance and expense information, financial statements, and a list of the fund's portfolio securities. The annual shareholder report must also provide management's discussion of fund performance, describing the factors that affected the fund's performance, including relevant market conditions and investment strategies and techniques used by the fund's investment adviser.

[12] SB 253, Section 1(g).

[13] SB 253 applies to a "reporting entity" with "total annual revenues in excess of one billion dollars" and SB 261 applies to a "covered entity" with "total annual revenues in excess of five hundred million United States dollars…."

[14] Financial Accounting Standards Board Accounting Standards Codification Topic 606, *Revenue from Contracts with Customers,* specifies generally accepted accounting principles for revenue recognition.

[15] Regulation S-X, Rule 5-03, *Statements of Comprehensive Income.*

Funds do not sell or transfer goods or services to customers and do not report revenue in their financial statements. Instead, funds invest money received from shareholders in stocks, bonds, and other assets for the purpose of earning income, appreciation, or both. Funds are organized to provide professional investment management services to individual investors and to enable them to save and invest to meet their financial goals.

Fund financial reporting reflects the limited nature of their investment activities.[16] Funds report dividend income on their stock investments and interest income on their bond investments.[17] They also report gains and losses (both realized and unrealized) attributable to the change in value of their investment securities over the reporting period. SEC rules applicable to a fund's income statement characterize the dividends and interest received on investment securities as investment income rather than revenue.[18] Given this context, the plain language of the Legislation does not include funds, as funds do not generate any "revenue."

Critically, CARB's confirmation that funds are excluded from the operative definitions will have no impact on the efficacy of the Legislation. As noted above, funds do not generate any emissions, and any climate risk reporting would be duplicative of that of the operating companies that are subject to these disclosure requirements.

Given the clear focus on operating companies and the use of the term "revenue" in the scoping definitions, ICI requests that any implementing regulations confirm that funds are out of scope for both SB 253 and SB 261.

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[16] The format and content of fund financial reporting is regulated by Article 6 of Regulation S-X.

[17] Importantly, the financial instruments in which funds invest are excluded from the scope of Accounting Standards Topic 606, *Revenue from Contracts with Customers,* and the dividend and interest payments that they receive are not characterized as revenue.

[18] Regulation S-X, Rule 6-07, *Statements of Operations.*

Conclusion

We urge CARB to ensure that regulations closely align with the intended policy objectives of SB 253 and SB 261. ICI looks forward to engaging further in the rulemaking process and collaborating with CARB staff to achieve these goals.

Please do not hesitate to contact Paul Cellupica at paul.cellupica@ici.org or Josh Weinberg at joshua.weinberg@ici.org if you require further information.

Sincerely,

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